

UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

# THE LEAST DEVELOPED COUNTRIES REPORT 2009

*The State and Development Governance*



UNITED NATIONS

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UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT  
Geneva

# THE LEAST DEVELOPED COUNTRIES REPORT 2009

*The State and Development Governance*



UNITED NATIONS  
New York and Geneva, 2009

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UNCTAD/LDC/2009

UNITED NATIONS PUBLICATION

Sales No. E.09.II.D.9

ISBN 978-92-1-112769-0

ISSN 0257-7550



## What are the least developed countries?

Forty-nine countries are currently designated by the United Nations as “least developed countries” (LDCs). These are: Afghanistan, Angola, Bangladesh, Benin, Bhutan, Burkina Faso, Burundi, Cambodia, the Central African Republic, Chad, the Comoros, the Democratic Republic of the Congo, Djibouti, Equatorial Guinea, Eritrea, Ethiopia, Gambia, Guinea, Guinea-Bissau, Haiti, Kiribati, the Lao People’s Democratic Republic, Lesotho, Liberia, Madagascar, Malawi, Maldives, Mali, Mauritania, Mozambique, Myanmar, Nepal, Niger, Rwanda, Samoa, Sao Tome and Principe, Senegal, Sierra Leone, the Solomon Islands, Somalia, Sudan, Timor-Leste, Togo, Tuvalu, Uganda, the United Republic of Tanzania, Vanuatu, Yemen and Zambia.

The list of LDCs is reviewed every three years by the United Nations Economic and Social Council, in the light of recommendations by the Committee for Development Policy (CDP). The following three criteria were used by the CDP in the latest review of the list of LDCs, which took place in March 2009:

- (a) the **“low-income”** criterion, based on a three-year average estimate of the gross national income (GNI) per capita, with a threshold of \$905 for addition to the list, and a threshold of \$1,086 for graduation from LDC status;
- (b) the **“human assets weakness”** criterion, involving a composite index (the Human Assets Index) based on indicators of: (i) nutrition (the percentage of the population that is undernourished); (ii) health (the child mortality rate); (iii) school enrolment (the gross secondary school enrolment rate); and (iv) literacy (the adult literacy rate); and
- (c) the **“economic vulnerability”** criterion, involving a composite index (the Economic Vulnerability Index) based on indicators of: (i) natural shocks (the index of the instability of agricultural production, and the share of the population displaced by natural disasters); (ii) trade shocks (the index of the instability of exports of goods and services); (iii) exposure to shocks (the share of agriculture, forestry and fisheries in GDP, and the index of merchandise export concentration); (iv) economic smallness (the population in logarithm); and (v) economic remoteness (the index of remoteness).

For all three criteria, different thresholds are used for identifying addition cases and graduation cases. A country will qualify to be added to the list of LDCs if it meets the addition thresholds on all three criteria and does not have a population greater than 75 million. Qualification for addition to the list will effectively lead to LDC status only if the government of the relevant country accepts this status. A country will normally qualify for graduation from LDC status if it has met the graduation thresholds under at least two of the three criteria in at least two consecutive triennial reviews of the list. However, if the GNI per capita of an LDC has risen to a level at least double that of the graduation threshold, the country will be deemed eligible for graduation regardless of its performance under the other two criteria.

Only two countries have so far graduated from LDC status: Botswana in December 1994, and Cape Verde in December 2007. Samoa is currently expected to graduate on 17 December 2010, and Maldives on 1 January 2011. In 2009, the CDP recommended that Equatorial Guinea be graduated from the list of LDCs.

After a recommendation by the CDP to graduate a country has been endorsed by the Economic and Social Council and the General Assembly, the graduating country is granted a three-year grace period before graduation effectively takes place. This grace period, during which the country remains an LDC, is designed to enable the graduating State and its development and trade partners to agree on a “smooth transition” strategy, so that the possible loss of LDC-specific concessions at the time of graduation does not disrupt the socio-economic progress of the country.

## Acknowledgements

*The Least Developed Countries Report 2009* was prepared by a team consisting of Zeljka Kozul-Wright (team leader), Alberto Amurgo Pacheco (until February 2009), Agnès Collardeau-Angley, Junior Davis, Marwan El Khoury (until March 2009), Madasamyraja Rajalingam, Rolf Traeger, Giovanni Valensisi (from March 2009) and Stefanie West. Nancy Biersteker, Lisa Borgatti, Pierre Encontre, Charles Gore, Massimiliano La Marca, Terry McKinley (consultant) and Paul Rayment (consultant) also made specific inputs to the Report. Simona Foltyn participated in the final stage of preparing the Report. The work was carried out under the overall supervision of Habib Ouane, Director, Division for Africa, Least Developed Countries and Special Programmes (ALDC), and Charles Gore, Head, Research and Policy Analysis Branch, ALDC.

An ad hoc expert group meeting on “The State, development governance and productive capacities”, was held in Geneva on 5 and 6 March 2009 to review a first draft of the Report and specific inputs. It brought together specialists in the fields of industrial policy, macroeconomic policy, agricultural development, international trade and development strategies. The participants in the meeting were: Heiner Flassbeck, Jörg Mayer, Terry McKinley, Anne Posthuma, Paul Rayment, Helen Shapiro, Servaas Storm, Gianni Vaggi and Giovanni Valensisi. The meeting discussed papers and inputs prepared by Junior Davis, Marwan El Khoury, Charles Gore, Zeljka Kozul-Wright, Massimiliano La Marca, Terry McKinley, Smita Srinivas and Rolf Traeger.

The Report draws on background papers prepared by John Di John, William Kalema and Frances Nsonzi, Paul Jourdan, Mushtaq Khan, Smita Srinivas, Morris Teubal and Ole Therkildsen. Initial thinking on the role of the State and governance issues in LDCs also benefited from in-depth discussions with Brian Van Arkadie — who acted as principal consultant in the preliminary stages of the project — and also Nguyuru Lipumba. Paul Rayment provided the substantive editing and contributed to the overall Report. The text was edited by Michael Gibson, Eleanor Loukass and Daniel Sanderson.

Secretarial support was provided at different times by Regina Ogunyinka, Sylvie Guy and Stefanie West. Hadrien GlioZZo and Sophie Combette designed the cover. The overall layout, graphics and desktop publishing were done by Madasamyraja Rajalingam.

The financial support of donors to the UNCTAD LDC Trust Fund, particularly the Governments of Norway and Finland, is gratefully acknowledged.

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## Explanatory Notes

The term “dollars” (\$) refers to United States dollars unless otherwise stated. The term “billion” signifies 1,000 million. Annual rates of growth and changes refer to compound rates. Exports are valued f.o.b. (free on board) and imports c.i.f. (cost, insurance, freight) unless otherwise specified.

Use of a dash (–) between dates representing years, e.g. 1981–1990, signifies the full period involved, including the initial and final years. An oblique stroke (/) between two years, e.g. 1991/92, signifies a fiscal or crop year.

The term “least developed country” (LDC) refers, throughout this report, to a country included in the United Nations list of least developed countries.

### In the tables:

Two dots (..) indicate that the data are not available, or are not separately reported.

One dot (.) indicates that the data are not applicable.

A hyphen (-) indicates that the amount is nil or negligible.

Details and percentages do not necessarily add up to totals, because of rounding.

## Abbreviations

AGOA	African Growth and Opportunity Act
ARM	agricultural raw materials
BNDES	Banco Nacional de Desenvolvimento Econômico e Social
BRDB	Bangladeshi Rural Development Board
CAADP	Comprehensive Africa Agriculture Development Programme
CDP	Committee for Development Policy
CGIAR	Consultative Group on International Agricultural Research
CPI	consumer price index
DIP	developmental industrial policy
DME	developed market economy
DRAF	domestic resources available for finance
EU	European Union
FAO	Food and Agriculture Organization of the United Nations
FDI	foreign direct investment
GDP	gross domestic product
GNI	gross national income
HIPC	heavily indebted, poor countries
ICT	information and communications technology
IDA	International Development Association
IFAD	International Fund for Agricultural Development
IFI	international financial institution
IFPRI	International Food Policy Research Institute
ILO	International Labour Organization
IMF	International Monetary Fund
ISI	import substitution industrialization
KBE	knowledge-based economy
LDC	least developed country
MDG	Millennium Development Goal
MDRI	Multilateral Debt Relief Initiative
MFI	micro-finance institutions
MVA	manufacturing value added
NEER	nominal effective exchange rate
NEPAD	New Partnership for Africa's Development
NERICA	New Rice for Africa
NGO	non-governmental organization
NIC	newly industrialized countries
NPM	new public management
NSI	national systems of innovation
ODA	official development assistance

ODC	other developing country
OECD	Organisation for Economic Co-operation and Development
PIF	performance improvement fund
PRGF	Poverty Reduction and Growth Facility
PRSP	poverty reduction strategy paper
R&D	research and development
REER	real effective exchange rate
RNF	rural non-farm
RTA	regional trade agreement
SAP	structural adjustment programme
SMEs	small and medium-sized enterprises
SOE	state-owned enterprise
SPS	sanitary and phytosanitary
SSA	sub-Saharan Africa
STI	science, technology and innovation
TNC	transnational corporation
TRIMS	the Agreement on Trade-related Investment Measures
TRIPS	the Agreement on Trade-related Intellectual Property Rights
UNCTAD	United Nations Conference for Trade and Development
UNIDO	United Nations Industrial Development Organization
UNDP	United Nations Development Programme
UNECA	United Nations Economic Commission for Africa
VAT	value-added tax
WGI	Worldwide Governance Indicator
WRS	warehouse receipt schemes
WTO	World Trade Organization

## Country classification used in this Report

For statistical and analytical purposes, LDCs are classified according to three criteria: (a) geographical; and (b) export specialization; and (c) net agricultural trade. They are grouped as follows:

### 1. Geographical groupings

- 1.1 Africa and Haiti:** Angola, Benin, Burkina Faso, Burundi, Central African Republic, Chad, Democratic Republic of the Congo, Djibouti, Equatorial Guinea, Eritrea, Ethiopia, Gambia, Guinea, Guinea-Bissau, Haiti, Lesotho, Liberia, Madagascar, Malawi, Mali, Mauritania, Mozambique, Niger, Rwanda, Senegal, Sierra Leone, Somalia, Sudan, Togo, Uganda, United Republic of Tanzania, Zambia.
- 1.2 Asia:** Afghanistan, Bangladesh, Bhutan, Cambodia, Lao People's Democratic Republic, Myanmar, Nepal, Yemen.
- 1.3 Islands:** Comoros, Kiribati, Maldives, Samoa, Sao Tome and Principe, Solomon Islands, Timor-Leste, Tuvalu, Vanuatu.

Some of the island LDCs are geographically in Africa or Asia but are grouped together with the Pacific islands due to their structural similarities. For the same reason, Haiti and Madagascar are grouped together with African LDCs.

### 2. Groupings by export specialization

- 2.1 Oil exporters:** Angola, Chad, Equatorial Guinea, Sudan, Timor-Leste, Yemen.
- 2.2 Agricultural exporters:** Afghanistan, Benin, Burkina Faso, Guinea-Bissau, Kiribati, Liberia, Malawi, Solomon Islands, Somalia, Tuvalu, Uganda.
- 2.3 Mineral exporters:** Burundi, Central African Republic, Democratic Republic of the Congo, Guinea, Mali, Mauritania, Mozambique, Niger, Sierra Leone, Zambia.
- 2.4 Manufactures exporters:** Bangladesh, Bhutan, Cambodia, Haiti, Lesotho, Nepal.
- 2.5 Services exporters:** Comoros, Djibouti, Eritrea, Ethiopia, Gambia, Maldives, Rwanda, Samoa, Sao Tome and Principe, United Republic of Tanzania, Vanuatu
- 2.6 Mixed exporters:** Lao People's Democratic Republic, Madagascar, Senegal, Togo.

For these groupings LDCs are classified according to which export category accounts for at least 45 per cent of their total exports of goods and services, with some adjustments in a few cases. For a detailed discussion of the criteria and data, see UNCTAD (2008: xii–xiv).<sup>1</sup> Updated statistics on exports have been compiled for this Report and have confirmed the country classifications above.

### 3. Groupings according to net agricultural trade

- 3.1 Net food importers and net importers of agricultural raw materials:** Angola, Bangladesh, Comoros, Djibouti, Eritrea, Gambia, Haiti, Kiribati, Maldives, Nepal, Niger, Samoa, Sao Tome and Principe, Senegal, Sierra Leone, Somalia, Tuvalu, Yemen.
- 3.2 Net food importers and net exporters of agricultural raw materials:** Benin, Cambodia, Central African Republic, Democratic Republic of the Congo, Equatorial Guinea, Guinea, Lao People's Democratic Republic, Lesotho, Liberia, Mozambique, Sudan, Chad, Togo, Mali.
- 3.3 Net food exporters and net importers of agricultural raw materials:** Afghanistan, Bhutan, Burundi, Mauritania, Rwanda.
- 3.4 Net food exporters and net exporters of agricultural raw materials:** Ethiopia, Guinea-Bissau, Madagascar, Malawi, Myanmar, Solomon Islands, Tanzania, Uganda, Vanuatu, Zambia.

For these groupings LDCs are classified according to their average net trade in food and agricultural raw materials in 2004–2006. For a detailed discussion of the criteria and data, see UNCTAD (2008: 79).<sup>1</sup>

<sup>1</sup> UNCTAD (2008). *The Least Developed Countries Report 2008: Growth, Poverty and the Terms of Development Partnership*. United Nations publication, Sales No. E.08.II.D.20. New York and Geneva.



# Overview

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## IMPLICATIONS OF THE GLOBAL ECONOMIC CRISIS IN LDCs: A TURNING POINT FOR CHANGE

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*The Least Developed Countries Report 2009* argues that the impact of the global economic crisis is likely to be so severe in the least developed countries (LDCs) that “business as usual” is no longer possible. This will necessitate a rethinking of the development paradigm. The magnitude of the crisis offers both the necessity and an opportunity for change. Coping with the impact of the crisis in LDCs will require an innovative and informed policy design response. But beyond this, new policy approaches are necessary to ensure that development after the crisis will be more resilient and more inclusive.

It is widely recognized that the current financial crisis is the result of weaknesses in the neoliberal model that has been shaping global economic policies in the last three decades, weaknesses that have been magnified by policy failures and lax regulation in the advanced countries. The cost in terms of the bailouts and recapitalization of banks has already reached unprecedented levels. However, the adverse impact on the real economy and the cost in terms of lost output and employment are now the great concern. Most advanced economies are in recession and emerging markets are undergoing significant slowdowns. But the LDCs are likely to be particularly hard hit in the coming period. Because they are deeply integrated into the global economy, they are highly exposed to external shocks. Moreover, many are still suffering the adverse impact of recent energy and food crises, and they have the least capacity to cope with yet another major economic disruption. The combination of high exposure to shocks as well as weak resilience to those shocks is likely to mean that the LDCs, which already face chronic development challenges, will be harder hit than most other developing countries.

The crisis is already undermining those factors that enabled the strong growth performance of the LDCs as a group between 2002 and 2007. Their vulnerability is not just a reflection of traditional commodity dependence and related sensitivity to price fluctuations; it is due to the combined threat from falling commodity prices, the slowdown in global demand and the contraction in financial flows. As a result, manufactures and service exporters (mostly Asian and island LDCs) are likely to be hit hard, but the commodity-dependent economies (mostly African LDCs) will be hit even harder. The LDCs are unlikely to weather the crisis without considerable additional international assistance in the short run and support for alternative development strategies in the longer run. Changes on both fronts will be needed to induce a steadier and more resilient development trajectory.

As noted in previous *Least Developed Countries Reports*, most LDCs (with the exception of oil-exporting LDCs) have quasi-chronic deficits in their trade and current accounts. Faced with decreasing global demand — United Nations estimates in May this year expect world gross domestic product (GDP) to decline by 2.6 per cent in 2009 — the current account imbalances are likely to deteriorate even further as export revenue diminishes. The vulnerability of LDCs is related to the highly concentrated production and export structures of commodity-dependent LDCs, especially African LDCs, as well as the dependence of Asian LDCs on low-skill manufactures. The global recession is likely to constrain international trade and impede long-term investment, representing an additional source of contraction of LDC output and exports. Asian LDCs are somewhat more diversified and can better withstand the crisis, although their situation is hardly enviable. The crisis is likely to result in substantial reduction of their exports (both in volumes and prices) associated with a slowdown in global demand, especially in China and India. The external payments imbalances on the current account are likely to be exacerbated by trends in capital flows. Private capital flows, including both foreign direct investment (FDI) and remittances, are predicted to decline, and if the experience of previous economic crises is repeated, official development assistance (ODA) will decline, too. In this context, the future of ODA will be vital. The international reserves of LDCs accumulated during the years of export boom may be insufficient protection from significant and persistent current account shocks associated with the drying up of external sources of finance.

Excessive commodity dependence exposes most LDCs to large terms of trade shocks. Indeed, many countries have recently gone through years of record growth performance driven primarily by commodity sectors and propelled by the boom in international prices stemming from speculation in commodity derivatives. In mid-2008, however, the eruption of the global crisis put a sudden end to this boom and there have since been sharp price reversals. Such boom-and-bust

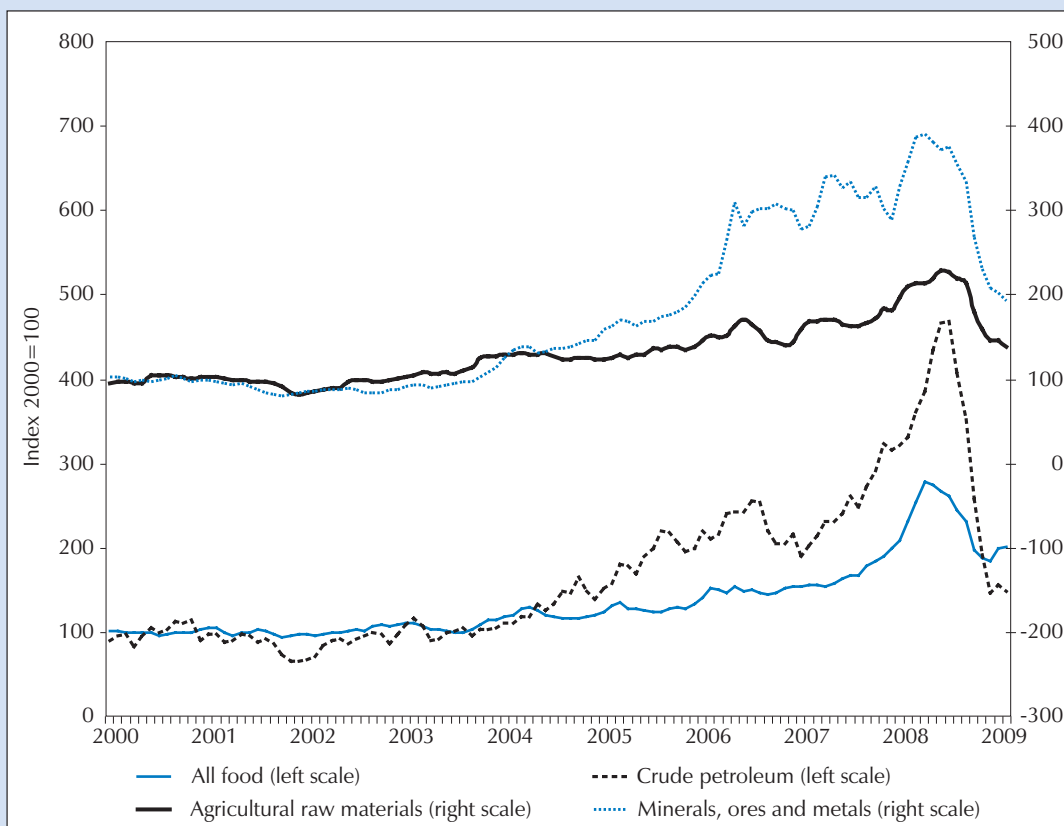
cycles have contributed to output volatility and uncertainty, thereby discouraging investment in long-term development of productive capacities. A sharp contraction in commodity markets is particularly damaging to LDCs for an additional reason; contractions in demand, prices and output imply a reduction in government revenues, thereby reducing the capacity of the State to utilize fiscal policy to mitigate output volatility.

Moreover, external vulnerability of LDCs is further aggravated by their high level of indebtedness; in LDCs, the debt burden represents on average 42 per cent of gross national income, compared to 26 per cent in other developing countries before the crisis. As UNCTAD has repeatedly warned in recent months, there is the potential for a new debt crisis to emerge in poor countries. For many LDCs, the current crisis can jeopardize their hard-won debt sustainability.

What happens in the future to external financial flows is critical. Although there may be differences from country to country, the general expectation is that FDI to LDCs will decline over the next few years, owing to (a) lower expectation of profitability; (b) reduced access to credit to finance new investments; and (c) balance sheet consolidation by transnational corporations in the face of financial pressures. This is particularly true of FDI to LDCs, which has been predominantly natural resource-seeking and focused on the extractive sectors, and which is likely to decline during 2008 and beyond because of sharply falling mineral prices and the transnational corporations' cautious approach to exploration and expansion during this volatile period.

Remittances are also set to decline. Workers' remittances have become an important supplement to basic incomes in LDCs, where they generally support consumption rather than investment. According to World Bank estimates, remittances to developing countries as a whole have been increasing at a slower pace in recent years, with the annual increase down from 18 per cent in 2006 to 9 per cent in 2008. They are expected to decline by 5 per cent in 2009, with a possible slight recovery in 2010.

Monthly commodity price indices, January 2000 to February 2009  
(Index, 2000=100)



Source: UNCTAD secretariat calculations, based on the GlobStat database.

Against this background, official aid trends will become a central determinant of what happens to LDCs. Unfortunately, past experience shows that ODA tends to decline during recessions in donor countries. It will be critical that donors maintain the levels of aid to the LDCs and also honour their commitments for increased aid. As we have argued in past *Least Developed Countries Reports*, there is a major tension between aid delivery mechanisms, including the working of policy conditionality, and national ownership of policies. It is therefore vital that the increased aid dependence — which is a likely outcome of the crisis — is not associated with diminished policy space, in the sense of the ability to choose appropriate policy options.

The recent financial and economic crisis has exposed the myth of self-regulating markets. In response to the crisis, most large developed market economies have shifted away from free market-based forms of economic governance and are exploring alternatives that include a much bigger role for the State in economic management. These countries recognize that the alternative has to involve giving the State a greater role, not only through regulation but — more importantly — through Keynesian fiscal stimulus packages, of the kind being currently pursued in most large Western nations. Yet, this tendency has been more evident in the advanced countries than in the developing world. More recently, several larger developing countries — such as China, Brazil and South Africa — have begun to deploy public stimulus packages to revive their economies. However, most LDCs simply cannot afford to deploy similar packages.

In the last decades, most LDCs have followed economic reform programmes which have severely reduced government involvement in promoting development. However, these programmes have not been able to address the key structural constraints which LDCs face, including: (a) bottlenecks in production, related to the structure of their balance-of-payment deficits; (b) inadequate infrastructure; (c) chronic deficits; (d) serious skills and knowledge shortages; and (e) vulnerability to external shocks. Furthermore, these policies based on minimal government action have not led to structural change and economic diversification. Instead, LDCs have even further deepened their unfavourable production patterns and specialization in exports of commodities, and many LDCs have undergone deindustrialization and seen stagnating performance of their manufacturing sectors. This has increased their exposure and vulnerability to external market shocks.

The current financial crisis thus exposes a deeper, long-term development problem. Despite record rates of GDP growth over the last five years, coinciding with the commodity boom, poverty reduction has been slow in the majority of LDCs, and most remain off-track to meet the Millennium Development Goals. In addition, many are facing recurrent crises of food security. These patterns are rooted in the combination of an accumulating crisis in agriculture with an inability to generate productive employment outside agriculture. The crisis in agriculture is rooted in structural problems of declining farm size, low productivity, inadequate infrastructure and environmental degradation. The result is that it has been difficult for the sector to play a dynamic role in the developmental process by providing an expanding national market and source of inputs for domestic producers. But at the same time, it is proving impossible to generate productive employment outside agriculture, in particular in manufacturing.

The current economic crisis creates both the necessity and the opportunity for a change of direction. This *Least Developed Countries Report* is based on the view that the crisis should be grasped as a turning point in the development path of LDCs.

In order to overcome LDCs' structural constraints and reduce their external dependence, it is necessary to reconsider the role of the State. The market only works through incremental changes and small steps. However, LDCs need to stimulate investments by socializing risk, in order to achieve long-term structural transformation. The market has not been and will not be able to carry out these changes alone.

The critical question now is not simply how LDCs can cope with the short-term immediate impact of the crisis. More importantly, the question is how can they emerge from the crisis in a stronger position? What policies should they be crafting now for the post-crisis era?

The present Report suggests that three major policy orientations are required:

- Firstly, there is even more reason now to refocus policy attention on developing productive capacities. This means that policies should be oriented towards stimulating productive investment, building technological capabilities, and strengthening linkages within and across sectors and between different enterprises. Strengthening domestic productive capacities should also be aimed at producing a wider range of more sophisticated products;

- Secondly, it is necessary to build a new developmental State. This is not a matter of going back to old-style development planning, but rather a question of finding new forms of development governance appropriate for the twenty-first century. Such development governance would be founded on a strategic collaboration between the State and the private sector, that will encourage the structural transformation of LDCs from agrarian to post-agrarian economies; and
- Thirdly, it is necessary to ensure effective multilateral support to LDCs. This is not simply a question of more and better aid, but also the design of rules that govern international economic relationships with regard to trade, finance, investment and technology flows, in ways which would support development in LDCs. It is also critical that support for LDCs does not impose unnecessary limits to the measures that Governments can take to promote development, structural transformation and poverty reduction.

Both national and international policies are necessary. However, this Report leaves aside the question of effective multilateral support and focuses on the second orientation mentioned above, namely the national policies and institutions for promoting development and the possibility of building the developmental State in a way which is adapted to the challenges and concerns of LDCs in the twentieth-first century. This will allow addressing the first policy orientation mentioned above.

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## THE ROLE OF THE STATE IN PROMOTING DEVELOPMENT IN LDCs

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The basic argument of this Report is that, in the wake of the financial crisis, there is a need to rethink the role of the State in promoting development in LDCs. However, neither the good governance institutional reforms which many LDCs are currently implementing, nor the old developmental State, including successful East Asian cases, are entirely appropriate models now. Addressing the structural problems of LDCs will require a rebalancing of the roles of the State and the market. Discussion on the issue of governance must move beyond unhelpful and false dichotomies. Governments do not face a stark choice of good versus evil, the “vice” of State dirigisme versus the “virtue” of markets, privatization and deregulation. This is a false caricature. The institutions of the “State” and the “market” have always coexisted organically in all market-based economies; hence, the “choice” between the market and the State is a false dichotomy. This has been recognized at least since the time of Adam Smith, although these insights have been lost in subsequent interpretations. The challenge is to design effective governance practices which interrelate States and markets in creative new ways in the service of national development within a global context.

What is required now is a developmental State that is adapted to the challenges facing an interdependent world in the twenty-first century. This State should seek to harness local, bottom-up problem-solving energies through stakeholder involvement and citizen participation that creates and renews the micro-foundations of democratic practice. It should also embrace a wide range of development governance modalities and mechanisms within a mixed economy model to harness private enterprise, through public action, to achieve a national development vision.

### The limits of the good governance institutional reforms

What constitutes “good governance” is inevitably contestable because the goodness of governance rests on values and ethical judgement. One list of the core principles of good governance which has been suggested and is useful, because it is universal rather than culturally specific, is the following:

- **Participation:** the degree of involvement by affected stakeholders;
- **Fairness:** the degree to which rules apply equally to everyone in society;
- **Decency:** the degree to which the formation and stewardship of the rule is undertaken without humiliating or harming people;
- **Accountability:** the extent to which political actors are responsible for what they say and do;
- **Transparency:** the degree of clarity and openness with which decisions are made; and
- **Efficiency:** the extent to which limited human and financial resources are applied without unnecessary waste, delay or corruption.

These principles, together with a commitment to predictability in policies and rules, could be realized through a variety of institutions or institutional configurations.

It must also be recognized that the goodness of governance is not simply a matter of processes of governing, but also a question of effectively achieving outcomes. It would be a curious type of “good governance” if the governance processes were considered to be perfect, according to the valued principles, but the outcomes were poor. For a country concerned with promoting development, good governance should thus also encompass governance which effectively delivers development.

LDCs should aspire to a kind of good governance in which the practices of governing are imbued with the principles of participation, fairness, decency, accountability, transparency and efficiency in a non-culturally-specific way. They should also aspire to a kind of good governance which delivers developmental outcomes, such as growing income per capita, achieving structural transformation, expanding employment opportunities in line with the increasing labour force and reducing poverty. However, at present, the good governance institutional reforms which are being propagated and undertaken in the LDCs are founded on a much narrower view of what constitutes good governance. This narrower view does not have an explicit developmental dimension.

The narrower understanding is rooted in an implicit dichotomy between good and bad government systems. This contrasts a formalized type of good governance system with an informal, personalized, bad governance system. Both these governance systems are “ideal types”, i.e. abstractions from individual countries, with the good governance systems stereotypically understood to be typical of developed countries, whilst the bad governance systems are stereotypically understood to be typical of poor countries. The good governance institutional reform agenda seeks to turn these bad governance systems into good governance systems. This involves introducing into developing countries particular types of institutions which are characteristic in developed countries. It has also involved prescribing a particular role for the State.

One major type of institution which the good governance reform agenda seeks to introduce is electoral democracy. This intrinsically valuable institution is intended to ensure that policies and governance practices are regularly scrutinized by the general public. The good governance agenda also includes a style of public administration and management known as “new public management”. This approach advocates that Government should be run according to private sector styles of management with an active, visible hands-on approach, using market mechanisms, client orientation and performance management to increase productivity, often favouring the unbundling of monolithic organizations into corporatized units and decentralization.

The role of the State that the current good governance reform agenda prescribes is essentially to support markets by adopting policies and providing institutions that allow free markets to work efficiently. Initially, in the 1980s, the institutional reforms were oriented towards a minimal and laissez-faire State. But since the 1990s, there has been limited recognition of the existence of market failures as well as the need to build States which can capably support markets. From this perspective, particular priorities for institutional reforms have included (a) achieving and maintaining stable property rights; (b) maintaining good rule of law and contract enforcement; (c) minimizing expropriation risks; (d) minimizing rent-seeking and corruption; and (e) achieving transparent and accountable provision of public goods, particularly in health and education, in line with democratically expressed preferences.

Irrespective of the *intrinsic* value of the institutions recommended in this reform agenda, an important question for LDCs seeking to promote economic development is whether or not these institutional reforms deliver *instrumentally* for development.

This issue unleashes fierce passions. The evidence is clouded by severe methodological problems in measuring the quality of institutions. One critical insight from cross-country statistical analyses is that the quality of governance is closely associated with *levels of per capita income*. That is to say, according to the indicators, high income per capita is associated with good governance practices and low income per capita with the absence of good governance practices. However, it is much more difficult to identify a close relationship between the quality of governance and growth of per capita income over time. As the United Nations Committee for Development Policy, which reviews the list of LDCs, put it in its annual report in 2004, “There is some empirical evidence to suggest that weak governance reinforces poverty”, but the relationship between governance and poverty reduction is not yet decisively proven and “in the absence of conclusive evidence, it is plausible to suggest that the link sometimes exists, but that at other times, there is no link”.



This is particularly “in the light of the superior economic performance for some countries that are not ranked very highly with respect to good governance”.

Existing practice of implementing the good governance reform agenda on the ground also shows that the agenda is so ambitious that it can lead to reform overload, which is itself incapacitating. In the end, it is questionable whether it is possible or desirable to transfer institutions of governance which are functioning in advanced countries into very poor countries with a much smaller financial resource base. The average government final consumption expenditure (an amount which covers all government current expenditures for purchases of goods and services, including compensation of employees) in LDCs in 2006 was just \$60 per capita. This may be compared with \$295 per capita in lower-middle-income countries, \$1,051 in upper-middle-income countries and \$6,561 in high-income countries. The central question is, “How can the institutions of rich countries be expected to work with this financial base?” The answer is that they cannot.

### A forward-looking agenda for development governance

LDCs need to go beyond the current good governance institutional reform agenda and pursue good *development* governance. Development governance, or governance for development, is about creating a better future for members of a society through using the authority of the State to promote economic development, and in particular to catalyse structural transformation. In general terms, governance is about the processes of interaction between the Government — the formal institutions of the State, including the executive, legislature, bureaucracy, judiciary and police — and society. Development governance is governance oriented to solve common national development problems, create new national development opportunities and achieve common national development goals. This is not simply a matter of designing appropriate institutions, but also a question of policies and the processes through which they are formulated and implemented. Which institutions matter is inseparable from which policies are adopted. Development governance is thus about the processes, policies and institutions associated with purposefully promoting national development and ensuring a socially legitimate and inclusive distribution of its costs and benefits.

During the 1960s and 1970s, development planning was very common. Indeed, LDCs were often recommended by international financial institutions and donors to engage in development planning. After the debt crisis of the early 1980s, structural adjustment programmes were generally adopted in most LDCs and they discontinued development planning and policies designed to promote development and dismantled their associated institutions. The role of the State in economic life was drastically downsized, as there was a shift towards *laissez-faire* embodied in a reform programme of stabilization, privatization, liberalization and deregulation. However, some developing countries, notably in East Asia, maintained and evolved the apparatus of a developmental State throughout this period.

In calling for development governance now, this Report is not arguing for a return to old-style development planning. Nor is it calling for a return to the developmental State of the 1960s and 1970s. It must be recognized that there have been both successes and failures associated with developmental State action. However, the Report does argue that it is possible to design a forward-looking agenda for development governance in LDCs by drawing lessons about economic governance in successful developmental States in the past and by adapting them to the twenty-first century.

The main lessons from economic governance from successful developmental States are that national policies were oriented to promoting structural transformation and this was achieved through a mix of macroeconomic and sector-specific productive development policies. These sectoral policies were directed to both agriculture and the non-agricultural sectors. Agricultural policies were designed to address the structural constraints limiting agricultural productivity and build up domestic demand in rural areas in the early stages of development. But they were complemented by an industrial policy which fostered structural transformation both intersectorally and intrasectorally. This policy mix was not simply about establishing new activities, but rather aimed at promoting capital accumulation and technological progress as the basis for dynamic structural change. In the language which UNCTAD has used in past *Least Developed Countries Reports*, they were geared toward developing productive capacities, expanding productive employment and increasing labour productivity, with a view to increasing national wealth and raising national living standards.

A basic feature of development governance in successful developmental States was the adoption of a mixed economy model, which sought to discover the policies and institutions which could harness the pursuit of private profit to achieve national development. This Report does not romanticize the capabilities of public officials in successful countries. They were not omniscient Supermen and Bionic Women. However, competent bureaucracies were constructed in a few

key strategic agencies, and State capabilities to promote development were built up through a continuous process of policy learning about what worked and what did not work. Governments also did not devise policies in a top-down fashion, but in close cooperation and communication with the business sector. The whole process was driven by a developmentally-oriented leadership of politicians and bureaucrats committed to achieving a development vision for society rather than personal enrichment and perpetuation of their own privileges. The political legitimacy of this visionary group was rooted in a social contract, in the sense that the aims of the developmentalist project were broadly shared within society and there was societal mobilization behind the goals of the project. The risks, costs and benefits of structural transformation were shared amongst the different groups of society.

Building a new developmental State which is capable of meeting the challenges of the twenty-first century will involve:

- Giving greater emphasis to the role of knowledge in processes of growth and development. This directs attention to the important role of knowledge systems and national innovation systems, alongside financial systems, as critical institutional complexes in the development process;
- Considering how to promote economic growth and structural transformation through a type of diversification which does not rely solely on industrialization. In this regard, there is a need to shift from economic activities characterized by decreasing returns to those characterized by increasing returns;
- Exploring how to make better use of the opportunities of interaction between domestic and foreign capital by increasing the developmental impact of FDI and upgrading through links with global value chains; and
- Adopting a regional approach to developmentalism which exploits potential for joint action to create the conditions for structural transformation

The new developmental State should also move away from the authoritarian practices that have been associated with some East Asian developmental success stories. It is possible in this respect to draw on other types of developmental State, including for example the Nordic model or the Celtic Tiger. Building democratic developmental States should involve, in particular, ensuring citizens' participation in development and governance processes. What this means is greater emphasis on deliberative democratic approaches in which people and their organizations interact to solve common problems and create new development opportunities.

One positive feature of successful developmental States in the past was that Governments used a range of practices to encourage and animate the private sector to act in ways which were designed to support a development transformation. The successful developmental States were not high "tax-and-spend" Governments. Rather, they fulfilled four major functions which sought to catalyse the creative powers of markets: (a) providing a developmental vision; (b) supporting the development of the institutional and organizational capabilities of the economic system, including developing entrepreneurs and building the government's own capabilities; (c) coordination of economic activities to ensure the co-evolution of different sectors and different parts of the economic system; and (d) conflict management.

The twenty-first century developmental State should continue to use a wide range of governance mechanisms and modalities within a mixed economy model to harness private enterprise to achieve a national development vision. In doing this, it is now possible to apply new thinking on "modern governance", which advocates that Governments promote multiple forms of two-way interaction between public and private actors. In this respect, development problems will be addressed not simply through the formal and impersonal procedures of the market — or top-down, ex ante goal-setting of hierarchical governance — but also through continuing reflexive procedures, in which different actors in networks identify mutually beneficial joint projects, refine and redefine them as they monitor how far they are being achieved, and respond to changes in the external environment. The new developmental State is also likely to adopt a wide array of policy instruments which goes beyond a "one-size-fits-all" approach. Instead, a mix of policy instruments which are appropriate for the particular context should be selected, with the State more or less involved and with different degrees of compulsion and voluntary action in the way in which outcomes are achieved.

### Some development governance priorities for LDCs

Development governance should be at the heart of the LDC response to the global financial crisis. There is no unique optimal model which is applicable to all countries; responses must be tailored to country circumstances. However, the present Report recommends that most LDCs should adopt sector-specific development policies to promote agricultural

productivity growth and industrial transformation. This should encompass both developmental agricultural policies and developmental industrial policies. The Report also recommends that these sectoral policies should be supported by a more growth-oriented macroeconomic policy. The positive interplay between a growth-oriented macroeconomic policy and the sectoral policies — which improve meso-level and micro-level capabilities, incentives, institutions and infrastructure — is vital for sustained development success and substantial poverty reduction. These policies should aim to develop the domestic productive capacities of the LDCs. Such policies would serve not only to mitigate the short-term impact of the crisis, but also propel the LDCs on a different development trajectory for the post-crisis era, a trajectory which is more dynamic, more resilient, more inclusive and less dependent. This is necessary to prevent future exposure to external shocks and externally-generated crises. Possible policy directions for macroeconomic policy, agricultural policy and industrial policy are discussed in the next three sections of this overview, whilst the last section takes up the issue of priorities in an institutional reform agenda to build developmental State capabilities for good development governance.

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## MEETING THE MACROECONOMIC CHALLENGES

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For much of the last three decades, macroeconomic policies in the LDCs have been strongly influenced by the recommendations of the international finance institutions and bilateral aid donors. Typically, the main recommendations have been that monetary policy focuses on containing inflation and creating an environment for private investment, and fiscal policy should ensure that fiscal deficits remain below 3 per cent of GDP. Public investment has generally not been seen as having an important role in promoting economic development and structural change. Behind this policy stance were fears of inflation. This was significant in the 1980s and 1990s. However, inflation has not been a special problem in most LDCs during the current decade. Moreover, the source of past inflation has usually been structural rather than due to loose monetary policies. Worries that the excessive government spending could “crowd out” private investment and fuel inflation are an unlikely outcome in countries where there is widespread under-utilization of all resources. The contention of this policy was that liberalization of trade and finance, privatization and minimization of government intervention in the economy would provide the spur to private sector development and hence sustained growth. As argued in previous editions of this Report, the reforms based on this approach have largely failed to develop the private sector as the driving force for development.

The present Report argues for a marked change in the approach to macroeconomic policies in the LDCs and for one that recognizes that government has a vital role to play in restructuring the economy and in creating the conditions for a “takeoff” into sustained growth. Since economic development is about societal transformation — it is not just a technical economic problem to be left to economists — Governments must also act to ensure that the costs and benefits of adjustment are distributed in an equitable and socially acceptable manner. Failure to do so would likely produce social unrest and a general backlash against necessary reforms.

Public investment — especially but not exclusively in traditional infrastructure such as transport, irrigation and energy networks — has a key role to play in driving the development process. This has tended to deteriorate in recent years as ODA has been more directed toward social issues. Social concerns are important, but if progress on these is made at the expense of needed public investment in production sectors and economic infrastructure, the basis for sustained growth will be undermined. Given the severity of the current economic crisis, LDC governments will be faced with rising fiscal deficits as they try to maintain domestic demand and if they also attempt to boost infrastructure investments. These deficits will need to be accommodated over the short-to-medium term in order to mitigate increased hardship for the population and to keep development programmes on track. Given the limited alternative sources of finance, ODA will be critical in enabling these objectives to be met. LDC governments will still have to explore innovative ways of raising revenue, but they need to do so in ways that avoid regressiveness, and which take account of the still-limited administrative capabilities of the State.

Excessive reliance on monetary policy as a source of macroeconomic stability limits the effectiveness of monetary policy beyond price stabilization, owing to the underdeveloped State of financial institutions and the absence of viable bond markets. LDCs are generally faced with structurally high real rates of interest that are simply not conducive to an investment-driven growth path. For most of these countries, the credit crunch is more of a chronic condition than a consequence of the global banking crisis. The dramatic effects of a credit shortage have become apparent in rich countries in the current financial crisis. But this is actually a picture of everyday business life in LDCs.

Monetary policy in LDCs should focus on supporting investment-focused fiscal policy, and one way to ensure this would be to have the central banks cooperate more closely with other departments of the State in developing and promoting the overall economic development programme of their countries. As we argued in the *Least Developed Countries Report 2006*, addressing the weaknesses of domestic financial institutions should be a priority in a strategy to develop productive capacities.

Another key support for an investment-driven strategy is to manage the exchange rate and, as a corollary, the capital account of the balance of payments. The current orthodoxy of floating rates, usually combined with monetary policy focused on inflation targets, has increased exchange rate volatility and frequently undermined domestic macroeconomic stabilization efforts. Managing the exchange rate — through a managed float or an adjustable peg, for example — requires resources and policy capabilities. However, it allows greater macroeconomic policy options. There is no single model of exchange rate management applicable to LDCs, but there is increasing consensus that the extreme solutions of purely floating or totally fixed pegs do not work. Managing the exchange rate — through a managed float or an adjustable peg, for example — would (a) support fiscal policy by helping to avoid a depreciation because of exaggerated fears of inflation; (b) aim to check the volatility of the rate following external shocks; and (c) seek to stabilize the exchange rate at a level that would strengthen the competitiveness of exports, especially of new products, and support the diversification of the economy.

The effectiveness of capital controls in reducing highly speculative flows and exchange rate instability in the short run has been shown by previous crisis experiences in emerging market economies. Destabilizing surges of inflows and outflows of speculative capital occur suddenly and have been a regular feature of the financial system over the last 30 years, so it is important for countries to be able to deploy such controls whenever they consider it necessary. For most LDCs, the most common problem at present may be dealing with outflows of capital (including capital flight on the part of elite groups), but commodity-producing countries also experienced speculative capital inflows during the recent boom in world prices, and short-term measures may be necessary now to slow down the outflow of speculative portfolio investment.

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## SETTING THE AGENDA FOR AGRICULTURAL POLICY

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In addition to the effects of the global economic crisis on their exports, developing countries — and especially the LDCs — suffered a severe shock in the first half of 2008 from the sharp rise in food and energy prices. There had already been a steady rise in prices from around 2000 but, between the last quarter of 2007 and the second quarter of 2008, non-fuel prices rose by some 50 per cent and crude oil prices by nearly 40 per cent. These increases pushed millions more people into hunger and poverty, provoking widespread riots and social unrest in many of the poorest countries. Prices have since fallen sharply, although at the start of 2009 they were higher than in 2005. Moreover, the Food and Agricultural Organization of the United Nations (FAO) has reported that local food prices in most of sub-Saharan Africa and in many countries of Asia and Central America in the first quarter of 2009 were still higher than a year earlier.

The food crisis of 2008, however, was in reality a sharp reminder of the precarious State of food supply in many parts of the world, not least in the LDCs, a situation that has been deteriorating for many years. Among the longer-term influences on prices has been the collision between rising food demand in some of the largest emerging market economies with a relatively inelastic response of supply. For the LDCs, the food crisis is really a chronic rather than a short-term problem, the result of low or falling levels of agricultural investment and fundamental failures of policy. It has long been UNCTAD's judgement that an effective strategy for growth and development, based on the creation of new comparative advantages and production capacities, cannot succeed unless agriculture is made more productive. Without a significant agricultural surplus, food security will remain precarious and diversification of the national economy into manufacturing and other sectors will be undermined by rising food prices and wage costs.

The medium- and long-term problems of agriculture in the LDCs are considerable: (a) decades of neglect have left productivity in decline or stagnant; (b) there are growing population pressures on the available stock of productive land; and (c) there are also increasing pressures on the supply of land for food production from climate change and from incentives to switch to the production and export of biofuels. It is the argument of this Report that these problems can only be tackled effectively with a significant developmental role on the part of the State. In contrast, the main thrust of the neoliberal approach to agricultural development since the 1980s has been to diminish the role of the

State and to enhance that of the private sector. Agricultural marketing boards were privatized, farm subsidies were reduced or abolished, and the functions of the State were narrowed to the provision of public goods, such as research and development and certain infrastructure investments. The overall impact of these reforms has been very mixed. As shown in *The Least Developed Countries Report 2006*, agricultural productivity has stagnated or declined in many LDCs. Reversing this trend will require, first, a firm commitment on the part of LDC governments to give high priority to agriculture in their development programmes and especially to increase the share of public investment in GDP. An effort at institutional reconstruction will be needed, insofar as ministries of agriculture are generally among the weakest departments of the State. Their present capacity to deliver extension services to the agricultural sector and, more generally, to play a strategic role in national development, is very limited and needs to be reversed. In some LDCs, the gaps in such services are being filled not by the private sector but by non-governmental organizations and international organizations. Ministries of agriculture need to be incorporated into the central policy planning of governments for development. The rehabilitation of ministries of agriculture could well be a litmus test of an LDC government's commitment to a revived and coherent development strategy.

Agriculture is highly complicated and inter-country differences in land rights, climate, soil qualities, social structures and so on rule out any single policy prescription for all LDCs. However, a number of general points can be made, although their individual weights will vary with different national contexts. For example, land rights and systems of tenure vary widely but, in terms of general governance, the key principle is that land rights should be secure, transparent and enforceable by law. If these conditions are met, and tenure is not restricted to unreasonably short periods, the economic value of land should rise and one serious source of disincentives to raising productivity will be removed. A corollary, of course, is that a government committed to national development must act firmly against the illegal expropriation of land, a problem that has plagued many LDCs.

The emphasis of this Report is on restoring an active development role to the State and on reviving public investment within a coherent policy framework. In the case of agriculture, effective State intervention will also need to be supported by effective local authorities which are in closer touch with local communities and therefore better informed about their precise needs. At the same time, however, it must be recognized that local authorities can hinder development with predatory and arbitrary behaviour towards the local population under their authority. Striking a correct balance between different levels of authority and ensuring policy coherence between them is therefore an important condition for an effective developmental State. Public investments, in turn, must be carefully targeted at key structural constraints, which may consist of poor or missing infrastructure, poor education and training, lack of small credit facilities, and so on. The essential point is that well-prepared public investments, including a careful assessment of likely linkage or multiplier effects, will crowd in private initiative and investment. In approaching the problems of agricultural underdevelopment, however, it is important not to frame the issues just in terms of farmers and crop or livestock production, but more broadly in a context of developing the "rural economy", or rather "rural economies" in countries where the national economy is still weakly integrated. These would focus on developing clusters of interrelated activities, including various services to support the local community. Given the likely constraints on governments' finances in the foreseeable future, it will be worthwhile to look closely at possible alternative modes of financing infrastructure projects.

The presence of a rural economy in a given area does not mean that it is either possible or desirable to promote a flourishing rural non-farm (RNF) economy, either through work for wages or self-employment. (The RNF economy may be defined as comprising all those non-agricultural activities which generate income to rural households, including in-kind income and remittances.) In some contexts — e.g. mining and timber processing — RNF activities are also important sources of local economic growth. For some areas, the only future might be the long-term decline of farming, accompanied by substantial outward population migration. What this implies, essentially, is that — before contemplating serious measures to promote agricultural growth and RNF intersectoral linkages in a given area — LDCs should take a hard look at agriculture in that area, examine its economics and consider what income levels it can reasonably support.

Moreover, it is important for policymakers not to discriminate against people residing in rural areas. In designing economic policy, and the accompanying institutional reforms, the focus should be on generating improved incomes and living conditions for the whole population. In all cases, support and institutional measures should consider the medium- and long-term economic viability of the activities and people benefiting from intervention (sustainability), whether rural or urban, which is difficult to assess reliably, and thus vulnerable to political and pressure group manipulation.

Policy for the promotion of RNF intersectoral linkages may be more a matter of attending to some well-known areas rather than advocating novel approaches. Basic points include the importance of education and of having the physical



infrastructure in place. Also, the development and dissemination of appropriate technological packages aimed at emerging smallholder farmers could significantly enhance agricultural productivity. There is much to be done to resolve the credit and finance bottleneck. Fortunately, the lessons of microfinance are being learned and may provide useful lessons and application for the LDC RNF economy. Providing business support services in training, technical assistance and information is important, but it is not clear where the “best” models lie. The role of the State will be critical in this regard. Governments should, under specific conditions, become involved in seasonal finance, infrastructure provision, input supply and subsidies (to cover transaction costs), land reform and extension services, to promote the growth of the sector. The need for policy space in this context cannot be overemphasized, since learning is an experimental process that is time-consuming and costly.

In view of weak institutional and administrative structures, it will also be important to explore other organizations as alternatives to private enterprise and the State — such as farmers’ groups and other local cooperatives — for the organization of supplies of inputs, machinery, credit and so forth. Such collective effort can encourage productivity growth throughout the rural economy at the local level and may often be able to be developed on the basis of traditional forms of cooperation.

In the present Report, we highlight seven key strategies that should govern LDC interventions to promote the development of the sector and promote inter-linkages:

- Prioritize activities that are targeted at local and regional markets;
- Support producers to meet market requirements;
- Improve access to product and factor markets for the rural population;
- Whenever relevant and feasible, encourage the development of common-interest producer associations and cooperatives;
- Develop flexible and innovative cross-sectoral institutional arrangements;
- Recognize the diversity of agricultural production and adopt a subsector approach to the policy intervention, investment or development programme; and
- Develop sustainability strategies from the start of any investment or development programme.

LDC economies need to improve agricultural productivity and diversify their economies to create non-agricultural employment opportunities and generate intersectoral linkages. This will require a new development model focused on building productive capacities, enhancing rural–urban intersectoral linkages and shifting from commodity price-led growth to “catch-up” growth. This implies a change from static to dynamic comparative advantage, and the active application of science and technology to all economic activities.

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## TAILORING INDUSTRIAL POLICY TO LDCs

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### The nature of developmental industrial policy

Industrial performance in most LDCs has been weak by comparative standards. Indeed, previous UNCTAD work has shown that, even during periods of strong investment and growth, the manufacturing sector in many LDCs, particularly in sub-Saharan Africa, failed to take off. The market-led reforms since the debt crisis of the early 1980s have, to a large extent, failed to correct this deep-seated structural weakness. As a result, unbalanced, stagnating or declining manufacturing performance has been part of uneven and unsustainable growth in many LDCs over the last three to four decades. In most LDCs, there is very little large-scale domestic industry. The manufacturing sector is largely composed of light manufacturing and other labour-intensive activities, organized in small enterprises, including in the informal sector, often employing 20 people or less. On average, light manufacturing, low technology products accounted for over 90 per cent of all LDC manufactured exports in the 2005–2006 period (including food, drinks, garments and textiles); medium and highly manufactured exports are less than 2 per cent of total manufactured exports.

This Report argues that policymakers at the national and international levels need to recognize the need for structural change in the development process of LDCs if they are to reinvigorate growth in activities characterized by increasing

returns, dynamic comparative advantage and rapid technological progress. Not all economic activities are generators of such growth: for example, commodities and agricultural activities tend to be characterized by decreasing returns to scale, low productivity and low rates of formal employment. Different economic activities transmit different learning patterns and knowledge spillovers. Activities that generate dynamic growth tend to be those with the ability to absorb the innovations and new knowledge that produce increasing returns to scale.

Successful growth episodes almost always entail rapid capital formation. Also, as discussed earlier, pro-investment financial and macroeconomic policies are essential parts of the policy agenda in LDCs. However, this is not enough for sustained growth. Recent research indicates that growth accelerations based on structural change and diversification have exerted an enduring impact on productivity performance and economic welfare in developing countries. Increasingly, evidence suggests that mastery over an expanding range of more sophisticated products is central to the growth development process.

The pertinent question is how to design a set of policies that would stimulate the transformation of LDC economies from being dominated by activities with decreasing or constant returns (agriculture) into those with increasing returns (processing and manufacturing), as was the case in Malaysia, the Republic Korea, Sweden, Taiwan Province of China and Finland. The present Report does not claim it has the solution, but draws on a variety of experiences of accelerated growth in countries that have undergone successful and rapid industrialization and thereby contributes to the knowledge of range of policy choices in LDCs.

The concept “industrial policy” in the context of the LDCs should be understood in a broad definition, given the relatively small contribution of the manufacturing sector to the GDP in these economies. The need for continuous upgrading of products and processes underlies the broad objectives of a Schumpeterian transformative policy that we call the developmental industrial policy (DIP), as elaborated in this Report — tailored specifically for LDCs. This Report defines a DIP as “any strategic intervention by the State that catalyses structural change and stimulates economic restructuring toward more dynamic, higher value added activities”. The objective of a proactive DIP is to enable learning to take place at the level of the firm and the market through both internal and, more importantly, external economies. This can be done by transferring skills, capabilities, accumulating knowledge and “know-how” and diffusing it throughout the society as much as possible.

The function of developmental industrial policy in LDCs transcends “targeting sectors” or “picking winners”, to provide fundamental support and direction for satisfying the needs of broad sections of society and setting the terms of public–private partnerships. The standard conceptions of industrial policy are far too narrow, when applied to LDCs attempting to embark on programmes of major economic transformation. In departing from the mainstream perspective, there are several dynamic objectives the new developmental industrial policy should strive for:

- Creating a dynamic domestic comparative advantage in an increasingly complex and sophisticated range of products and services;
- Upgrading productive capacities, in the sense of innovating to increase value added. The concept of upgrading — “making better products, making them more efficiently” — or moving into more skilled activities is critical in this context;
- Building capability, decreasing social marginalization and reducing poverty through incomes and “labour market” policies, fiscal policy, entrepreneurship and technological development policies, as described in *The Least Developed Countries Report 2007*;
- Creating conditions for full employment and inclusive growth, through a compatible combination of pro-growth macroeconomic policies and sectoral meso-policies, which include consideration of intersectoral linkages;
- Creating conditions for the transformation from agrarian to post-agrarian societies;
- Improving the supply of all public inputs with a view to raising labour productivity;
- Facilitating diversification of natural resource activities; and
- Building capacities at the firm level (learning).

It is important to recognize that, in light of historical legacies, initial local conditions and surrounding international circumstances, industrial development pathways are not identical. The one-size-fits-all policy prescription of recent years is no longer feasible. Industrial policy instruments will vary according to the conditions that prevail in a given

economy at a particular time, and both the form and content of industrial policy should evolve in relation to the development of market institutions, as well as the capabilities of the State itself to manage economic change and transformation. Accordingly, this Report argues that policymakers in LDCs should be given sufficient time and space to set priorities, discover which policy mix works best in meeting those priorities, and adapt their institutions and behavioural conventions to changing circumstances and evolving political and social preferences.

This Report also recognizes that no industrial policy is infallible. Governments are not omniscient. They have imperfect information, and not all decisions made by Governments are always rational. Governments are also subject to capture by special interests. The same criticisms, however, apply equally to the market. The key question is the costs and benefits associated with each. This Report takes the view that finding the appropriate balance between States and markets is important, and that government policy is a fundamental influence on growth and industrialization.

### Adapting developmental industrial policy to LDCs

A goal for DIP in LDCs should be to create domestic firms of varying sizes, including large firms, and to increase the size of their available markets. But this is not sufficient. It also needs to focus on (a) promoting entrepreneurship; (b) facilitating and enabling access to new technologies; (c) developing human resources; (d) general training; and (e) collecting, analysing and diffusing technical data. This approach advocates State intervention through a proactive technology policy towards the generation of productive and technological capabilities at the firm and farm levels. A mixture of general and selective policy tools is available to governments for promoting technological development.

As argued by UNCTAD in 2007, such an approach needs to differentiate the different phases of development, namely between infant and mature industries. One of the priorities of industrial policy in LDCs is to create the conditions for learning, through the acquisition of technological and productive capacities. Market signals, if left to themselves, may even discourage the accumulation of technological capabilities. At the enterprise level, the State needs to invest in the accumulation of technological capabilities and to create the conditions to stimulate learning. At the national level, the State needs to find and ensure financing for technical change and innovation. Creating these conditions is a core function of the developmental industrial policy.

The proposed developmental industrial policy should build firm-level capacities by generating a cumulative process of growth of commercial innovation in the business sector, until that growth becomes internalized. Policy implementation should aim at rapidly generating a critical mass of firms undertaking commercial innovation, i.e. continually introducing products and processes that are new to the country. Institutional mechanisms should be devised to ensure that sufficient financial resources are made available to encourage risk-taking activity and cover the costs of learning. This perspective shifts the role of the industrial policy towards one that focuses on facilitating assimilation through learning (copying, imitating and eventually innovating), in addition to capital accumulation. This implies that the modern form of industrial policy is indispensable for articulating the links between science, technology and economic activities, through networking, collaboration and fine-tuning the learning components (education, research and development, and labour training) into an integrated development strategy. However, such interactions cannot be created by decree — they require institutions, resources and capabilities.

In devising how to do this, LDCs should not simply look to the policy tools used in East Asia. Industrial policy success is not limited to East Asian newly industrialized countries, with their unprecedented and sustained growth experiences. Some form of industrial policy to promote development has been used in most economies. It has been argued that a long history of successful industrial policy in advanced economies since the nineteenth century persists. Examples include (a) the first-tier East Asian newly industrialized countries, such as Hong Kong (China), the Republic of Korea, Singapore and Taiwan Province of China; (b) the Nordic countries, such as Sweden and Finland; (c) Ireland; (d) some Latin American countries; and (e) almost all developed market economies. There are also interesting examples from South-east Asia, including Malaysia and Thailand, and both Bangladesh and Cambodia have had successful experiences in increasing manufacturing employment and value added.

Beyond a few core elements, there is no single homogeneous model of State–market relations into which the appropriate industrial policy can be inserted. Each country must experiment and find the configuration of institutions and conventions that will work best in its national conditions and meet the expectations of its population. Particularly where large structural changes are involved and there is a significant level of risk and uncertainty about the sources of progress, careful experimentation with institutions and policies is needed to discover what will be effective in a

particular national context, where history, culture and initial economic conditions all have important influences on the possibilities for growth and development. Given the premium on flexibility and “adaptive efficiency”, and also given the absence of universal laws of economic growth, restricting the policymaking space available to developing countries is more than likely to be counterproductive. The underlying assumption argued by this Report is that — owing to externalities, missing institutions, economies of scale and many other types of market failure — markets alone cannot be relied upon to coordinate the processes of capital accumulation, structural change and technological upgrading in a way consistent with sustainable growth and development.

LDCs can deploy a large menu of instruments for industrial development, including preferential treatment reflected in incentives or support targeted at building particular capabilities, a plethora of fiscal and investment incentives, as well as trade policy tools (tariffs and non-tariff barriers), subsidies, grants or loans. Most of these can be used to encourage capacity-building in the private sector and stimulate the process of economic transformation. Moreover, “new-style” industrial policy tools — such as fiscal and investment incentives — are less susceptible to rent-seeking and more self-limiting than tariffs or quotas. Additionally, governments can facilitate this process by strengthening their domestic financial institutions, whether State-owned development banks such as the BNDES in Brazil, or privately owned credit institutions, such as Grameen Bank in Bangladesh.

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## BUILDING DEVELOPMENTAL STATE CAPABILITIES IN LDCs

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It is advisable to be realistic about the task of building capable developmental States in LDCs. Both skilled staff and financial resources are in short supply, and the constraints noted earlier on the problem of institutional reform overload in relation to “good governance” apply equally to the vision of good development governance which is being recommended here. However, one should not be too pessimistic on the basis of past experience. Firstly, from the experience of successful developmental States, it is clear that the technical capacities of their governments for promoting development were not particularly advanced at the outset. They built up developmental State capabilities over time, often through a deliberate strategy that focused in particular on improving a few strategically important public agencies. Large-scale institutional transformations, such as those being attempted in the good governance reform agenda, were not necessary to get the process going. Secondly, the limited success of recent experience of institutional reforms in LDCs is particularly related to the fact that these initiatives have often been donor-driven. The more a developmental project is country-owned, the easier the building developmental State capabilities should be.

A pragmatic approach to building developmental State capabilities in LDCs would be a focused approach which seeks to sequentially build minimum governance capabilities for achieving evolving development outcomes. This would involve the adoption of a small number of institutional reforms which have a “good fit” with the existing context. Models transferred wholesale from successful East Asian newly industrializing economies are likely to be as unsuccessful as models of good governance transferred from advanced countries. Institutional reforms will progress if (a) their outputs and outcomes meet the political demands for them; (b) there is a good fit between political capacity and technical capacity; and (c) technical competencies fit the requirements of the reform tasks.

Both technical capacity and political capacity matter. Technical capacities can be built up incrementally through policy learning and institutional experimentation, focusing initially on extending the experience of islands of excellence within the public administration and executive agencies. Such a strategic incrementalist approach should aim to build governance capabilities required to relax binding constraints on the development of productive capacities. It should develop governance capabilities that support processes of capital accumulation and technological progress in sectors that are strategically important for economic development and the generation of productive employment. Islands of excellence within the ministries and executive agencies of LDCs — which are hidden by the country-wide governance indicators — can provide lessons about what works and does not work in particular contexts, and also models for spreading these practices. However, it is important that there be a competent pilot agency, close to political power, that can provide overall vision and coordination. Moreover, an institution dedicated to aid management is also critical.

In terms of political capacity, a defining characteristic of successful developmental States is the existence of developmentally-oriented leadership. Unless such a leadership exists, there is no possibility of creating developmental State capabilities. If a governing elite is simply committed to personal enrichment and perpetuation of its own privileges, rather than national development, structural transformation and economic development will be impossible.

This leadership will be most successful if it establishes a social compact through which broad sections of society support the development project. This should include both rural and urban interests and thus developmental policies should include both developmental agricultural policies and developmental industrial policies. A final important ingredient is the development of growth coalitions. These arise when relations between business and government elites take the form of active cooperation towards achieving the goals of fostering investment and technological learning, and increasing productivity. LDC governments should use the financial crisis as a moment to build positive growth coalitions between governments and the domestic business community.

Finally, it is important to note that, without the support of LDC development partners for a domestically-owned developmental project, that project will be very difficult to realize. Firstly, policy space is necessary, to allow policy pluralism and experimentation, which are necessary conditions for developmental success. Adherence to international agreements, policy conditionalities attached to aid and close guidance by donors should not undermine the policy learning critical to building developmental State capabilities. Secondly, the formation of domestic growth coalitions can be stymied if aid is more oriented to donor concerns than to building up domestic business. Paradoxically, although past policies have been ostensibly focused on private sector development, the private sector remains very weak in most LDCs. It is vital therefore that aid support the formation of growth coalitions. Thirdly, domestic financial resource constraints also mean that donor support will be necessary to build developmental State capabilities.

Development partners can best support genuine country ownership in LDCs, and also achieve mutual goals, by supporting the realization of national developmental aspirations. Approximately 20 per cent of aid to LDCs now goes to improve government capabilities. This aid should be refocused from the current good governance institutional reforms towards promoting good development governance and building developmentally-capable States in LDCs.

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The basic message of this Report is that LDC governments should view the global economic crisis as an opportunity for a turning point in their development path. They need to shift towards a catch-up growth strategy based on the development of productive capacities and expansion of productive employment opportunities. The Report argues that LDC governments have a vital role to play in the restructuring of their economies, and in creating conditions for catch-up growth. It is high time to inject a developmental dimension into the good governance agenda. LDC policymakers need to be more cognizant and informed of the policy options that exist and have been used successfully in other cases of accelerated growth and structural transformation. The Report is intended to contribute to this process and increase the capacity of LDCs to govern developmentally. The development partners and the international community should support the LDCs in their quest for good development governance. The crisis demands that it is time to catch up, by broadening and adapting public action to conditions suitable for small, open-market developing economies. Historical evidence suggests that this objective is achievable. This Report sketches out a concrete alternative economic strategy and a fresh agenda for LDC policymakers that include institutional capacity-building and the strengthening of the market-complementing developmental State.



Dr. Supachai Panitchpakdi  
Secretary-General of UNCTAD





# Introduction: The Implications of the Global Economic Crisis for LDCs

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## A. Introduction

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The current economic crisis is the result of weaknesses in the neoliberal thinking that has shaped global economic policies in the last three decades; weaknesses that have been magnified by policy failures and lax regulation in the advanced countries. The cost in terms of the bailouts and recapitalization of banks has already reached unprecedented levels. However, the adverse impact on the real economy and the cost in terms of lost output and employment are now the great concerns. Most advanced economies are in recession and emerging markets have slowed. But the major victims of this contagion are likely to be the least developed countries (LDCs), many of which are still suffering the adverse impact of recent energy and food crises (UNCTAD, 2008a) and have the least capacity to cope with yet another major external shock.

The current crisis is already undercutting those factors that enabled the strong growth performances of LDCs as a group between 2002 and 2007. Their exposure is not just a reflection of traditional commodity dependence and related sensitivity to price fluctuations; it is rather the combined threat from price reversals, the slowdown in global demand and the contraction in financial flows. As a result, manufactures and service exporters (mostly Asian and island LDCs) are likely to be hit hard but less so than the commodity-dependent economies (mostly African LDCs). The LDCs are unlikely to weather the crisis without considerable additional international assistance in the short run and support for alternative development strategies in the longer run. Changes on both fronts will be needed to induce a steadier and more resilient development trajectory.

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*Most advanced economies are in recession and emerging markets have slowed. But the major victims of the current economic crisis are likely to be the LDCs.*

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## B. The likely impact of the global economic crisis on LDCs

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### 1. GLOBAL PROSPECTS

Forecasts for the global economy in 2009 are bleak. The current financial crisis has already pushed most developed countries into a recession that is likely to have negative consequences for LDCs' future economic prospects. Global gross domestic product (GDP) in 2009 is now expected to fall and, largely as a result, UNCTAD expects world trade to contract by 7–8 per cent. This will be the first decline in world trade since the early 1980s, and probably the largest in 80 years. Given the fall of imports in the advanced economies and in the emerging and developing economies as a group, there is likely to be a major reduction in the

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*Most LDCs remain particularly vulnerable to current-account shocks triggered by the global growth slowdown, owing to their weak product diversification and their high dependence on external resources to finance their development.*

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export earnings of LDCs. The global credit crunch will exacerbate those difficulties by reducing the availability of trade finance. The global slowdown will also hit the relatively more resilient manufacturing economies, as their productive and export capacities are mostly limited to low-skilled manufactures, while service exporters, particularly those dependent on tourism, will also suffer from the contraction in developed country spending. Forecasts for the global economy in 2009 were still being lowered when this Report was being prepared, increasing the likelihood of a major downturn and negative per capita growth for the LDCs as a whole.

The impressive aggregate growth performance of the LDCs in the last decade hid significant differences in the growth of individual countries and in the extent of their dependence on external factors. Still, most LDCs remain particularly vulnerable to current-account shocks triggered by the global growth slowdown, owing to their weak product diversification and their high dependence on external resources to finance their development.

## 2. EXTERNAL VULNERABILITIES OF LDCs

Although not deeply integrated into the world financial system, LDCs are sensitive to changes in capital flows and exchange rate fluctuations, and most are currently experiencing a major trade shock. The present weakness of commodity prices and the contraction of global demand are the key channels of transmission of the current crisis from the developed and fast-industrializing economies (China and India) to the LDCs.

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Many LDCs are experiencing sharp falls in export revenue owing to declining commodity prices and weak demand for manufactures exports. Volatile prices continue to exert an adverse impact on LDCs' economic prospects, particularly amongst those specializing in commodity exports. There have been sharp declines in prices of many commodities since mid-2008 (chart 1). The reliance on commodities as the main source of export and fiscal revenues, along with the strong pro-cyclicality of commodity prices, contributes to the considerable volatility of output growth in many developing countries, but especially in the LDCs. While the impact of increases in the price of fuels, non-fuel commodities and food have varied, nonetheless, for those LDCs that depend heavily on food and energy imports, the net effect is unlikely to be positive, given the relative price movements of their exports and imports.

Most LDCs are prone to chronic external deficits. Chart 2 shows that only the oil exporters as a group have achieved positive, though volatile, external balances in recent years, while all the other LDC exporters have been in chronic deficit on both current and trade accounts. External imbalances are a source of vulnerability at a time of crisis, as even small reversals of capital flows can force domestic contraction, unless accompanied by extremely large improvements in the terms of trade (UNCTAD, 2008b).

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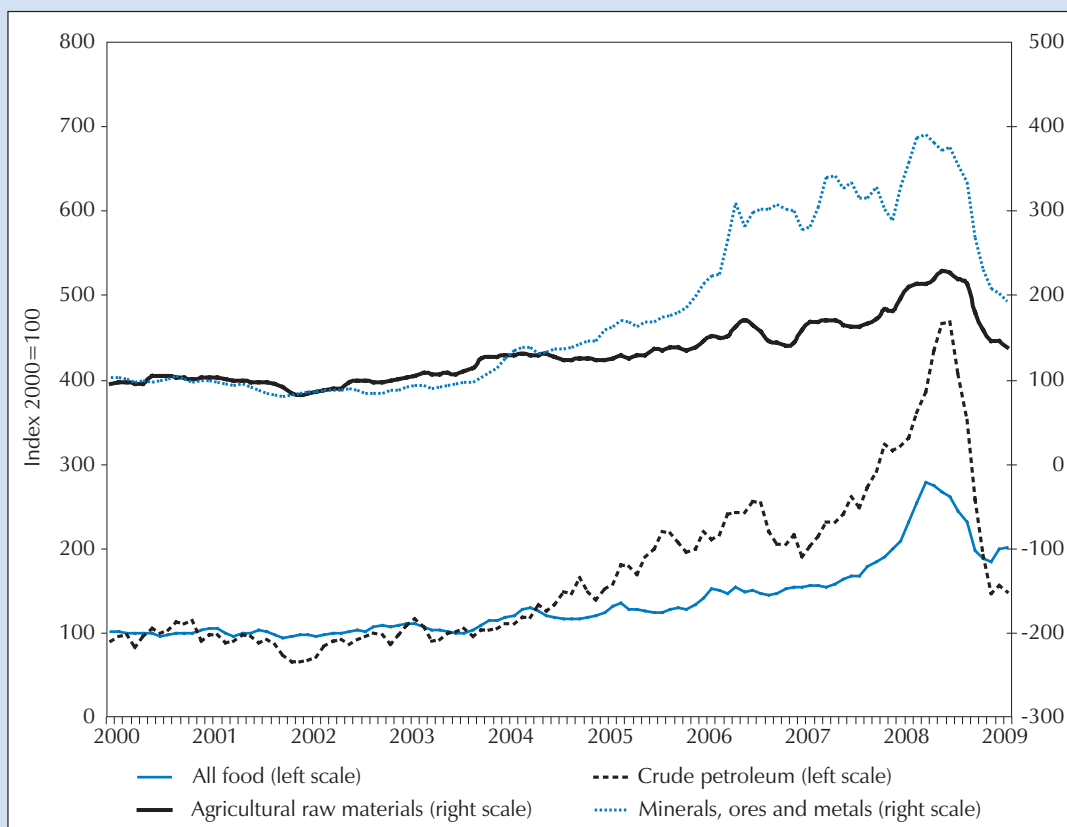
*The debt burden remains unsustainably high in most LDCs — an average of 42 per cent of GNI, compared to 26 per cent in other developing countries.*

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High levels of indebtedness represent a chronic structural weakness in LDCs. Despite an overall improvement during the recent boom, the debt burden remains unsustainably high in most LDCs, much higher than in other developing countries — an average of 42 per cent of gross national income (GNI), compared to 26 per cent in other developing countries. In about half (22) of the LDCs, the burden is between 50 per cent and 100 per cent of GNI. The growth of total external debt did not slow in LDCs as in the other developing countries, although the ratios of total debt to exports declined as the latter boomed. Debt sustainability therefore remains a critical issue for LDCs, despite the major debt write-offs under the Multilateral Debt Relief Initiative in 2006. With the expected fall in their export

Chart 1

Monthly commodity price indices, January 2000 to February 2009  
(Index, 2000=100)



Source: UNCTAD secretariat calculations, based on the GlobStat database.

revenues, LDCs are likely to return in the short term to unsustainable fiscal and current account deficits.

International reserves will not be enough to protect LDCs from a shortage of external finance. Reserves were increasing in LDCs as a group over the last decade, but unevenly. The accumulation of reserves as self-insurance against a balance-of-payment crisis implied diverting capital inflows from more productive uses. With reserves on average equal to between three and five months of imports in 2006 (the latest available data, chart 3), many LDCs remain highly exposed to the present crisis.

Many LDCs do not show a persistent pattern of overvaluation but are prone to nominal exchange rate volatility. Although not deeply integrated into the world financial system, LDCs are sensitive to changes in capital flows (UNCTAD, 2006: chap. 6) and exchange rate fluctuations. While an overvalued exchange rate can be an obstacle to industrialization in the long run, exchange rate volatility against major trading partners can add to investment uncertainty and amplify financing problems, particularly through its effects on the values of external debt, debt servicing, and the domestic value of remittances. Chart 4 (upper and lower left panels) shows the real and nominal effective exchange rates (REER and NEER) of LDCs grouped by exchange rate arrangement.<sup>1</sup> Chart 4, lower right panel, shows

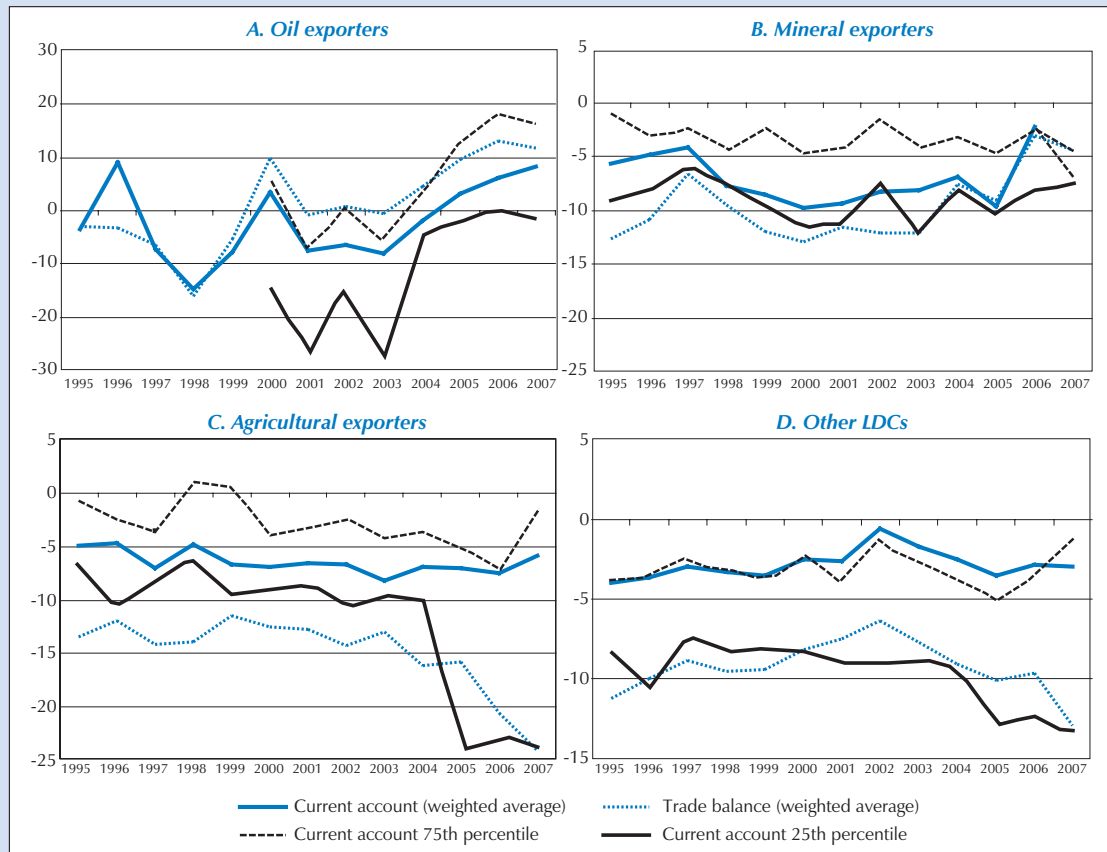
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*Reserves were increasing in LDCs as a group over the last decade, but this implied diverting capital inflows from more productive uses.*

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Chart 2

### External imbalances (Percentage of GDP)



Source: UNCTAD secretariat calculations, based on the GlobStat database.

Note: Current accounts and trade balances are GDP-weighted averages for the groups. A 75th (25th) percentile is the value below (above) which 75 (25) per cent of the observations are found.

*Currency volatility and large gyrations of major currencies create risks and policy dilemmas even for the less financially integrated developing economies.*

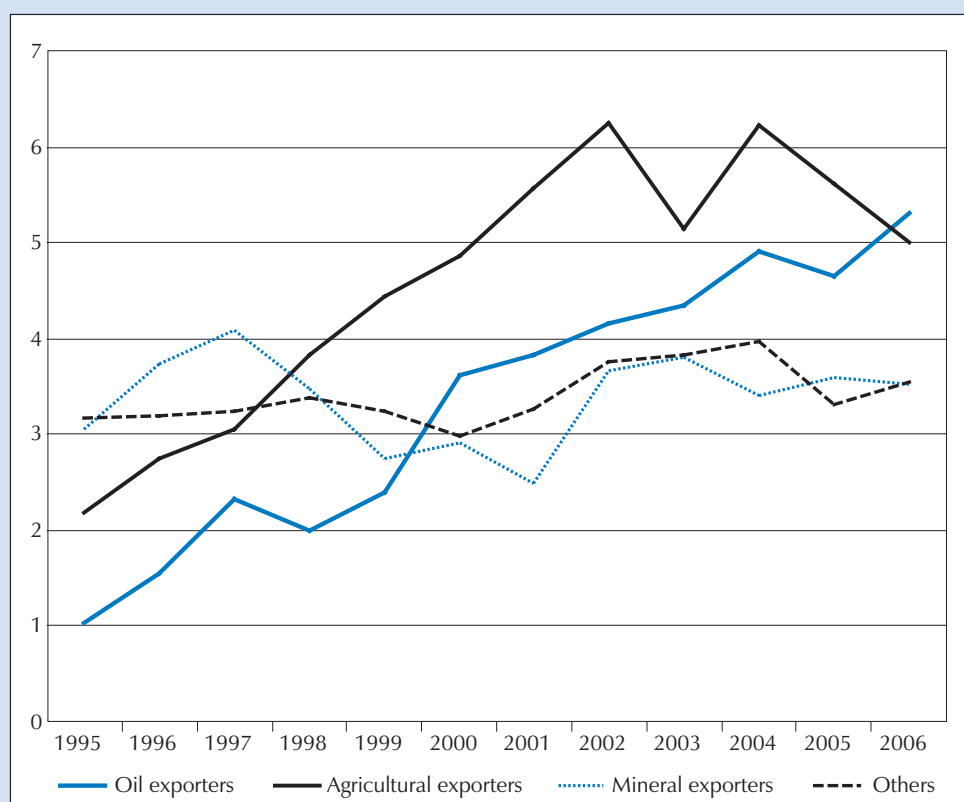
the nominal bilateral exchange rates by groups in 2008.<sup>2</sup> Floating currencies followed the mild dollar depreciation in the first half of the year, but resisted the strong dollar appreciation of the second half (blue line). In doing so, they depreciated vis-à-vis the dollar (black line). While appreciating with the dollar requires the use of reserves, depreciating against it can generate an adverse revaluation of external liabilities and debt servicing. Currency volatility and large gyrations of major currencies create risks and policy dilemmas even for the less financially integrated developing economies.

Official development assistance (ODA) levels may decline, given historical trends suggesting ODA declines following significant crises in donor countries (UNCTAD, 2008b). Despite recent pronouncements by donor countries to maintain aid levels in the face of the economic global crisis (see, for example, the G-20 statements, Washington, November 2008 and London, April 2009), there is an underlying concern that these will be difficult to respect with the shift in donors' budgetary priorities (see below).

Foreign direct investment (FDI) to LDCs is likely to decline over the next few years, owing to (a) lower expectation of profitability; (b) reduced access to credit to finance new investments; and (c) balance sheet consolidation by transnational

Chart 3

## Months of imports covered by international reserves



Source: UNCTAD secretariat calculations, based on the GlobStat database.

corporations (TNCs) in the face of financial pressures. This is particularly true of FDI to LDCs that has been predominantly *natural resource-seeking* and focused on the extractive sectors, which is likely to decline during 2008 and beyond because of sharply falling mineral prices and the TNCs' cautious approach to exploration and expansion during this volatile period.

Remittances are also set to decline. Workers' remittances have become an important supplement to basic incomes in LDCs, where they generally support consumption rather than investment. According to World Bank estimates, remittances to developing countries as a whole have been increasing at a slower pace in recent years, with the annual percentage increase down from 18 per cent in 2006 to 9 per cent in 2008. They are expected to decline by between 5 per cent and 8 per cent in 2009, with a possible slight recovery in 2010.

### 3. THE CUMULATIVE IMPACT

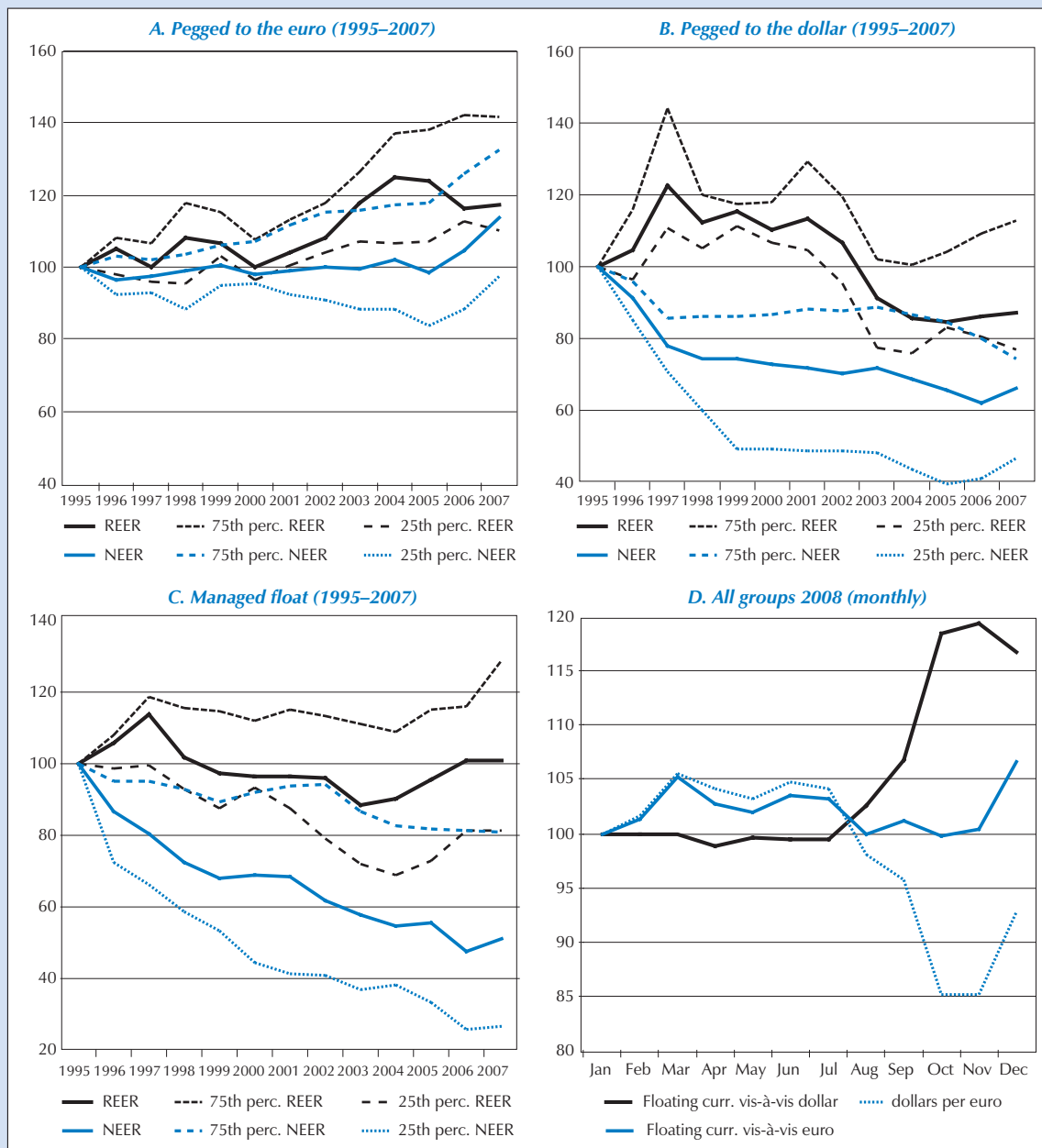
Given the global economic prospects and specific vulnerabilities of LDCs, it is highly unlikely that they will be able to attain for the next few years anything like the growth rates they achieved for most of the present decade. Unlike advanced countries and some emerging economies, most LDCs are unable to support countercyclical measures or bail out their leading sectors. This is likely to undermine their achievements of the present decade in lowering poverty and

*FDI to LDCs, which has been predominantly natural resource-seeking, is likely to decline during 2008 and beyond because of sharply falling mineral prices and the TNCs' cautious approach during this volatile period.*



Chart 4

## Exchange rates indices by groups of LDCs



Source: UNCTAD secretariat calculations, based on the GlobStat database.

Note: REER and NEER are the median of the real and nominal effective exchange rates within the group, while a 75th (25th) percentile is the value below (above) which 75 (25) per cent of the observations are found.

improving social welfare. Even before the marked deterioration in global economic prospects in the second half of 2008, it was becoming clear that there was little chance that most LDCs would be able to meet the Millennium Development Goal (MDG) of halving poverty between 1990 and 2015; for the majority, most of the other MDGs still appear to be beyond reach. The human and social costs of the present crisis are considerable everywhere, but for the poorest countries, they will include not just the loss of employment but also rising levels of poverty, spreading malnutrition and higher mortality rates for children and other vulnerable groups.

There will also be increased pressure on the skilled and able-bodied to emigrate. For many LDCs, there is thus a real risk that this economic crisis will turn into a social and humanitarian disaster.

The immediate challenge facing the LDCs is now twofold: (a) to check and, if possible, offset the fall in domestic demand in their economies; and (b) at the same time, to maintain and, if possible, increase their efforts to diversify their economies and lay the basis for a more secure path for growth and development. In particular, a crucial objective for most LDCs is to make agriculture significantly more productive in order to achieve greater security of food supplies and to provide the basis for the development of a more diversified range of productive capacities. In the present circumstances, the LDCs will be unable to meet this challenge without substantial and speedy help from the advanced economies.

In a recent study of the implications of the global financial crisis on low-income economies, the International Monetary Fund (IMF) has reached similar conclusions (IMF, 2009). The critical questions are where and how the LDCs will find the resources to revive investment, increase social spending and lower poverty levels, and how they will begin to adapt to the threats from climate change. These are major questions for both domestic policymakers and the international community.

What will actually happen in LDCs over the next few years will critically depend on ODA trends. It is imperative that ODA not be reduced, particularly under present conditions. ODA can play an important role in long-run development by facilitating both social spending and productive capacity-building, but the composition and volatility of ODA continues to work against such goals. UNCTAD research has highlighted the need for its more effective use in supporting capital formation, for example, in smallholder agriculture, as well as for reducing its volatility (UNCTAD, 2000; 2006). In a similar vein, the United Nations Commission of Experts on Reforms of the International Monetary and Financial System (United Nations, New York, 6 January 2008) called for the advanced countries to increase aid by up to 20 per cent, including for infrastructure and long-term development and environmental projects. Long-term policies and measures are needed to diversify exports, enhance domestic resource mobilization, and build domestic financial sectors as well as domestic productive capacities. Building new institutions and improving the functioning of financial markets and institutions in order to provide credit to productive enterprises will also help to build resilience to external shocks.

### C. Alternative development strategies for LDCs

The current economic crisis creates both the necessity and the opportunity for a change of direction by LDCs and their development partners. The LDCs, although in a vulnerable position, must start to address their chronic structural weaknesses. In this context, this Report recommends:

- Refocusing attention on developing productive capacities;
- Building a new developmental State based on a better balance between States and markets; and
- Ensuring effective multilateral support.

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*A crucial objective for most LDCs is to make agriculture significantly more productive in order to achieve greater food security and allow for the development of a more diversified range of productive capacities.*

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*ODA contribute to long-run development by facilitating both social spending and productive capacity-building, but the composition and volatility of ODA continues to work against such goals.*

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*Long-term policies and measures are needed to diversify exports, enhance domestic resource mobilization, and build domestic financial sectors and productive capacities.*

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## 1. REFOCUSING ATTENTION ON DEVELOPING PRODUCTIVE CAPACITIES

*Thirty-eight LDCs are currently producing PRSPs, which continue to focus on liberalization, attracting external resources and increasing social sector spending.*

*The hope that FDI would play a major role in diversifying LDC economies has not been fulfilled. FDI is invariably a lagging — not a leading — variable in the development process.*

*Developing productive capacities implies giving increased attention to mobilizing domestic resources, accelerating capital formation and promoting technological learning and innovation.*

*The challenge is to design effective governance practices which interrelate States and markets in creative new ways in the service of national development within a global context.*

Thirty-eight LDCs are currently producing poverty reduction strategy papers (PRSPs). As shown in past *Least Developed Countries Reports*, these policy documents continue to focus on liberalization, attracting external resources and increasing social sector spending. In general, domestically-generated resources have either failed to be mobilized or have been inadequate to support significant investments in new productive capacities. The hope that FDI would play a major role in diversifying LDC economies has not been fulfilled. FDI is invariably a lagging — not a leading — variable in the development process. What FDI has flowed to the LDCs in Africa has been largely concentrated in resource-based activities with weak linkages to the rest of the economy (in Asia, foreign investment was more involved in the manufacturing industry). ODA, consequently, has been the major source of external finance, but for some years it has been largely focused on improving social services and “governance”, rather than the expansion of productive capacities. The needs of the LDCs for ODA, both for development and current-account financing, will not diminish in the current crisis; instead, they are likely to increase considerably.

Policies need to refocus on developing productive capacities. This idea has been set out in detail in earlier *Least Developed Countries Reports*, particularly UNCTAD (2006). However, it is now more pertinent than ever. Developing productive capacities implies that increased attention needs to be given to mobilizing domestic resources, accelerating the pace of capital formation (both public and private) and promoting technological learning and innovation. Policies should also seek to establish strong backward and forward linkages within and across sectors, and to promote structural change.

## 2. BUILDING A NEW DEVELOPMENTAL STATE

Promoting the development of productive capacities will require a new balance between States and markets. However, neither the good governance institutional reforms which many LDCs are currently implementing, nor the old developmental State, including successful East Asian cases, are entirely appropriate models now. Discussion on the issue of governance must move beyond unhelpful and false dichotomies. Governments do not face a stark choice of good versus evil, the “vice” of State dirigisme versus the “virtue” of markets, privatization and deregulation. The institutions of the “State” and the “market” have always coexisted organically in all market-based economies; hence, the “choice” between the market and the State is a false dichotomy. This has been recognized at least since the time of Adam Smith, although these insights have been lost in subsequent interpretations. The challenge is to design effective governance practices which interrelate States and markets in creative new ways in the service of national development within a global context.

What is required now is a developmental State that is adapted to the challenges facing an interdependent world in the twenty-first century. The preferences and priorities of the people of LDCs can only be set by a strong representative State with a clear developmental vision. This State should seek to harness local, bottom-up problem-solving energies through stakeholder involvement and citizen participation that creates and renews the micro-foundations of democratic practice. It should also embrace a wide range of development governance modalities and mechanisms within a mixed economy model to harness private enterprise, through public action, to achieve a national development vision.

There is also a need for policy space to allow experimentation. The need for flexibility is evident in the actions of the Governments of the advanced economies in their response to the systemic crisis afflicting them. Policymakers in the advanced economies have markedly changed their ideas about the desirability of hitherto rejected policies to provide fiscal stimuli to growth, for tighter regulation of the financial sector, to nationalize failed banks, and in general to allow a much greater role for the State in controlling and guiding the national economy. Even “industrial policy”, previously subsumed under various titles such as “competitiveness policy” or “defence policy”, has now been brought back into the open in the United States and Western Europe (Hollinger, 2009).

### 3. ENSURING EFFECTIVE MULTILATERAL SUPPORT

One of the characteristics of the current global economic crisis is that speculative activities have not been confined within national boundaries and they have had a de-stabilizing influence on the global economy. The rapid descent into recession of the developed countries has led to an even more severe and rapid downturn in the exports of most developing countries. At the same time, the banking and financial crisis in the United States and Western Europe has led to a major and indiscriminate withdrawal of funds from emerging market economies, as banks and other financial institutions struggle to reconstruct their balance sheets in the wake of massive losses in the asset markets of the advanced economies and as private and other corporate investors move their funds to safer havens. This contrasts with the four decades before the First World War, when foreign capital flowed from the North to the South when the former slowed down, and thus had a stabilizing influence on the world economy.

A key question is whether official lending is able and willing to offset the current retreat of private sector finance from developing countries. The World Bank, as a triple-A rated institution, was one of the few beneficiaries of the “flight to safety” in 2008: it raised some \$19 billion in medium- to long-term bonds in fiscal 2008 at relatively favourable rates of interest. More significantly for the LDCs, donor countries pledged a record \$41.7 billion in International Development Association (IDA) funding for fiscal years 2009–2011. Together with a transfer of \$3.5 billion from the International Bank for Reconstruction and Development and the International Finance Corporation, this should make available some \$15 billion a year for nearly 80 of the poorest countries. More recently, however, the World Bank has estimated that the developing countries face a funding gap of anywhere from \$270 billion to \$700 billion a year as a result of capital flows evaporating. Only about a quarter of vulnerable countries have been able to obtain some relief against the slump.

Whether or not the international institutions will be able to support every country that needs help to cope with the impact of the financial crisis remains to be seen. In early 2009, much of the attention of the international financial institutions was focused on the problems of some of the Central and Eastern European economies and related fears for Western European banks. The LDC economies, however, are smaller and, because of their limited exposure to the international financial system, their situation is not seen as posing a serious systemic risk to the global economy. There are therefore grounds to fear that their needs will be treated less urgently than those of others. It is the argument of this Report that the developed market economies, which are most responsible for the global financial collapse, not only have a moral obligation to help the poorest countries through the present crisis, but they also share a mutual interest in setting the LDC economies on a sustainable growth path. Failure to do so will

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*The LDC economies are mostly small and their situation is not seen as posing a serious systemic risk to the global economy. It can be feared that their needs will be treated less urgently than those of others.*

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risk increasing the number of unstable States and thus the wider threats to peace and security. Poverty and related social problems have already increased and the intensification of the food crisis in early 2008 quickly led to widespread riots in many of the poorest countries.

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There were, however, some encouraging signs in early April 2009, when the leaders of the G-20 countries agreed to a potentially large increase in the funds available to the developing countries through the mediation of the international financial institutions. IMF resources are to be raised to \$750 billion (from \$250 billion)<sup>3</sup> and there was also support for a new issue of special drawing rights worth \$250 billion, the latter carrying very low rates of interest and not subject to intrusive conditionality. The G-20 leaders also agreed to “support” an additional \$100 billion by the multilateral development banks (including regional institutions such as the Asian Development Bank), and accepted an African proposal to sell part of the IMF gold reserve to finance a \$50 billion rescue package for low-income countries. Another \$250 billion was promised, over two years, to support the provision of international trade credit by export credit agencies, development banks, etc.

This appears to be a significant increase in funding but, as with all such declarations, it needs to be borne in mind that not all of this is new money. Much of it is promised rather than being immediately (or imminently) available, and not all of it is likely to be spent. Part of the increase in IMF resources will be held in reserve, in case the global economy deteriorates more than currently expected.

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*National ownership of the development agenda and a more efficient use of ODA could be achieved if the recipient countries were to set out their macroeconomic and microeconomic objectives, provide an account of how they intend to reach them, and indicate where they think ODA would be most effective.*

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Increasing the resources available for ODA, however, whether it be done through the international financial institutions or by individual donor countries, will have a limited impact in strengthening the conditions for sustained growth in the LDCs — and in contributing to the support of global demand — unless there are changes in the basic approach of such donors, both to stabilization policy and to longer-term development strategy in developing countries. Some of the key elements of such a change have already been discussed but, although the G-20 leaders expect the IMF to take the lead role in assisting the developing countries most affected by the crisis, they did not link increased funding to radical reform of the organization, nor did they insist on substantial changes in the conditions attached to its loans. Although Prime Minister Gordon Brown of the United Kingdom declared at the G-20 meeting an end to the “Washington Consensus” triad of liberalization, privatization and deregulation, there are continued concerns with the IMF’s business-as-usual approach. At least to date, there are few signs of change in IMF conditionality on its short-term lending: recent loans to Ethiopia and Ukraine, for example, were accompanied by demands for pro-cyclical and severe tightening of fiscal and monetary policies, as well as for a number of institutional reforms (IADB, 2001).

Throughout this Report, the need for ODA is constantly underlined, but the key emphasis is on the need for the recipient countries to exercise a much greater control over the uses to which such assistance is put. The problems of aid effectiveness have been discussed for a long time, often in somewhat polemical terms. But both national leadership (or ownership) of the development agenda and a more efficient use of ODA could be achieved if the recipient countries were to draw up their own four-to-five-year programmes, setting out their macroeconomic and microeconomic objectives, providing an account of how they intend to reach them, and indicating where they think ODA would be most effective in moving the development process forward. ODA is essentially a form of government intervention to ease shortages, bottlenecks and other constraints on growth, including fiscal and current-account deficits, but it is difficult to target assistance to where it will be most effective without a clear sense of priorities



and some idea of the potential impact of removing one particular bottleneck before another. Similarly, the impact of ODA will be reduced if important complementarities and linkages are overlooked. ODA is also likely to be more productive if it is committed and delivered to match the time-frame of a multi-year national programme, although it could still be released in tranches according to intermediate stages of the programme being achieved. Some conditionality will be necessary in order to maintain political support for assistance in the advanced economies, but with a transparent programme, the recipient country can suggest its own intermediate goals instead of an international organization imposing its conditions.

ODA could also be more effective if neighbouring countries were to prepare and implement their programmes simultaneously, with a view to developing regional infrastructure projects, for example, or increasing their intraregional trade. Infant industries may stand a better chance of survival if they can have access to their neighbours' markets as well as their own. Peer reviews of programmes and experience in a regional context can also stimulate the processes of learning, experimentation and adaptation that are inescapable requirements for successful development. Regional cooperation is itself a sign of increased political stability and that can have a positive effect on the propensity to invest. A constraint on establishing such development programmes is the shortage of relevant technical skills in a country, but this can be overcome to some extent by drawing on independent advice from abroad.<sup>4</sup>

There is a critical political dimension to developmental success. A development programme is not simply a technical document: (a) it serves an important political function, insofar as it sets out the Government's vision of the economic and social transformation at which it is aiming; and (b) it effectively lays out its goals and priorities, as well as the path chosen — or thought most likely — to achieve them. It is the task of politics to build and retain popular support for the development programme, to create a framework of democratic engagement and accountability, and to persuade the population that it is for the benefit of all and not just for a privileged few. This would be a step towards providing a concrete, operational basis for such ideas as "ownership" and "partnership", which otherwise run a high risk of degenerating into empty slogans. Countries essentially develop a growth dynamic from their own culture and history, and from the internal demands of the population for change. The "developmental State" is fundamentally about the leadership required to trigger those demands for change and unite them behind a feasible programme for development. If the politics are right, many different routes can lead to success; if the politics are wrong, little or nothing will be achieved.

Rethinking development policies and improving the effectiveness of ODA will take time. Meanwhile, the LDCs are facing a major crisis and are seeking urgent assistance. How can that be organized? The place to start is the affirmation by some of the major advanced economies, including the United States and the United Kingdom, that the fiscal stimulus by the G-20 economies must be global in outlook and in practice: those who can contribute to expansion must do so; those that need help must receive it. In other words, any fiscal stimulus must be directed not just at the rich countries, but also at the poorest. One way to do this, and do it quickly, would be to transfer a proportion of the stimulus in the advanced economies directly to the LDCs in the form of grants. Grants can be delivered more rapidly than loans. It would not be helpful to increase the indebtedness of countries already burdened with debt, and there is a moral issue raised by rich countries forcing the poorest to go further into debt in order to deal with a problem created by the rich. A rapid transfer of such grants would have the objective of supporting the LDCs in their attempts to cope with the two broad challenges mentioned earlier: (a) to prevent a severe contraction of

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*... the "developmental State" is fundamentally about the leadership required to trigger those demands for change and unite them behind a feasible programme.*

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*The fiscal stimulus by the G-20 economies must be global in outlook and in practice... it must be directed not just at the rich countries, but also at the poorest.*

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*The IMF has estimated that the poorest countries may need some \$25 billion to cope with the immediate impact of the crisis on their reserves but, depending on how far the global economy deteriorates, their needs could be as high as \$140 billion.*

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domestic demand that would drive millions more people into poverty and hunger; and (b) to ensure that development programmes and projects already underway (for infrastructure investment, pandemic disease control, etc.) are not suddenly disrupted or abandoned because of a cut-off in the supply of finance or critical imports.

The IMF has estimated that the poorest countries may need some \$25 billion to cope with the immediate impact of the crisis on their reserves but, depending on how far the global economy deteriorates, their needs could be as high as \$140 billion. The rich countries have, together, put a \$5 trillion stimulus into the global economy, largely focused on saving their own banks and boosting domestic demand. If they were to divert, say, 0.7 per cent of that in grants to support demand in the poorest countries, \$35 billion could be quickly transferred to the LDCs; another 1 per cent of the stimulus would take the sum to the mid-point of the IMF's estimated range. Combined with a rapid deployment of "soft" loans from the World Bank's IDA, such a programme would deliver real aid where it is most needed. The propensity of LDCs to spend such cash grants, an important requirement of the global stimulus, is likely to be very high, and much of it is likely to be spent on the output of the advanced economies.<sup>5</sup>

By making cash grants available to the LDCs, rapidly and without restrictive conditions, the G-20 would be able to demonstrate both its commitment to an inclusive approach to dealing with the current crisis and to an open, liberal trading system. A failure of the advanced countries to respond with exceptional measures would only heighten the United Nations Secretary General's fear that this "may not only be an economic crisis, but may develop into global political instability".

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For the longer term, the current crisis is an opportunity to reconsider policies and the role of institutions. This Report discusses a selection of key, longer-term policy issues, from different approaches to macroeconomic policy and governance, through the key role of agriculture as a trigger for broader development to industrial policies. The underlying theme is to revive and renew the role of the developmental State as the means of laying the basis for sustained development in the most disadvantaged countries.

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## D. Organization of this Report

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This Report is organized in four chapters.

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*Finding a better balance between States and markets is not a matter of going back to old-style development planning, but rather a question of finding new forms of development governance appropriate for the twenty-first century.*

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Drawing mainly from existing literature, the first chapter, "Rethinking the Role of the State in LDCs: Towards Development Governance", examines how it is possible to inject a development dimension into discussions of governance. It begins by assessing the current good governance institutional reform agenda from a development perspective, and goes on to review the relevance of the idea of the developmental State for LDCs. It argues that there is a need for a new developmental State adapted to the challenges of the twenty-first century, and discusses how it may be possible to build developmental State capabilities in LDCs. Overall, it argues that finding a better balance between States and markets is not a matter of going back to old-style development planning, but rather a question of finding new forms of development governance appropriate for the twenty-first century. Such development governance would be founded on a strategic collaboration between the State and the private sector that will encourage the structural transformation of LDCs from agrarian to post-agrarian economies.

The second chapter, “Meeting the Macroeconomic Challenges”, discusses the role of macroeconomic policies in supporting domestic resource mobilization and expansion of productive capacity. It offers a sketch of an alternative macroeconomic framework for the LDCs. It evaluates the neglected role of fiscal policy in LDCs, aimed at expanding the scope of counter-cyclical policies, given the current fiscal and current-account imbalances. Moreover, the chapter revisits the role of monetary policies, the effects of targeting low inflation as well as the role of exchange rate management. The findings underscore the general need for the coordination of macroeconomic policies and need for greater use of Keynesian-style macroeconomic policies in supporting domestic resource mobilization and expansion of productive capacity.

The third chapter, “Setting the Agenda for Agricultural Policy in LDCs”, considers the neglected role of agricultural policy in the transformation process in LDCs aimed at achieving food security and poverty reduction. Whilst agriculture is a major component of almost all LDC economies, the key policy challenge they face is how to promote agricultural growth which would enable a structural transformation towards a dynamic growth path. The chapter suggests that, to enable this transition, policy issues in agriculture need to be addressed seriously in terms of multiple intersectoral linkages which often involve complex choices. The role of the State through public investment and collaboration with other productive agents in the transformation process is emphasized.

Chapter four, “Tailoring Industrial Policy to LDCs”, delineates a general framework for a renewed industrial policy specifically tailored toward LDCs — the Developmental Industrial Policy (DIP) — which is defined as any strategic intervention by the State that catalyses structural change and stimulates economic restructuring towards more dynamic, higher value added activities. The chapter reviews a number of alternative approaches to industrial policy, including from successful small, open economies (Nordic countries, such as Sweden and Finland, and Ireland) as well as in contemporary LDCs, along with lessons that might be drawn from their experiences, given their respective constraints and opportunities. It suggests that, while the role of the State is vital, there is no universally successful model of State–market relations or industrial policy. Consequently far greater policy space, scope for experimentation and learning is required than is currently available, to find the most appropriate path to development. This implies using the fullest flexibility of policies and measures to mitigate the adverse impact of the global economic crisis, both in the short and the long term.

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*A key policy challenge LDCs face is how to promote agricultural growth which would enable a structural transformation towards a dynamic growth path.*

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## Notes

- 1 A progressive nominal depreciation vis-à-vis the main trading partners has allowed managed floating and dollar-pegged economies to avoid overvaluation of their currencies in real terms. African CFA franc zone economies have suffered from the progressive appreciation of the euro in recent years (a nominal appreciation vis-à-vis other trading partners), as well as from a real appreciation induced by inflation differentials.
- 2 The United States dollar/euro exchange rate index (light blue line) shows the mild depreciation of the dollar against the euro in the first half of 2008, its large appreciation between June and October and its partial reversal in December. It therefore shows the appreciation of the dollar-pegged currencies relative to the euro and the depreciation of euro-pegged currencies to the dollar.
- 3 The increase of \$500 billion is to come from member countries making loans to the organization. This arrangement was criticized during the United Nations General Assembly's dialogue on the global economic crisis (25–27 March 2009) for potentially weakening the IMF's surveillance role by making it reluctant to censure the policies of countries from which it had borrowed funds.
- 4 These suggestions for improving the effectiveness of ODA draw on the operating principles that guided the Marshall Plan in Western Europe after the Second World War, but which appear to have been largely forgotten when it came to assisting developing countries. For a more detailed discussion, see Kozul-Wright and Rayment (2007).
- 5 In addition to these grants, the advanced economies will also need to ensure that the developing countries have access to ample liquidity in 2009 and 2010, as estimates of their need to roll over debt due in these years are relatively high. The G-20's decision to increase the resources of the IMF should ease the process, at least if implementation is rapid and if conditionality is not restrictive.

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# Rethinking the Role of the State in LDCs — Towards Development Governance

Chapter

1

## A. Introduction

The current financial crisis has given added urgency to a reconsideration of the potential for new roles and functions for the State in the current global context. This chapter examines what this might mean in general terms for the least developed countries (LDCs). Its central argument is that the LDCs should pursue good development governance and that with this in view they should seek to build developmental State capabilities.

Development governance, or governance for development, is about creating a better future for members of a society by using the authority of the State to promote economic development, and in particular to catalyze structural transformation, create productive employment opportunities and raise living standards for present and future generations. In general terms, governance is about the processes of interaction between the Government — the formal institutions of the State including the executive, legislature, bureaucracy, judiciary and police — and society. Development governance is governance that is oriented to solve common national development problems, create new national development opportunities and achieve common national development goals. This is not simply a matter of designing appropriate institutions but also a question of policies and the processes through which they are formulated and implemented. Which institutions matter is inseparable from what policies are adopted. Development governance is thus about the processes, policies and institutions that are associated with purposefully promoting national development and ensuring a socially legitimate and inclusive distribution of its costs and benefits.

Drawing principally on existing literature, this chapter examines possible approaches to effective development governance in LDCs. It argues that neither the current good governance institutional reform agenda, nor the old developmental State, including successful East Asian cases, are entirely appropriate now. What is required is a new developmental State that: (a) is adapted to the challenges of the twenty-first century; (b) creates and renews the micro-foundations of democratic practice to harness local, bottom-up problem solving and opportunity-creating energies; and (c) embraces a wide range of governance modalities and mechanisms within a mixed economy model to harness private enterprise, through public action, to achieve a national development vision. The chapter considers how this concept of the new developmental State can be adapted to provide a viable and useful model for development governance in LDCs.

The chapter is organized in four main sections. Section B discusses the good governance institutional reform agenda from a developmental perspective, whilst sections C and D focus on the governance practices within developmental States as an alternative approach to development governance. These sections examine in particular the economic governance practices that made some developmental States more successful than others and also how lessons about development

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*Neither the current good governance institutional reform agenda, nor the old developmental State, are entirely appropriate now. What is required is a new developmental State.*

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governance in successful developmental States may be adapted to be relevant for the twenty-first century. Section E discusses how LDCs can use these insights to build developmental State capabilities, including the implications for development partners of LDCs. The conclusion summarizes the major messages of the chapter.

## B. The good governance reform agenda and development

### 1. THE IMPERATIVE OF GOOD DEVELOPMENT GOVERNANCE

*Within this Report, governance will be broadly understood as “the processes through which individuals and State officials interact to express their interests, exercise their rights and obligations, work out their differences and cooperate to produce public goods”.*

What good governance means is essentially contestable. Firstly, the term “governance” is not readily understood. Some academics and practitioners use it as a synonym for “Government”, whilst others refer to a broader set of the structures and processes through which individuals and institutions manage their common affairs (for example, Weiss, 2000). Secondly, the “goodness” of governance necessarily rests on values and ethical judgments. At the most basic level, some base the goodness of governance on outcomes (for example, is governance effective for economic development?), whilst others base the goodness of governance on procedures (for example, is governance transparent and accountable?).

Within this Report, governance will be broadly understood as “the processes through which individuals and State officials interact to express their interests, exercise their rights and obligations, work out their differences and cooperate to produce public goods” (Brinkerhoff and Goldsmith, 2005: 200). This covers both what Governments do (the nature of policies) and how they do it (the nature of institutions).

One list of the core principles of good governance that has been suggested (Court, 2006) and is useful because it is universal rather than culturally specific, is the following:

- (a) Participation: the degree of involvement by affected stakeholders;
- (b) Fairness: the degree to which rules apply equally to everyone in society;
- (c) Decency: the degree to which the formation and stewardship of the rule is undertaken without humiliating or harming people;
- (d) Accountability: the extent to which political actors are responsible for what they say and do;
- (e) Transparency: the degree of clarity and openness with which decisions are made; and
- (f) Efficiency: the extent to which limited human and financial resources are applied without unnecessary waste, delay or corruption.

These principles, together with the predictability of rules and policies, can be realized through a variety of institutions or institutional configurations.

It must also be recognized that the goodness of governance is not simply a matter of processes and procedures of governing, but also a question of effectively achieving outcomes. It would be a curious type of “good governance” if the governance processes in themselves were considered to be perfect according to the valued principles, but the outcomes were poor. For a country concerned with promoting development, good governance should thus also encompass

*Core principles of good governance include: participation, fairness, decency, accountability, transparency and efficiency.*

governance that effectively delivers development. Here the key question is whether the governance system creates the conditions for increased investment, innovation and structural transformation and thus leads to increased employment opportunities and rising and widely shared prosperity.

LDCs should aspire to a kind of good governance in which the practices of governing are imbued with the principles of participation, fairness, decency, accountability, transparency and efficiency in a non-culturally-specific way. They should also aspire to a kind of good governance that delivers developmental outcomes, such as growing income per capita, structural transformation, expanding employment opportunities in line with the increasing labour force and reduced poverty. In short, they should aspire to good development governance.

## 2. THE SCOPE, CONTENT AND PROPAGATION OF THE GOOD GOVERNANCE REFORM AGENDA

Whilst good development governance in the sense defined above is essential for LDCs, a narrower understanding of what “good governance” means has come to dominate efforts to promote institutional reforms in LDCs.

The idea of “good governance” was initially introduced into international policy debates in the late 1980s following the realization that “getting the institutions right” was as important as “getting the prices right” to the success of policy reforms. At first some definitions of governance had an explicit developmental dimension. Thus World Bank (1992: 3) states that: “Governance is the manner in which power is exercised in the management of a country’s economic and social resources for development.” The European Commission similarly defined “good governance” as “the transparent and accountable management of all a country’s resources for its equitable and sustainable economic and social development” (quoted in Landman and Hausermann 2003: 2). But over time, the development dimension has evaporated from many definitions of good governance. In World Bank (2006: 2, paragraph 4), for example, governance is defined as “the manner in which public officials and institutions acquire and exercise the authority to shape public policy and provide public goods and services”. The pursuit of “good governance” has also increasingly focused on processes and procedures as a good in themselves, rather than on outcomes. In this way, “good governance” has been seen as a developmental end in itself rather than an important means for achieving economic development.

The precise content of the current good governance institutional reform agenda in LDCs is implicitly rooted in a dichotomy between a formalized “good governance” system and an informal, personalized, “bad governance” system (table 1). Both these governance systems are “ideal types”, that is to say they are abstractions from the way in which governing actually happens in individual countries. However, the good governance systems are stereotypically understood to be typical of developed countries, whilst the bad governance systems are stereotypically understood to be typical of very poor countries.

Within the good governance reform agenda, the task of turning bad governance systems into good governance systems has involved introducing particular types of formal institutions into LDCs. This is a complex agenda with different agencies emphasizing different issues (Weiss, 2000; Doornbos 2001). However, the typical vision of good governance reforms has usually included both the practices of public administration and the political processes through which Governments gain their authority and people are ruled.

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*Over time, the development dimension has evaporated from many definitions of good governance.*

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*The pursuit of “good governance” has increasingly focused on processes and procedures as a good in themselves, rather than on outcomes.*

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*Good governance reforms have sought to introduce a particular style of public administration and management, namely the methods of new public management.*

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**Table 1**  
**“Ideal types” of governance systems: good governance versus bad governance**

Good governance	Bad governance
Authority is institutional, resides with official roles	Authority is personal, resides with individuals
Political leaders share power with others and are accountable for actions	Political leaders monopolize power and are unaccountable for their actions
Leaders hold onto power by providing collective benefits that earn support of large segments of society	Leaders hold onto power by providing personal favours that secure the loyalty of key followers
Policy decisions are taken in the open after public discussion and review	Policy decisions are taken in secret without public involvement
Decision-making standards are explicit and procedures are transparent	Decision-making standards are tacit and procedures are indecipherable
Political parties are organized around stated programs that affect large numbers of beneficiaries defined by universalistic or generic categories	Political parties are organized around personalities and the distribution of individual benefits
Political campaigns are financed by many small, unconcealed donations	Political campaigns are financed by a few large, secret donations
Elections are free, fair and open	Elections are marked by intimidation, vote buying and fraud
Civil engineering projects are disbursed to serve the interests of large portions of the country's citizenry	Civil engineering projects are geographically targeted to serve the interests of small portions of the country's citizenry
Administrators are recruited and promoted in competitive processes that judge their merit and expertise	Administrators are recruited and promoted as reward for personal connections with political leaders
There is an authorized administrative hierarchy with clear division of labour, specific standards for output and well-defined reporting channels	There is an unspoken administrative hierarchy, with little specialization or specification of output and uncertain reporting channels
Administrators can only be dismissed with cause	Administrators can be dismissed for no reason
Administrators are prohibited from supplementing their salary	Administrators supplement their salary with bribes and kickbacks
Administrators' actions are predictable, based on objective methods and follow uniform procedures	Administrators' actions are arbitrary, based on subjective reasoning, and follow ad hoc procedures
Rules are applied with neutrality and all citizens receive equal treatment	Rules are applied with partiality, and people with close ties to Government get preferential treatment
Binding legal contracts are used in Government procurement and sales	Verbal agreements are used in Government procurement and sales
Internal controls are strict, thorough records are maintained and regularly audited	Internal controls are lax, documentation is spotty with sensitive matters left off the books
Citizens have appeal channels if given poor service	Subjects have little recourse for poor service

Source: Brinkerhoff and Goldsmith (2005).

With regard to the former, good governance reforms have sought to introduce a particular style of public administration and management, namely the methods of new public management (NPM). This approach advocates that Government should be run according to private sector styles with an active, visible, “hands on” approach, using market mechanisms, client orientation and performance management to increase productivity, often favouring the unbundling of monolithic organizations into corporatized units and decentralization (table 2). With regard to political processes, good governance reforms have been particularly concerned with promoting liberal democracy. As Leftwich (1993:611) has put it:

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*With regard to political processes, good governance reforms have been particularly concerned with promoting liberal democracy.*

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good governance implies a State enjoying both legitimacy and authority, derived from a democratic mandate and built on the traditional liberal notion of a clear separation of legislative, executive and judicial powers. And, whether presidential or parliamentary, federal or unitary, it would normally involve a pluralist polity with some kind of freely elected representative legislature, subject to regular elections, with capacity at the very least to influence and check executive power and protect human rights.

An important aspect of the current good governance institutional reform agenda is that it also defines a particular role for the State. This is to support markets. World Bank (2002: 99), for example, states: “Many of the institutions

**Table 2**

**Seven core principles in new public management reforms**

“Hands-on” management	Active, visible control of organizations by identifiable professional managers who are free to manage using private sector styles of management
Unbundling	Disaggregation of formerly monolithic organizations into corporatized units around specific products and services
Productivity	Do more with less. Public service provision with lower resource use
Marketization	Use market mechanisms and competition to overcome pathologies of traditional bureaucracy.
Performance orientation	Define, preferably quantitatively, goals, targets, outputs and indicators of success based on explicit standards. Deliver what is promised. Link resource allocation and rewards to measured performance to enhance accountability
Service orientation	Improve Government-customer relations so as to improve the satisfaction of the latter
Decentralization	Place policy decisions as close as possible to the people who will be affected by those decisions

Source: Therkildsen (2008).

that support markets are publicly provided. The ability of the State to provide these institutions is therefore an important determinant of how well markets function. Successful provision of such institutions is often referred to as ‘good governance’.” Khan (2006a; 2006b) has identified the key governance goals of such market-supporting governance as: (a) achieving and maintaining stable property rights; (b) maintaining good rule of law and contract enforcement; (c) minimizing expropriation risks; (d) minimizing rent seeking and corruption; and (e) achieving transparent and accountable provision of public goods in line with democratically expressed preferences.

Within LDCs, the good governance reforms that were initially undertaken in the 1990s were closely linked to policy conditionality attached to aid inflows. Governance-related conditionalities were particularly prevalent in African LDCs. Kapur and Webb (2000) analyze the conditionalities contained in International Monetary Fund (IMF) Letters of Intent, Policy Framework Papers and Memorandum of Economic Policies during the period 1997 to 1999 and find that in sub-Saharan Africa, 40 per cent of the conditionalities in the form of quantitative performance criteria and 72 per cent of the more loosely-defined conditionalities were governance-related. Since 2000, the nature of conditionality has been changing. There is now less emphasis on externally imposed conditions and more attempts to align conditionality with nationally produced policy documents. However, as shown in UNCTAD (2008), the efforts to enable country ownership of national policies and institutional reforms in the LDCs have not been completely successful and conditionality in relation to governance practices continues to be important.

A significant feature of the second generation reforms that are being formulated and implemented by LDC Governments is the importance they themselves now attach to “good governance”. The Poverty Reduction Strategy Paper (PRSP), prepared in consultation with civil society, has been adopted as a key mechanism for achieving poverty reduction goals as well as allocating aid, and it is also used in external assessments as an indicator of good governance. By the end of 2008, 26 LDCs had prepared a second full PRSP. Good governance is a strategic pillar in most of these documents, with particular emphasis being placed on decentralization, improving the efficiency of public administration and reducing corruption (table 3).

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*The current good governance institutional reform agenda defines a particular role for the State. This is to support markets.*

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*Governance should be assessed for its instrumental value as well as its intrinsic value. Good governance is not simply an end in itself but also a means to an end.*

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### 3. THE MIXED EVIDENCE ON DEVELOPMENTAL IMPACT

It is difficult to disagree with the intrinsic value of some key institutions being promoted through the current good governance reform agenda. However, as Rodrik (2007) argues, governance should be assessed for its instrumental value as well as its intrinsic value. Good governance, from this perspective, is not

**Table 3**  
**Governance priorities in second-generation PRSPs in LDCs**

LDC	Year	Key governance priorities	Strategic pillar <sup>a</sup>
Afghanistan	2008	Strengthen democratic processes and institutions, human rights, the rule of law, delivery of public services and government accountability. Goals: reduce gender inequality, reduction of corruption.	Yes
Bangladesh	2005	Promoting good governance: improving implementation capacity, promoting local governance, strengthening anti-corruption strategy, reforming critical justice and access to justice by the poor, improving sectoral governance.	No
Benin	2008	Promotion of good governance: acceleration of administration reform, strengthening the rule of law and individual liberties.	Yes
Burkina Faso	2004	Promoting good governance: democratic governance, improving economic governance, local governance.	Yes
Burundi	2006	Improving governance and security: promoting good governance: (a) strengthening the culture of democracy; (b) promoting effective public administration; and (c) strengthening the entities in charge of planning and economic management.	Yes
Cambodia	2006	Good governance: Fighting corruption, legal and judicial reform, public administration reform, armed forces reform and demobilization.	Yes
Democratic Republic of the Congo	2006	Promoting good governance: Administrative governance, political governance, economic governance, improving the quality of statistics.	Yes
Ethiopia	2006	Open, transparent and democratic governance: strengthening the rule of law, institutions, civil society organizations; decentralization; human rights.	No
Gambia	2007	Enhancing governance systems and building the capacity of local communities and civil society organizations to play an active in economic growth and poverty reduction. Decentralization.	Yes
Guinea	2008	Improving political and economic governance (promoting human rights, boosting the capacities of institutions, strengthening civil society), strengthening economic governance (strengthening macroeconomic analytical and forecasting capabilities, strategic planning capabilities, statistics). Local governance, administrative governance, corruption, gender and equality.	Yes
Guinea-Bissau	2006	Modernizing the public administration and building capacities, strengthening the rule of law and the judicial apparatus, supporting decentralization.	No
Haiti	2007	Justice and security.	Yes
Lesotho	2006	Improving legislative efficiency of the parliament, strengthen the Directorate of Corruption and Economic Offences. At the local level: strengthen human rights and decentralization.	No
Madagascar	2007	Responsible governance.	Yes
Malawi	2007	Improved governance: fiscal management, fighting corruption, corporate governance, peace and security, effective legal system, human rights.	Yes
Mali	2006	Promotion of democratic governance: rule of law, strengthening public administration, fight against corruption, coordination of national and regional governments.	No
Mauritania	2007	Governance and capacity-building: the rule of law, public administration, management of public funds, decentralization, capacity-building for civil society.	Yes
Mozambique	2007	Good governance: corruption, the rule of law, decentralization.	Yes
Niger	2008	Promotion of good governance: entrenching the rule of law and ensuring effectiveness and transparency in economic and financial management.	Yes
Rwanda	2008	Governance: control of corruption, strengthening decentralization, enhancing public sector capacity and accountability.	Yes
Senegal	2007	Good governance: improving the quality of public service and economic governance, judicial governance, local development and decentralization, developing secondary hubs, promoting social dialogue.	Yes
Sierra Leone	2005	Promoting good governance: public sector reform, decentralization of state governance, public financial management and procurement reform and anti-corruption "empowerment with information".	Yes
Uganda	2005	Good governance: democratization; justice, law and order; managing the public sector; public expenditure priorities for governance.	Yes
The United Rep. of Tanzania	2006	Good governance and the rule of law, accountability of leaders and public servants, deepening democracy, political and social tolerance, sustaining peace, political stability, national unity and social cohesion. Addressing corruption, equitable allocation of public resources, decentralization, reducing political and social exclusion.	Yes
Zambia	2006	Total adherence to the principles of good governance by 2030: administration of justice, constitutionalism, democratization, human rights, accountability and transparency.	No

Source: UNCTAD secretariat compilation, based on PRSPs.  
a By "strategic pillar", what is meant is that governance is a crucial element in the PRSP.

simply an end in itself but also a means to an end. In the present context what is important, as argued above, is whether or not the good governance institutional reforms support economic development. As Meisel and Ould Aoudia (2007) have provocatively put it: “Is ‘good governance’ a good development strategy?”

This is a very controversial subject that inflames passions. It is now clear that institutions matter for growth and economic development. But the question then is: which institutions matter?

Some recent broad reviews of all the evidence linking the good governance agenda to development reach very mixed conclusions. Indeed they suggest that the links between the good governance reform agenda and development are weak. Thus:

(a) The Committee for Development Policy finds that “there is some empirical evidence to suggest that weak governance reinforces poverty” but the relationship between governance and poverty reduction is not yet decisively proven and “in the absence of conclusive evidence, it is plausible to suggest that the link sometimes exists, but that at other times, there is no link” (UNDESA, 2004: 68). This is particularly “in the light of the superior economic performance for some countries that are not ranked very highly with respect to good governance”;

(b) Grindle (2007: 571) argues that whilst cross-country statistical studies “tend to find a strong linkage between governance and development”, “those who focus on the particular conditions of specific countries frequently find reason to question this relationship and put forward arguments that link the impact of governance to those particular conditions”;

(c) Gray (2007: 6–7) states that:

Over the last decade, the gradual accumulation of indicators and research based on them has provided broad support for the arguments and institutions such as property rights, stability, reducing corruption, transparent and accountable public sector, democratic government, rule of law and rent-free markets to achieve sustainable growth in developing countries. A closer look at the debate, however, reveals important areas of contention and significant doubts about the validity of the data and evidence presented so far. Beyond the discussion on data quality and methodologies of measurement another more fundamental debate is also building steam which suggests that other governance criteria, not covered by good governance are in fact the crucial institutions for growth;

(d) Kurtz and Schrank (2007b: 552) conclude that:

The balance of the evidence to date leaves us with two imperfect conclusions. Either we cannot reasonably conclude that improvements in governance produce meaningful increases in the rate of economic growth, or the absence of such an observed connection implies that our conceptualization and measurement of governance is as yet quite imperfect. We remain agnostic as to which (or perhaps both?) is true, but we have sought to make the case that the oft-asserted connection between growth and governance lies on exceedingly shaky foundations.

Kurtz and Schrank regard this as a very dangerous situation because “potentially flawed indicators of governance quality are being utilized by policy makers to condition development aid and to shape development efforts” (ibid: 552).<sup>1</sup>

This literature has resulted in a much greater understanding of the conceptual and technical limitations of indicators that assess the goodness of governance. It

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*Recent broad reviews of all the evidence linking the good governance agenda to development reach very mixed conclusions, suggesting that the links between the two concepts are weak.*

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has been shown that indicators of good governance, such as the World Bank's Worldwide Governance Indicators (WGIs), have a number of serious limitations that need to be taken into account in interpreting results when efforts are made to interrelate governance with various developmental outcomes. Thus, for example, examination of all the potential pair-wise comparisons that can be made amongst the LDCs on the six governance dimensions using the WGI data set shows that 60 per cent of the differences in governance quality between LDCs were too small to be statistically significant (box 1).

### Box 1. Measuring the goodness of governance — some methodological problems

Within recent years there has been an explosion of different types of indicators that seek to measure the quality of governance (see, among others, Landman and Hausermann 2003; UNDESA 2007; UNDP, 2006; World Bank, 2006; Court, Fritz and Gyimah-Boadi, 2007; Kaufmann and Kraay, 2007). These indicators are based on both objective measures and subjective perceptions. Given the complexity of the notion of governance, they are often aggregated into composite indicators, and the technical procedures of what is selected and how they are aggregated into an overall indicator have important effects on determining where a country stands in terms of the goodness of governance and what inference can be made from the data.

This issue can be exemplified by the World Bank's Worldwide Governance Indicators (WGIs). These define governance as the set of "traditions and institutions by which authority in a country is exercised" (Kaufmann, Kraay and Zoido-Lobaton, 1999: 1), and the goodness of governance in each country is measured on three different dimensions, each of which is measured by two indicators, as follows:

- (a) The political dimension of governance refers to the process by which those in authority in a country are selected and replaced:
  - (i) *Voice and Accountability* — measuring the extent to which a country's citizens are able to participate in selecting their Government, as well as freedom of expression, freedom of association, and a free media;
  - (ii) *Political Stability and Absence of Violence* — measuring perceptions of the likelihood that the Government will be destabilized or overthrown by unconstitutional or violent means, including political violence or terrorism;
- (b) The economic dimension of governance refers to the capacity of the Government to formulate and implement policies:
  - (i) *Government Effectiveness* — measuring the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation and the credibility of the Government's commitment to policies;
  - (ii) *Regulatory Quality* — measuring the ability of the Government to formulate and implement sound policies and regulations that permit and promote private sector development. This includes measures of the incidence of market-unfriendly policies such as price controls or inadequate bank supervision, and the perceptions of the burdens imposed by excessive regulation in areas such as foreign trade and business development;
- (c) The institutional dimension of governance deals with the respect of the citizens and the State for institutions that govern interactions among them:
  - (i) *Rule of Law* — measuring the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, the police and the courts, as well as the likelihood of crime and violence;
  - (ii) *Control of Corruption* — measuring the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as "capture" of the State by elites and private interests.

The level of "good governance" is proportional to the country's score, as measured by the given indicator (the higher the indicator's score, the higher the quality of governance).

These indicators have been very influential. But close analysis of their methodological basis suggests that the information that they provide can easily be abused (Arndt and Oman, 2006). Amongst the problems Arndt and Oman note are:

- (a) The aggregation procedure assumes non-correlation between the errors amongst different sources. But there is a high likelihood of correlation of errors in practice among different sources and this means that the regression results on which the aggregation is built is spurious. As they put it: "Significant violations of the assumption of non-correlation of the sources' errors have significant negative implications for the reliability of the indicators" (ibid.: 67);
- (b) The average value of the indicator across all countries, worldwide, is always zero and its standard deviation is also one. As a result of this technical feature, the indicators "cannot reliably be used for monitoring changes in levels of governance over time, whether globally, in individual countries or among specific (e.g. regional groups) of countries (ibid.: 61).



## Box 1 (contd.)

(c) The aggregation procedure brings in a sample bias in the underlying indicators in favour of business surveys and expert assessments.

It is also clear that there is a conceptual bias in terms of a particular role for the State in these indicators. For example, the ability of the Government to formulate and implement sound policies and regulations is assessed through the incidence of market-unfriendly policies such as price controls or inadequate bank supervision, and the perceptions of the burdens imposed by excessive regulation in areas such as foreign trade and business development.

Regarding the comparability issue, the problem of statistically significant margins of error means that the indicators are most reliable if there is a very large difference between countries. Analysis of potential cross-country comparisons amongst LDCs on the six governance dimensions in WGI for 2006 showed that only 40 per cent of 14,700 comparisons were statistically significant. That is to say, 60 per cent of the differences in governance quality amongst LDCs were too small to be statistically significant. These indicators therefore pick up very coarse differences in the quality of governance. Donors must take great care if they use them for aid allocation.

For poor countries such as LDCs, a particular problem with these indicators is that they are not absolute indicators of the goodness of governance but rather relative indicators: they show the goodness of governance relative to other countries. The problem here is that there is close correlation between the indicators and GDP per capita. Thus there is a strong probability that the poorest countries will always rank towards the bottom. Also governance can be improving but this will not show up if other countries are also improving their position.

Leaving aside these technical problems, one critical insight from cross-country statistical analyses is that the quality of governance is closely associated with *levels of per capita income*. That is to say, according to the indicators high income per capita is associated with good governance practices and low income per capita with the absence of good governance practices. This pattern is illustrated with regard to the “government effectiveness” indicator in the WGI data set in chart 5A. The quality of government effectiveness is measured here through assessments of the quality of public services, the quality of the civil service and its degree of independence from political pressures, the quality of policy formulation and implementation and the credibility of the Government’s commitment to policies. As is evident from the chart, the countries with the highest income per capita stand out with the best quality of government effectiveness whilst the countries with the lowest income per capita stand out with the worst quality according to this assessment.

Whilst there is a close relationship between the quality of governance (according to these indicators) and levels of per capita income it is much more difficult to identify a close relationship between the quality of governance and *growth of per capita income over time*. Thus, for example, Knack (2006: 9) finds a statistically significant but weak relationship between the quality of governance and growth, but states that “this finding does not rule out the possibility of mutual causation, or of a ‘halo effect’ by which growth affects expert perceptions of the quality of governance”. Rodrik (2008: 2) is more skeptical, stating that: “I am not aware of any strong econometric evidence that relates standard governance criteria to *growth* (all the evidence is about *income levels*).” This result arises because some countries are growing rapidly even though they do not have “good governance” according to the standard criteria.

In a series of papers, Khan (2004a; 2004b; 2006a; 2006b) has gone even further in specifying the nature of the relationship between governance and the economic performance of developing countries. This work has underlined the point that some features of governance that are not covered in the current good governance institutional reform agenda may be crucial when the developmental efficacy of governance is a central concern. He divides developing countries into those with a good economic performance in the sense that their gross domestic product (GDP) per capita is converging with developed countries and those that have had bad performance in the sense that their GDP per capita growth

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*Cross-country statistical analyses shows that the quality of governance is closely associated with levels of per capita income. Thus the countries with the highest income per capita stand out with the best quality of government effectiveness ...*

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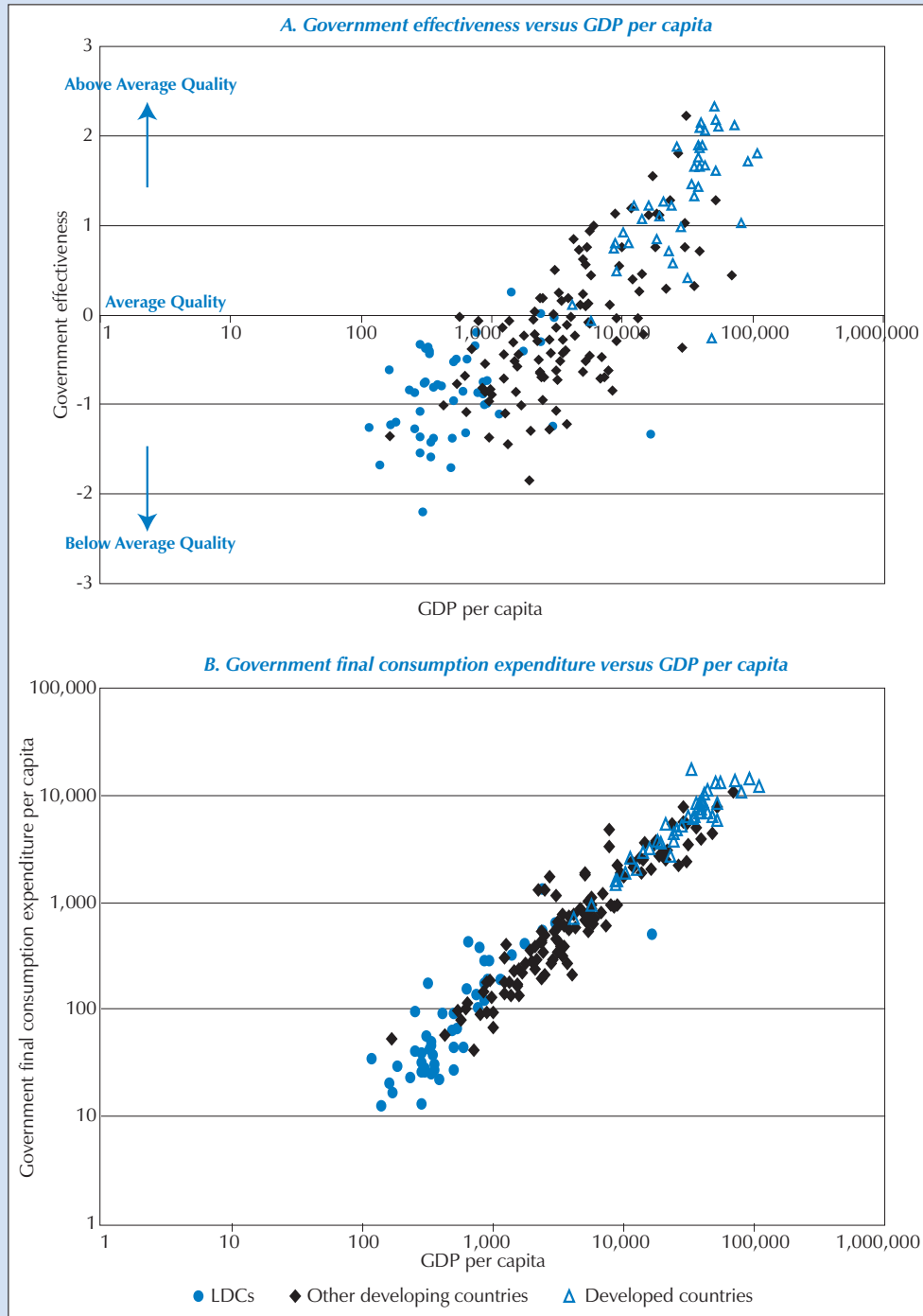
*... but it is much more difficult to identify a close relationship between the quality of governance and growth of per capita income over time.*

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Chart 5

GDP per capita, Government effectiveness and Government final consumption expenditure per capita in LDCs, other developing countries and developed countries in 2006  
(Current \$)



Source: UNCTAD secretariat calculations based on GlobStat, and World Bank, *Worldwide Governance Indicators (WGI) 1996–2007*, online, May 2009.

Notes: Data on GDP per capita and Government final consumption expenditure per capita are in log scale.

- a Government effectiveness represents one of the six dimensions of governance identified in the World Bank *Worldwide Governance Indicators*. It is measured through assessments of the quality of public services, the quality of civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of a Government's commitment to policies.
- b Government final consumption expenditure includes all Government current expenditures for the purchase of goods and services (including compensations for employees).

is slower and they are thus diverging from developed countries in terms of their past economic growth record. Khan then examines differences in their quality of governance according to selected indicators in the WGI data set. He finds that with regard to the control of corruption and the protection of property rights there is actually no significant difference between the converging countries and diverging countries in terms of the quality of their governance. However, he notes that this does not mean that there are no important differences in the governance characteristics between the countries that have performed relatively well and those that have performed relatively badly. Rather, he argues that “the important differences in their governance characteristics are not identified by the good governance analytical framework” (Khan, 2006b: 8).

From this perspective, Khan has identified two potential routes for governance reforms in poor countries. The first route — the good governance institutional reform agenda — is to implement institutional reforms that will transform their institutions into copies of those in advanced countries. The second route is to discover and implement specific governance changes, including both policies and institutions, which enable a country to accelerate its growth rate over an extended period of time and achieve structural transformation. This latter route would undertake governance reforms that are directly geared to transform it from one diverging in per capita terms from developed countries to one experiencing “catching-up” growth. The expectation is that as average income per capita increases the governance practices of the developing country will progressively conform to those in developed countries.

The latter route involves the adoption of a different set of institutional reforms from the good governance reform agenda. In short, these reforms should not simply be supporting markets. Rather, they should be building what Khan calls “growth-promoting governance” (Khan, 2008). This type of governance reform focuses on the effectiveness of institutions for accelerating capital accumulation and the transfer of assets and resources to more productive sectors, accelerating technological learning and maintaining political stability in a context of rapid social transformation. For Khan, such governance reforms involve transforming States that are currently experiencing socio-economic marginalization in the global economy into developmental States. This idea is very similar to the notion of development governance advocated in this chapter, and the possibility of using the developmental State as a model for development governance in LDCs will be taken up later in the chapter.

#### 4. THE PROBLEM OF GOOD GOVERNANCE REFORM OVERLOAD

The developmental impact of the good governance reform agenda is not simply an abstract issue but it is also related to how well the content of the reforms are fitted to the context where they are being implemented. In this regard, an important and problematic feature of the good governance institutional reform agenda is that it demands a complex set of reforms across many institutions. As Grindle (2004: 525–6) argues:

Getting good governance calls for improvements that touch virtually all aspects of the public sector — from institutions that set the rules of the game for economic and political interaction, to decision-making structures that determine priorities among public problems and allocate resources to respond to them, to organizations that manage administrative systems and deliver goods and services to citizens, to human resources that staff government bureaucracies, to the interface of officials and citizens in political and bureaucratic arenas.

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*Some countries are growing rapidly even though they do not have “good governance” according to the standard criteria.*

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*Good governance reforms should not simply be supporting markets. Rather, they should build “growth-promoting governance”.*

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*The good governance institutional reform agenda demands a complex set of reforms across many institutions which has led to reform overload in a number of countries.*

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*Regulatory reform, in which specific agencies are established to provide specific pro-market enabling roles, has often been strongly constrained, reflecting inappropriate transfer of models of regulation from developed to developing countries.*

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Implementing this agenda has led to reform overload in a number of countries. Thus institutional outcomes have diverged from expectations in implementing the good governance agenda on the ground. Brinkerhoff and Goldsmith (2005) have suggested that one tendency has been the emergence of institutional dualism, in which there is a double character to the way that things work, with elements of both the good (formal) governance systems and bad (informal) governance systems interacting. This may involve a tendency for the formal systems to be a façade within which informal practices continue to prevail, or sometimes it could involve a new productive synthesis of practices.<sup>2</sup> However, the reforms themselves are sometimes so ambitious that they can undermine the very possibility of good governance in very poor countries because officials are simply swamped by a constant round of reforms. In effect, the drive to implement an overambitious, unrealistic good governance agenda can in itself be incapacitating.

There is no comprehensive survey of how good governance reforms are working in practice in the LDCs. However, the experience of public administration reforms, even basic ones, implemented in some African LDCs has generally been very mixed so far (box 2). There have been particular weaknesses with reforms associated with the NPM. Performance enhancement reforms, which are central to NPM, have often failed in these countries because the basics — predictable multi-year funding, reliable measures of performance, rewards sufficiently large to make a difference and credible commitments to reward actual performance and not patronage — are not in place. It has also been noted that Performance Improvement Funds, which have been strongly promoted by donors, are “building without foundation” (Stevens and Teggemann, 2004: 70). Similarly, regulatory reform, in which specific agencies are established to provide specific pro-market enabling roles, has often been strongly constrained. This, it is argued, reflects an inappropriate transfer of models of regulation from developed to developing countries, with insufficient sensitivity to context (Therkildsen, 2008).

#### **Box 2. Public sector reforms in LDCs: some lessons from experience in African LDCs**

Two distinct waves of public sector reforms have occurred during the past twenty-five years. First generation reforms focused on redefining the roles of the public sector, reducing its size, bringing order to inappropriate structures in public organizations and their mandates, and controlling the activities of public sector workers through retrenchments, pay reform and payroll control. Second generation reforms started around the mid-1990s and were much broader in scope than the first generation reforms. Recent reforms seek to improve Government performance by building managerial capacities, developing positive organizational cultures and providing incentives for performance at the individual, organizational and country levels.

The World Bank supported the following types of initiatives: (a) pay reform, but shifting from across-the-board attempts to decompress and raise salaries towards more strategic increases for selected groups of staff ; (b) a renewed effort to focus Government on its “core” functions — law and order, regulation of the private sector, economic management and the provision of social services — to “reverse the relentless expansion” of programmes during the era of the developmental State; (c) creating executive agencies to enhance performance for specific functions; (d) pushing service delivery down to the local level — decentralization; (e) specific performance enhancing measures directed at ministries, local Governments and executive agencies; and (f) efforts to modernize budget and financial management and to strengthen audit institutions. New forms of State organization have emerged, inspired by the new public management and good governance. These include public–private partnerships in infrastructure development, (partial) privatizations of utilities and performance contracting arrangements between purchasers and providers. A particularly notable but underresearched trend in African LDCs has been the creation of many semi-autonomous executive agencies.

Reviewing major elements of this experience in African LDCs, particularly Uganda and the United Republic of Tanzania, Therkildsen draws the following lessons:

*Pay reform:* adequate pay is essential for the motivation, performance and integrity of public officials but pay reform has been conducted within an “iron triangle” of conflicting priorities: the size of the public sector, pay levels and budgetary wage limits. The latter have predominated. Uganda and the United Republic of Tanzania succeeded in improving pay in periods in the 1990s and early 2000s, but in Benin, Burkina Faso, Senegal and Zambia the civil service has experienced long-term pay deteriorations. The general situation is one in which average real pay is lower than at independence, even

## Box 2 (contd.)

in countries where it has improved recently. Recent efforts are focusing on Selective Accelerated Salary Enhancement, which aims to raise the salaries of key technical and professional staff, but the economic and political sustainability of these measures remains doubtful. Allowances are increasingly used and middle-level public servants interviewed in 2006 in Uganda and the United Republic of Tanzania said that these were as or more important for their take-home pay than salaries.

*Human resources management reform:* in the 1980s and 1990s, human resource management reforms were dominated by attempts to increase pay to correspond to “living wages” and to fund the reduction of public sector employment. Employment reductions were politically resisted, costly, often hastily implemented and generally unsuccessful. Experiences from Uganda show that where pay increases were made they were financed by increased tax revenue generated by economic growth and better tax collection rather than savings from retrenchment. More attention is now paid to reforming personnel management systems. There has been a shift from an old career system towards a position-based system in which merit is related to the specific position. There is also a move towards performance management with managers and staff working towards performance targets and output objectives that define individual tasks. Thus in Uganda and the United Republic of Tanzania there has been a push for strategic plans, action plans, client service charters, carrying out of service delivery surveys and self-assessments, staff appraisals and the establishment of results-oriented monitoring and evaluation systems. These are very ambitious undertakings and it is difficult to assess the outcomes of these systems where they have been introduced. The available studies indicate that progress has been slow. The conditions for introducing performance management are generally not in place and until basic administrative and budgetary requirements exist, such NPM-inspired reforms will not work well.

*Performance-enhancement reforms:* the United Republic of Tanzania and Zambia have experimented with performance improvement funds (PIFs) to encourage willingness to adopt new ways of doing things and also success in meeting performance targets. However, once again this model seems to be “building without foundations” (Stevens and Teggermann, 2004: 70). If incentives for performance are limited, uncertain and/or transaction cost-intensive then PIFs are unlikely to succeed. If, on the other hand, incentives are substantial and predictable and given without too many strings attached, then strong administrative capacities are needed to utilize them efficiently.

*Regulatory reforms:* systematic evidence of what works and does not work in terms of regulatory reform in poor countries is scarce. But it is clear that regulatory agencies need substantial capacity to meet their pro-market regulatory and enabling roles. Market conditions and incentives must be understood and assessed continuously, information must be collected and analyzed to help to make appropriate regulatory decisions, and there must be some arms’ length distance to and protection from political and business self-interests. Batley and Larbi (2004) found that business support services were most responsive to business needs when there was some degree of autonomy from the Government, some resource dependency on the firms to be supported (payment for services) and some institutional relations such as representation on boards.

*Executive agency reforms:* executive agencies are semi-autonomous contracting units that operate to achieve particular objectives under administrative accountability mechanisms. Such an agency can potentially recruit and offer appropriate incentives to qualified professionals. However, effective government management is needed to hold the agencies accountable to deliver the required services. Executive agencies have typically been established through the conversion of Government departments, previously operating in a hierarchical civil service, into semi-autonomous contracting units operating under administrative accountability mechanisms. This has been occurring in English-speaking African countries in particular. In the United Republic of Tanzania, 20 agencies were established in 2004 and more since. Uganda has around 75 agencies. Zambia has 40 agencies established by an act of Parliament. Examples of well-performing agencies are found in all countries, particularly when they have access to private finance. However, literature reviews suggest that performance has been mixed and there have been difficulties to hold agencies to account.

Source: Therkildsen (2008).

A particular constraint on the introduction of good governance institutions typical of advanced countries into LDCs is that the financial resource base of LDCs is very weak. Chart 5B shows the relationship between average government final consumption expenditure per capita and average GDP per capita for all countries in the world for which there are data in 2006. Government final consumption expenditure per capita covers all government current expenditures for purchases of goods and services (including compensation of employees). It is clear from the chart that there is a very close relationship between the ability of countries to finance governance and their GDP per capita. Moreover, the relationship between average government final consumption per capita and GDP per capita closely follows the relationship between government effectiveness as indicated by the good governance indicator and GDP per capita (chart 5A).

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*A constraint on the introduction of good governance institutions of advanced countries into LDCs is that the financial resource base of LDCs is very weak.*

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The average government final consumption per capita in LDCs in 2006 was just \$60 per capita, compared with \$295 per capita in lower-middle-income countries, \$1,051 per capita in upper-middle-income countries and \$6,561 per capita in high-income countries. The central question is: how can the institutions of advanced countries be expected to work in LDCs with this very low level of government expenditure per capita?

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*The average government final consumption per capita in LDCs in 2006 was just \$60 per capita, compared with \$295 per capita in lower-middle-income countries, \$1,051 per capita in upper-middle-income countries and \$6,561 per capita in high-income countries.*

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Khan (2008) argues that the structural weaknesses of LDCs are such that an attempt to implement the ambitious institutional changes of the good governance reform agenda is simply doomed to failure. Thus, he suggests that the tax base for protecting all property rights as a public good simply does not exist in most poor developing countries. Most assets are in low-productivity sectors with production organized through households, such as in peasant agriculture or the informal sector. These assets generate an insignificant surplus that is insufficient to pay for their protection either through taxation or the purchase of private security. Similarly, electoral democracy in LDCs remains fragile because conflicts over resources are intense. Fiscal constraints often mean that it is difficult to deliver public goods to everyone and political stability then depends on the ability of the political system to deliver to powerful factions through networks of patron–client relations.

This does not mean that the values embodied in the good governance reform agenda are inappropriate for LDCs. However, it does imply that the specific content of the institutional reforms to achieve those values should be more realistically calibrated to country circumstances and developed over time.

The rest of this chapter examines how it may be possible to inject a more explicit development dimension into governance practices. It focuses in particular on governance practices within the developmental State. It considers what governance practices made some developmental States more successful than others and how the governance practices of developmental States need to be adapted to play a key role in economic development and social transformation in the twenty-first century. In discussing the former issue, particular attention is paid to East Asian models, but the discussion of the latter issue draws on a broader range of models, including Nordic models and Ireland, as examples of developmental States. Just as with the good governance reform agenda, it is clear that LDCs cannot simply transplant institutions from other countries and expect success. Attention will thus also be given (in section E) to the issue of building developmental State capabilities in LDCs.

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*The specific content of governance reforms should be more realistically calibrated to country circumstances and developed over time.*

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### **C. What makes some developmental States more successful than others**

Like good governance, the concept of the developmental State has been conceptualized and defined in different ways by different people (box 3). A particular problem, as Mkandawire (2001: 291) argues, is that there is a danger that the developmental State is “deified into some kind of omnipotent and omniscient leviathan that always gets its way”. This arises because a State is defined as developmental if the economy is developing, economic success is equated to State strength, and the latter is measured by the presumed outcomes of policy.

It is possible to avoid this tautological view, in which outcomes are used as explanations of the phenomenon in question, by recognizing that the Governments in developmental States are certainly developmentalist in their vision, their priorities and their ideology, but they may fail to achieve their objectives. From



### Box 3. Different types of State: developmental States, regulatory States and enabling States

#### Developmental States

The idea of the developmental State has been applied in a number of contexts, including Latin America (Cardoso and Falletto, 1979; Schneider, 1999) and the late industrializing European countries such as Austria and Finland (Vartiainen, 1999). However, the original impetus to analyze the theory and practice of developmental States came from the work of Chalmers Johnson on Japan (Johnson, 1982) and the subsequent application of the concept as part of the explanation of East Asian development (Woo-Cummings, 1999; Johnson, 1999). Johnson distinguished between socialist developmental States, such as the Soviet Union before the fall of Communism, and capitalist developmental States which he found in East Asia. He defined the latter as existing when: “(i) there is a developmentally-oriented political elite committed to break out of the stagnation of dependency and underdevelopment and for whom economic growth is a fundamental goal, (ii) such an elite is not committed first and foremost to the enhancement and perpetuation of its own elite privileges, and (iii) the elite sees its primary leadership task to discover how, organizationally to make its own development goals compatible with the market mechanism and the private pursuit of profit” (Johnson, 1987: 140).

Generalizing from this work, different authors have defined the concept in different ways but all emphasize the Government’s commitment to developmentalism and the translation of this commitment into policies and institutions designed to achieve national economic development. Thus:

- (a) Fritz and Menocal (2007: 533) understand a developmental State to exist “when the state possesses the vision, leadership and capacity to bring about a positive transformation of society within a condensed period of time”;
- (b) Bagchi (2000: 398) defines a developmental State as “a state that puts economic development as the top priority of government policy and is able to design effective instruments to promote such a goal”;
- (c) Chang (1999: 183, 192) defines a developmental State as “a state which can create and regulate the economic and political relationships which support sustained industrialization. ... This State takes the goals of long-term growth and structural change seriously, ‘politically’ manages the economy to ease the conflicts inevitable during the process of such change (but with a firm eye on the long-term goals), and engages in institutional adaptation and innovation to achieve these goals.”

One important insight from Johnson’s work is that the activities of the developmental State, which involve harnessing the energies of the private sector for private economic development, comprise a complex task in which the Government may constantly be threatened with failure. It is wrong to deify the developmental State into “some kind of omnipotent and omniscient leviathan that always gets its way” (Mkandawire, 2001: 291).

Within this Report, the developmental State is therefore understood, following Mkandawire (2001), as a State whose ideological underpinnings are developmental and one that seriously attempts to deploy its administrative and political resources to the task of economic development.

#### Regulatory States and enabling States

The understanding of the idea of the developmental State can be sharpened by contrasting it with two other types of State currently discussed in policy analysis — the regulatory State and the enabling State.

In his initial work, Johnson distinguished between the developmental and regulatory State, and he noted that the latter differs from the developmental State in that its fundamental role is not to shape outcomes but rather to provide regulatory frameworks, i.e., to set the rules of the game. Regulation is the central role of the regulatory State. On top of this, the regulatory State has been closely associated with privatization and the subsequent need to correct the market failures caused by monopoly suppliers, to create competitive markets and to achieve public service objectives that cannot be delivered by market mechanisms. Typically, the emergence of the regulatory State is marked by the creation of new and autonomous regulatory institutions, such as independent central banks. The main role of the State is not to regulate but to set up the regulatory agencies and oversee these agencies. For this reason, the regulatory State is associated with an increasingly technocratic and juridical approach to economic governance and a “depoliticization” of economic management (Phillips, 2006; Minogue and Carino, 2006).

Regulation is certainly one policy mechanism of the developmental State. But it would be too restrictive to confine the policy mechanisms of the developmental State to regulation. Moreover, it is particularly restrictive in light of the important role of the developmental State to act in an entrepreneurial manner to nurture new activities (for example, Lazonick, 2008).

Another type of State that is talked about is the enabling State. This concept is particularly related in the literature to the transformation of the welfare State in rich countries. Taylor (2008) writes that “the notion of the enabling State gained currency in the [United Kingdom] in the 1990s as an alternative to the providing or welfare State. It reflected the process of contracting out in the [National Health Service] and compulsory competitive tendering in local Government in the 1980s, but was also associated with developments in the 1990s in health, social care and education in particular.” These developments were particularly focused on the creation of an internal market in the National Health Service and attempts were made to provide users with more opportunity to influence provision. Similarly, Gilbert (2005: 6) affirms that the enabling State is a State “whose role is to provide social protection through public support for private responsibility”.



## Box 3 (contd.)

This involves in particular the shifting of responsibility for social protection that aims to limit the direct role of the State and to increase private activity in the financing and delivery of social benefits. With these associations, it is clear that the notion of the enabling State is an inappropriate substitute for the developmental State.

Page and Wright (2008: 4) associate the enabling State with a particular modality of governance in which the main role of the State is “enabling other organizations — whether private, voluntary, semi-public, regional and local Government or judicial bodies or arm’s length government agencies — to provide services and to exercise hands on control over the application of regulation”. In the enabling State, senior officials become network managers rather than wielders of authority and there is a move from the direct application of hierarchical authority through Government to the mobilization of networks through governance.

As with regulation, such a mode of governance can certainly be an element of the practice of developmental States. Indeed, an argument later in this chapter is that these modern forms of network governance need to be adopted as a key element of the new developmental State. But reducing the policy mechanisms of developmental States only to such enabling forms of action would be unnecessarily restrictive.

The concept of the developmental State is thus more encompassing as a basis for reconsidering the role of the State. Neither the regulatory State nor the enabling State can capture the entrepreneurial nature of the developmental State or its commitment to structural transformation as a means to provide employment for people and improve their living standards.

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*A developmental State is defined as “a state that puts economic development as the top priority of government policy and seeks to design policies and institutions to promote this goal”.*

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*There are a wide range of developmental States. A central issue is what makes one type more successful than others.*

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this perspective a developmental State is defined in this chapter as “a state that puts economic development as the top priority of government policy and seeks to design policies and institutions to promote this goal” (Mkandawire, 2001: 291). With this definition, it is not assumed that that the developmental State inevitably achieves developmental outcomes, but rather that there is a constant commitment, effort and orientation to achieve developmental outcomes. This is a very complex process that requires policy experimentation, policy learning and institutional adaptation and innovation. Thus in developmental States, policies and institutions are constantly evolving and being adapted to new external circumstances and changes in internal structures, and policy-makers are always in danger of failing.

With this broad definition, there are a wide range of developmental States. These include the successful East Asian developmental States, notably the initial four Asian tigers — Hong Kong (China), the Republic of Korea, Singapore and Taiwan Province of China — and also more recent successes — Malaysia, Thailand and Viet Nam — as well as China. But beyond this, there are socialist developmental States such as the Soviet Union before the fall of communism (Johnson, 1982), the developmentalist States of Latin America in the 1940s and 1950s (Cardoso and Falletto, 1979; Schneider, 1999), late industrializing European countries such as Austria and Finland (Vartiainen, 1999) and early post-colonial African developmental States and also the democratic developmental States of Botswana and Mauritius (Mkandawire, 2001).

The central issue that then arises is what makes some developmental States more successful than others. Various possible conditions for success have been identified in the literature. These include firstly, initial conditions — most notably, the length of experience a country has in terms of its manufacturing experience (Amsden, 2001); secondly, international economic relations, including the existence of policy space (Chang, 2008b) and supportive political allies in rich countries (Cumings, 1987); and thirdly, political prerequisites, in particular cohesive rather than fragmented multiclass States (Kohli, 2004). However, a critical factor that has distinguished more successful from less successful developmental States has been the nature of development governance.

The rest of this section identifies key features of development governance in successful developmental States. It discusses both policies (what Governments did) and also institutions (how they did it), as both areas are important aspects of good development governance. The section draws in particular on the experience

of development governance in successful developmental States in East Asia, as these have been studied the most and UNCTAD has made a particularly strong contribution in this area.

### 1. WHAT GOVERNMENTS DID<sup>3</sup>

In the successful developmental States of East Asia, policies were production-focused. They sought to develop the productive capacities of a country with a view to expanding employment opportunities and labour productivity, thereby increasing living standards. In all successful cases, except the city States, policies have encouraged structural transformation, a process in which the relative importance of agriculture and primary commodity extraction has declined within the economy while that of manufacturing industries has increased, and in which production processes have progressed from less to more skill-, technology- and capital-intensive activities. At the macro level, structural transformation has been driven and facilitated by a rapid pace of capital accumulation that depends on increased domestic savings, investment and exports (both in absolute terms and as a share of GDP), linked together in a virtuous circle of cumulative causation. At the enterprise level, this process is founded on imitation, learning and adaptation of internationally available technologies in order to reduce costs, improve quality and introduce goods and services not existing in a country, and on the diffusion of best practices from more advanced to less advanced enterprises within a country, including from foreign owned to locally owned firms (Gore, 2000).

An important aspect of policies to develop productive capacities is that they did not simply involve macroeconomic policy or getting the overall investment climate right (a framework approach). Instead they involved a combination of macroeconomic, mesoeconomic and microeconomic policies. Thus economic governance invariably involved the adoption of some form of industrial policy or what ECLAC has more generally called productive development policy (ECLAC, 1996; 2004). This includes a range of measures, coordinated with macroeconomic and trade policies, designed to improve the supply capabilities of the economy as a whole and also specific sectors, and to help the private sector to identify and acquire competitive advantage. These measures, which evolved over time as the economy developed, were founded on a dynamic interpretation of comparative advantage. In this forward-looking approach, the opportunities of current relative cost advantages are exploited to the full, but efforts are made at the same time to promote investment and learning in economic activities where comparative advantage can be realistically expected to lie in the immediate future as the economy develops and as other late industrializing counties catch up.

Successful developmental States managed their integration into the world economy. This involved neither de-linking and closing the economy to the rest of the world, nor cross-the-board opening up of the economy to imports and external capital. Rather there was a process of strategic integration with the rest of the world, in which the timing, speed and sequencing of opening in relation to different types of international flows was decided on the basis of how they support the national interest in promoting economic growth and structural change.

Finally, successful developmental States also paid attention to distributional issues to ensure that the dynamic benefits of growth were socially acceptable. This was achieved through a production-oriented approach rather than redistributive transfers. Thus, a significant fact about successful developmental States is that they are not high “tax and spend” countries (Sindzingre, 2007). The main bases for a more equitable growth process were wide asset ownership, including though land reform and investment and education, and the expansion of productive

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*In the successful developmental States of East Asia, policies sought to develop the productive capacities, expanding employment opportunities, stimulating structural transformation and increasing living standards.*

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*Policies to develop productive capacities involved a combination of macroeconomic, mesoeconomic and microeconomic policies. Thus economic governance invariably involved the adoption of some form of industrial policy.*

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*Successful developmental States decided the timing, speed and sequencing of opening on the basis of how they support the national interest in promoting economic growth and structural change.*

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employment, as well as a business elite committed to investment rather than conspicuous and luxury consumption.

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*Successful developmental States also paid attention to distributional issues to ensure that the dynamic benefits of growth were socially acceptable.*

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*In successful developmental States, market failures have been understood in relation to the ability of the market mechanism to achieve the goals set by the Government.*

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*The possibility of Government failure does not foreclose public action. Rather it points to the need to build up the organizational and institutional capabilities of governance required for the implementation of a national development vision.*

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## 2. HOW GOVERNMENTS DID IT: THE ROLE OF THE STATE AND THE MARKET

Successful developmental States were based on a mixed economy model in which the Government worked in partnership with the private sector to achieve national development goals. This did not mean that public ownership was avoided in successful developmental States. Indeed it is an often ignored fact that some of the successful East Asian newly industrializing economies (the Republic of Korea, Singapore and Taiwan Province of China) made use of public ownership (Chang, 2008a). However, the commitment to public ownership in successful developmental States was pragmatic (i.e., does it contribute to the national economic development goals?) rather than ideological. Moreover, the major function of the State was not seen as being to replace the private sector but rather to design policies and institutions that harness private ownership, the animal spirits of entrepreneurs and the drive for profits, to achieve national development goals.

Whilst the idea of market failure has been important within successful developmental States, there is a different understanding of this concept than in mainstream economic theory. In the latter context, market failure is defined as occurring when the market economy fails to allocate resources efficiently, which is understood as a deviation from the general equilibrium that is expected in perfectly competitive markets.<sup>4</sup> But in successful developmental States, market failures have not been understood in this way but rather in relation to the ability of the market mechanism to achieve the goals set by the Government. For example, Kato et al. (1993: 28) defines market failures as arising “when the goods and services deemed necessary by society cannot be easily or adequately provided through the dependence on only the free economic activities of private sectors motivated by private profit”.

This developmentalist view of market failure has, in successful developmental States, also been embedded within a broader notion of system failure, which arises when the economic system as a whole fails to achieve the developmental goals set by the Government. This view rests on the fact that development depends on market institutions and non-market institutions. Market institutions in a capitalist system include the firm as the basic institution of production, but also various producer and consumer groupings such as conglomerations of firms, producer associations, trade unions, purchasing cooperatives and subcontracting networks (Chang, 2003a). The idea of systems failure is particularly important in developing economies at the early stages of development because, as Yanagihara (1997: 11) puts it, markets actually “are created and developed through an interactive process of decision-making and action-taking by economic agents in an attempt to establish and reform interrelationships among them”. This means that development efforts cannot be limited to “freeing markets”; rather an important role of Government should be to create and develop the capabilities of non-market institutions and promote the relationships between them so that markets are created and develop.

The notion that the problem that must be tackled is the failure of the whole economic system also brings government failure into the picture, as the Government is a key institution in the system. As Yanagihara (1997: 22) states:

The overall role of the Government is to facilitate the evolution of the economic system so that goals of economic development could be achieved.

... At a most general level government failures may be defined in relation to the attainment of this task. The extent to which the Government will be able to carry out this task will hinge on its own organizational/institutional capabilities. In cases of serious government failure the Government itself may turn into the source of system failure.

But from the systems failure perspective, the possibility of government failure does not foreclose public action. Rather it points to the need to build up the organizational and institutional capabilities of governance required for the implementation of a national development vision and facilitation of the development process.

### 3. HOW GOVERNMENTS DID IT: FUNCTIONS OF THE STATE

Against this background, in which the Government is working with a mixed economy model in partnership with the private sector, it is possible to identify four major functions of successful developmental States: (a) providing a vision; (b) supporting the development of the institutional and organizational capabilities of the economic system, including the Government's own capabilities; (c) coordinating economic activities to ensure the co-evolution of different sectors and different parts of the economic system; and (d) managing conflicts.

Providing a vision for the future of the economy is the most basic function of the State. The five-year development plan has been an important mechanism for this. It represents an indicative forecast of where the economy should and can develop and also provides basic guidelines that shape the expectations underlying household and business decisions. But as well as this general vision, more specific visions may be drawn up for the various sectors. The importance of such visions is that they lead "private sector agents into a concerted action without making them spend resources on information gathering and processing, bargaining and so on" (Chang, 2003b: 53). In providing the vision the State is acting like an entrepreneur and its vision may well be wrong. But what is necessary is not to dismiss State entrepreneurship as risky but to minimize the risk of promoting the wrong vision by "building a mechanism that will enable the State to put together and prepare different visions that exist in society and to create a consensus out of them" (ibid.: 54).

Realizing the vision requires policy and institutional innovation. Because it is through the private sector that the vision is realized, a second central role of the State is to strengthen the capabilities of economic agents. This is not simply a matter of strengthening capabilities at the firm level but also of deepening inter-firm relationships and networks.

The third essential role is coordination. This is essential as factors of production are "interdependent in use but dispersed in ownership" (Abramovitz, 1986: 402) and there are also many complementarities between investments such that one investment alone is unprofitable whilst a cluster of related investments can be profitable. There is also a need to ensure the co-evolution of different parts of an economic system so that supply bottlenecks (for example, caused by underinvestment in infrastructure), resource scarcities (such as particular types of human capital) or institutional scarcities (such as technology centres) do not arise.

Finally, a critical role of the State is conflict management. The societal transformation involved in structural transformation is massive and there are inevitable social conflicts as different people gain and others lose in the "creative destruction" of activities and institutions. Conflict management involves ensuring

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*The four major functions of successful developmental States are: (a) providing a vision; (b) supporting the development of the institutional and organizational capabilities; (c) coordinating economic activities; and (d) managing conflicts.*

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*Realizing a vision requires policy and institutional innovation. Because it is through the private sector that the vision is realized, a central role of the State is to strengthen the capabilities of economic agents.*

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*Coordination is essential as factors of production are interdependent in use but dispersed in ownership.*

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that the benefits, or expected benefits, of the transformation are widely shared. This is necessary for economic dynamism, but at the same time it is important that methods of conflict management do not have adverse effects on efficiency and productivity.

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*Governance in successful developmental States was founded on technically competent bureaucracies.*

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#### 4. HOW GOVERNMENTS DID IT: INSTITUTIONAL CAPABILITIES

An important lesson from governance in successful developmental States is that it was founded on technically competent bureaucracies. Investment in higher education was vital for this. But coherent governance for development was typically achieved through the establishment of a pilot agency that shaped development initiatives. Examples are the Ministry of International Trade and Industry in Japan, the Economic Planning Board in the Republic of Korea, the Economic Planning Board in Singapore and the Council on Economic Planning and Development in Taiwan Province of China.

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*The economic bureaucracy established close Government–business ties to enable the implementation of policies that supported the needs and general interests of business.*

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In successful developmental States, the economic bureaucracy also established close Government–business ties to enable the formulation and implementation of policies that supported the needs and general interests of business. This was not a situation in which bureaucrats worked in their own world, with textbook economic models or with donor blueprints. Rather as Evans (1998: 76) has put it: “Effective Government–business relations depended on large volumes of high quality information flowing between Government and corporations and on mutual confidence that predictions and commitments were credible. Neither could be generated by exchanging position papers and publicity releases.” A variety of institutional forms enabled effective information flows between Government and business, with Japan’s Deliberation Councils as an archetype in East Asia. Often, they were designed at the sectoral level.

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*A critical feature of successful developmental States is that incentives and resources that Governments provided to private sector activities were contingent upon performance.*

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A further critical feature of successful developmental States is that incentives and resources that Governments provided to animate and guide private sector activities were contingent upon performance (Amsden, 2001). Thus, for example, access to cheap credit depended on investment in new machinery, or access to duty-free imports was tied to 100 per cent exporting. The results-oriented performance standards adopted were particularly related to production and trade objectives that could be monitored at the firm level. Other important features of government support were that it often involved contests or competition amongst firms, and that it was time-limited. This was a way of reducing misuse and guarding against capture. For example, firms would compete for technology licenses that would give them exclusive access to the domestic market for, e.g., a five-year period. Another mechanism of ensuring effective use of government support was that firms were gradually made subject to the discipline of competition through international markets.

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*The incentives and resources provided by Government included the creation of rents for inducing new investments and innovative activity.*

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The incentives and resources provided by Government included the creation of rents. That is, policies were devised to ensure that private companies would secure profits above normal market conditions. Such rents were particularly important for inducing new investments and innovative activity. The management of rent-seeking was thus an essential part of governance in successful developmental States. In this model, rent-seeking was not in itself bad. But the key governance issue was to ensure that rents were derived through activities that had social as well as private returns and that the rents, when earned as profits, were reused in a way that supported national development.

Finally, a key feature of successful developmental States was that they designed a bank-based financial system that ensured that long-term finance was available



for productive investment by the private sector. This often involved either quite strong administrative guidance by the Government or State ownership of key financial institutions.

## D. Adapting the developmental State to the twenty-first century

These lessons about development governance in successful developmental States are drawn from the experience of developmental States from the 1960s to the 1990s. An important recent area of thinking has been to consider how the developmental State can be adapted so that it can continue to play a key role in economic development and social transformation in the twenty-first century. This draws upon a broader range of models than East Asian developmental success, including Nordic models and Ireland, the “Celtic Tiger”.

It is possible to identify six major types of adaptation that would constitute features of a forward-looking developmental State:

- (a) Giving greater emphasis to the role of knowledge in processes of growth and development. This is because “growth is driven more by ideas and information (both as a means of production and objects of consumption) than by the physical transformation of nature” and “profits increasingly depend on intangible assets (ideas, brand, images) and the protection of those assets through intellectual property rights” (Evans, 2008). This directs attention to the important role of knowledge systems and national innovation systems, alongside financial systems, as critical institutional complexes in the development process;
- (b) Considering how to shift from economic activities that are characterized by decreasing returns to those characterized by increasing returns (Reinert, 2007). This would promote economic growth and structural transformation through a type of diversification that does not solely rely on the expansion of manufacturing industries. In this regard, more attention may be given to services (Evans, 2008);
- (c) Exploring how to make better use of the opportunities of interaction between domestic and foreign capital by increasing the developmental impact of foreign direct investment (FDI) and upgrading through links with global value chains. This was particularly important for Ireland (O’Riain, 2000);
- (d) Adopting a regional approach to developmentalism that increases policy space and exploits the potential for joint action to create the conditions for structural transformation (UNCTAD, 2007);
- (e) Building democratic rather than authoritarian developmental States (Robinson and White, 1998; Kozul-Wright and Rayment, 2007); and
- (f) Drawing on new thinking about modern governance approaches that focus on new forms of interaction between Government and society and between the public and private sectors, and the associated diversification of policy mechanisms and policy instruments to apply this to the task of governance for development.

Some of these issues — notably the increasing importance of knowledge, the interaction of domestic and foreign capital and the potential of increasing returns through activities other than manufacturing industry – will be taken up later in this Report (in particular, chapter 4). However, the rest of this section looks at some

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*In the 21st century, the developmental State should give greater emphasis to the role of knowledge in processes of growth and development...*

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*... and it should make better use of the opportunities of interaction between domestic and foreign capital by increasing the developmental impact of FDI and upgrading through links with global value chains.*

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recent thinking on the democratic developmental State and modern governance practices that involve new forms of public sector/private sector interactions.

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*Democratic deliberation is critically important to build societal consensus around a national development project and to develop effective policies and institutions.*

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*In successful developmental States the ideological commitment to development is not simply held by a small cadre of political leaders and bureaucrats, but more widely shared in society.*

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*A democratic developmental State is one that not only embodies the principles of electoral democracy but also ensures citizens' participation in the development and governance process.*

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## 1. THE DEMOCRATIC DEVELOPMENTAL STATE

In recent discussions of the new developmental State, an important concept to emerge is the notion of the democratic developmental State. This idea is important because one principal objection to the desirability of the developmental State model is that many of the successful cases have had authoritarian regimes. Thus, some have admired the ability of the autocratic developmental State to deliver developmental results whilst regretting the price involved in terms of loss of democratic freedom, considering the latter too high (Kohli, 2004). Moreover, in the wake of the wave of democratization that has occurred since the early 1990s, in which the LDCs have certainly participated (UN-OHRLS/UNDP, 2006), the idea of the authoritarian developmental State has much less societal support. In this new context, the potential for building democratic developmental States, and the nature of the democratic developmental State, are the key issues.

The relationship between democracy and development is a very complex issue.<sup>5</sup> From those thinking about the nature of democratic developmental States, two key insights are noteworthy.

Firstly, it has been observed that electoral democracy with competitive political parties has yet to play an important role in fostering democratic developmental States. Randall (2007: 633) writes that “on the available evidence, parties make a very limited contribution to the emergence of new democratic developmental States, in terms of either democracy-building or policy-making, recruitment, ensuring accountability or policy implementation”. She argues that this is due to weak institutionalization and the prevalence of “clientelism”. However, it has also been noted that within some democracies with hegemonic and quasi-single ruling parties, these parties have sometimes played a significant developmental role. An example is the Botswana Democratic Party. In some cases, what has worked is that there is a single dominant party but there is frequent renewal of the leadership and elected representatives through the democratic process.

Secondly, it is clear that democratic deliberation is critically important to build societal consensus around a national development project and also to develop effective policies and institutions in what is necessarily an open-ended and uncertain development process. Kozul-Wright and Rayment (2007: 258) argue that democratization helps because “problem-solving involves experimentation, processes of trial and error, tolerance and encouragement of open criticism and willingness, or at least incentives, for Government to change direction as a result of that criticism”. But there is a need to promote “thicker” forms of democratic decision-making than simply holding regular elections. This means greater emphasis on deliberative democratic approaches in which people and their organizations interact to solve common problems and create new opportunities. Kozul-Wright and Rayment (2007: 260) argue that “by strengthening the local and micro-foundations of democracy, Governments can be helped to design more effective strategies for reform and to build a broad coalition for societal change”. It is through this mechanism that it is possible to deploy local knowledge and local interests to ensure that policies are contextually appropriate. From this perspective, it has been argued that “a democratic developmental State is one that not only embodies the principles of electoral democracy but also ensures citizens' participation in the development and governance process” (Edigheji, 2005: 5).

The most basic insight of recent thinking on democratic developmental States is therefore not that there should be a commitment to a particular type of democratization but rather to harnessing citizens' participation in governance for development purposes. Looking to the past it is clear that a feature of successful developmental States has been that the ideological commitment to development is not simply held by a small cadre of developmentally determined political leaders and bureaucrats but is also more widely shared in society. A national developmental vision is particularly effective when it becomes a shared national project and there is a societal mobilization behind the goals of this project. To the extent that a particular form of democratization supports this, both society-wide and in the local identification of development problems and development opportunities, democratization can make the developmental State more effective. But to the extent that the form of democratization undermines societal cohesion behind a shared development project, it will detract from this effectiveness.<sup>6</sup>

## 2. MODERN GOVERNANCE FOR DEVELOPMENT

A second area that is relevant to the new developmental State is the application of modern forms of governance to the task of development. From the earlier discussion, it is clear that successful developmental States in the past did not use simple top-down control but rather worked through public-private partnerships of various kinds. In recent years there has been much greater thinking and analysis on how such an approach to governance can work (for example, Kooiman, 1993; Rhodes, 1996; Peters and Pierre, 1998; Pierre, 2000). This thinking and analysis has been conducted in literature on the nature of modern governance and what it means for what Governments do. There is much scope now for application of these new ideas about modern governance to the task of development, and this can provide further ideas for the new developmental State.

The basic insight of the modern governance approach is that Governments cannot resolve societal problems or create societal opportunities alone, but that governing is rather a matter for both public and private actors, and in particular interactions between and amongst them. This changing role of Government is related to "the development of governing styles in which boundaries between and within public and private sectors have become blurred" (Stoker, 1998: 17). One elegant and much quoted metaphor to describe this shift is to say that the principal feature of emerging forms of governance is that Governments are giving up "rowing" (through direct service provision and State owned enterprises), which will now be undertaken by private sector actors and local communities, and focusing on "steering" (leading, thinking and guiding) — Osborne and Gaebler (1992). Kooimann (1993: 34) conceptualizes the shift as "away from 'one-way steering and control' to 'two-way or multi-way designs' in which people in a variety of roles and circumstances are engaged in mutual problem-solving"; whilst Pierre (2000: 242) characterizes the shift as:

a shift from a centripetal to a centrifugal model of governing. In the centripetal model, the political centre was the undisputed source of political power and institutional capabilities. In the centrifugal model of governing, however, the state seeks to increase its points of contact with its external environment as a means of conveying its objectives to the surrounding society.

Putting this into practice can be expected to be a key feature of governance in the new developmental State. This will involve attention to modalities of coordinating societal activities, types of policy instruments and sources of administrative effectiveness.

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*Harnessing citizen's participation in governance for development purposes is more important than commitment to a particular type of democratization.*

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*Governments cannot resolve societal problems or create societal opportunities alone, but governing is rather a matter for both public and private actors, and in particular interactions between them.*

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*In emerging forms of governance Governments are giving up "rowing", which will be undertaken by private sector and local communities, and focusing on "steering".*

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*The new developmental State is likely to use a judicious mix of different modalities of governance (hierarchy, markets and networks) and also to adopt a wide array of policy instruments.*

*Second generation theories of policy choice have moved beyond good and evil and focused more on why a particular combination of procedural and substantive instruments is utilized in specific contexts.*

In terms of modalities of governance, an important new strand of thinking relates to what is called “network governance”. As Jessop (1998) emphasizes, this modality of governance does not work through the formal and impersonal procedures of the market, or the top-down, ex ante goal-setting of hierarchical governance, but rather through continuing reflexive procedures, in which different actors in the network identify mutually beneficial joint projects, refine and redefine them as they monitor how far they are being achieved and respond to changes in the external environment. This involves continued negotiation of goals, cooperative mobilization of resources controlled by the different actors involved to achieve their interdependent goals and also continuing dialogue to establish the ground rules for negotiated consent, resource sharing and concerted action. Such networks can include a range of organizations, both State and non-State actors.

The new developmental State is likely to use a judicious mix of these different modalities of governance and also to adopt a wide array of policy instruments. These instruments may be designed to influence outcomes or processes through which outcomes are achieved and to do so through a variety of “governing resources”, namely giving information, using State authority to make laws and regulations, deploying financial resources through taxation and government expenditure, and employing the public sector in direct action (table 4). For the different instruments, the State is more or less involved, with different degrees of compulsion and voluntary action in the way in which outcomes are achieved (chart 6).

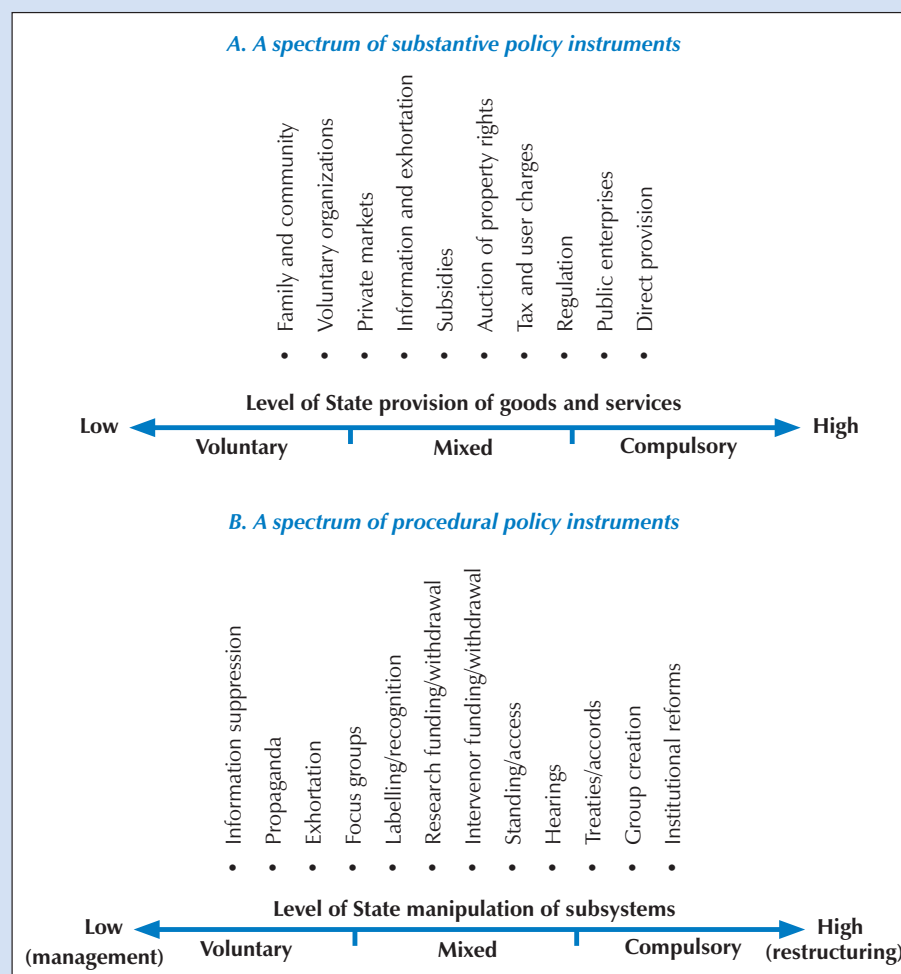
Modern governance involves matching the policy instruments to the task. First generation theories of policy instrument choice, Howlett (2004: 1) argues, were stuck in a “one size fits all” perspective and what he calls “a struggle between ‘good and evil’ in which an existing range of instrument used is condemned and the merits of some alternative single instruments trumpeted as the embodiment of all that is good in the world”. The unfortunate consequence of this approach, which pitted the vices of State dirigisme against the virtues of privatization, markets and deregulation, was to wield the policy instrument “less like the scalpel of a careful surgeon working on the body politic, and more like the butcher’s cleaver, with little respect for the tissue of the patient falling under the knife” (ibid.: 1). Second generation theories of policy choice, which are associated with the modern governance perspective, have moved “beyond good and evil” and focused much more on why a particular combination of procedural and substantive instruments

Principle use	Governance resource			
	Information	Authority	Finance	Organization
<b>A. Substantive policy instruments</b>				
<b>Effectors</b>	Advice Training	Licences User charges Regulation Certification	Grants Loans Tax Expenditures	Bureaucratic Administration Public enterprises
<b>Detectors</b>	Reporting Registration	Census-taking Consultants	Polling Policing	Record-keeping Surveys
<b>B. Procedural policy instruments</b>				
<b>Positive</b>	Education Exhortation Advertising Training	Agreements Treaties Advisory-group Creation	Interest-group funding Intervenor-funding	Hearings Evaluations Institutional- bureaucratic reform
<b>Negative</b>	Misleading information propaganda	Banning groups and associations	Eliminating funding	Administrative delay Information suppression

Source: UNCTAD secretariat, adapted from Howlett (2004).

Chart 6

## The spectrum of substantive and procedural policy instruments



Source: Howlett (2000).

is utilized in specific contexts. What matters here is the employment of “a mix of policy instruments carefully chosen to create positive interactions with each other and to respond to particular context-dependent features of the policy sector” (Howlett, 2004: 8). This type of approach is likely to be an important aspect of new developmental States.

Finally, the new developmental State is likely to draw on what Evans (2005) has called a “hybrid approach” to ensure administrative effectiveness. This approach would balance three basic modes of ensuring effectiveness: bureaucratic capacity, built on meritocratic recruitment, professional norms, predictable rewarding careers and coordinated organizational structures; market signals, which convey costs and benefits, facilitate the efficient allocation of resources and provide fiscal discipline to make sure that goals remain consistent; and bottom-up democratic control in which, through deliberative participation as well as transparency and accountability, the goals pursued by the State would reflect the needs and desires of ordinary citizens (Evans, 2005). Whereas the old developmental State was founded on bureaucratic capacity, and the NPM reform agenda has particularly emphasized the disciplinary power of the market on State actors, the new

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*The new developmental State is likely to draw on a “hybrid approach” to ensure administrative effectiveness, based on bureaucratic capacity, market signals, and bottom-up democratic accountability.*

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developmental State would seek a better balance between these ways of guiding public administration and also seek to inject bottom-up citizen participation.

## E. Can LDCs build developmental State capabilities?

### 1. YES THEY CAN!

It is necessary to be quite sanguine about the task of building capable developmental States in LDCs. However, although we must leave aside those few LDCs where internal conflict has left State structures weak and unviable, there are a number of factors that suggest that it would be possible to build developmental State capabilities in many LDCs.

Firstly, an important lesson from the experience of successful East Asian developmental States is that when they embarked on their development process, the technical capacities of their Governments were not particularly advanced. As Evans (1998: 71) puts it:

Public bureaucracies capable of fostering effective public performance in global markets were not some kind of natural resource, immediately available to East Asia following the Second World War. Modern bureaucracies were constructed through intense prolonged struggles for reform and endless experimentation over the course of the post-Second World War period.

They were built up over time, through policies of meritocratic recruitment, continuity of personnel and a career structure that produces rewards commensurate with those that capable individuals could attain in the private sector (Evans, 1998). Significantly, even in successful developmental States all the bureaucracy was not necessarily super-efficient. Policy learning was an integral aspect of the process of building developmental State capability, and this occurred over time.

Secondly, it is clear that there was a deliberate strategy to build a few strategically important agencies rather than to improve government effectiveness across the board and all at once. Thus, an important lesson of the East Asian experience is that “a substantial share of the benefits of superior bureaucratic performance may be obtained by focusing reforms on a relatively small set of economic agencies” (Evans, 1998: 73). Rodrik has also found in a cross-country analysis of the relationship between institutions and growth that “large-scale institutional transformation is hardly a prerequisite for getting growth going. ... The initial spurt in growth can be achieved with minimal changes in institutional arrangements. ... Countries do not need an extensive set of institutional reforms in order to start growing” (Rodrik 2007: 191).

Thirdly, one should not be overly pessimistic about the potential for public sector reform to build developmental State capabilities by looking at recent experience. Perhaps the major lesson of past experience with public sector reform in LDCs is that weak country ownership has undermined sustainability and success. Therkildsen (2008: 46) states that “there is no doubt that many reform initiatives have grounded to a halt because donors push too hard on issues that had a limited domestic constituency”. This has been a particular feature of past efforts to build general State capacity. It has been observed that the types of capacity development that donors are likely to do well normally do not lead

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*When East Asian developmental States embarked on their development process, the technical capacities of their Governments were not particularly advanced...*

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*... they were built up over time, through policies of meritocratic recruitment, continuity of personnel and rewards commensurate with those that capable individuals could attain in the private sector.*

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*There was a deliberate strategy to build a few strategically important agencies rather than to improve government effectiveness across the board and all at once.*

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directly to significant improvements in State capacity (Teskey, 2005). The reason is that improvements can be real at an individual organizational level but they do not have significant capacity impacts as they do not spill over into affecting inter-organizational relations and the rules of the game. The key lesson of many decades of donor assistance is that if such interventions are not domestically owned they will not have much impact. To the extent that a developmental vision and approach is country owned, building developmental State capabilities should be easier.

## 2. A PRAGMATIC APPROACH TO BUILDING DEVELOPMENTAL STATE CAPABILITIES

One major lesson of efforts at institutional reform is that “institutional innovations do not travel well” (Rodrik, 2005: 994). As noted above, this is clear in the implementation of the good governance reform agenda, but it is also clear that LDC Governments should not imagine that they can simply take policies and institutions from successful developmental States, for example in East Asia, and transplant them for guaranteed success.<sup>9</sup>

In building developmental State capabilities in LDCs, what is necessary is to look at successful models and then identify which principles and practices provide a “good fit” with the circumstances of each LDC. This is different from the wholesale transfer of best practice. What constitutes a “good fit” to particular country circumstances will change over time. It is necessary to have an evolutionary approach in which policies and institutions are adapted to the level of development of both productive capacities and governance capabilities.<sup>7</sup> This should build on what exists within a country rather than identifying what does not exist when its institutions are compared with some external norms of best practice — either as set out in the good governance agenda or provided by the models of successful East Asian newly industrializing economies. Models transferred wholesale from the newly industrializing economies are likely to be as unsuccessful as models transferred from advanced countries.

A pragmatic approach to building developmental State capabilities in LDCs would involve the adoption of a small number of institutional reforms that fit well within the existing context. Chart 7, drawn from Therkildsen (2008), shows the factors that need to fit well for any type of public sector reforms to work. In short, reforms will progress: (a) if their outputs and outcomes are well matched with political demands; (b) if there is a good fit between the political capacity and technical capacity for specific reforms; and (c) if technical competencies fit the requirements of the reform tasks. This is a matter of fitting the types and extent of the reforms both to technical and political capacity. There is a high degree of country specificity in this activity. As Therkildsen (2008: 45) puts it, “the bottom line is that reforms, to succeed, must be tailor-made to country and specific conditions”.

In applying this approach to building developmental State capabilities, both technical and political capacities matter. It is necessary for Governments to have an overall development vision that maps where they are going. But developmental State capabilities should be built up over time through a strategic incrementalist approach,<sup>8</sup> building on islands of excellence in public administration or executive agencies, promoting policy learning and nurturing growth coalitions (chart 8). Particular effort should be focused on building the governance requirements to address factors that are slowing down capital accumulation, technological upgrading, sectoral diversification and structural change (Khan, 2008). Box 4 (p.44) illustrates this idea for the Bangladesh garments sector.

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*Institutional innovations do not travel well. It is necessary to look at successful models and identify which principles and practices provide a “good fit” with the circumstances of each LDC.*

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*It is necessary for Governments to have an overall development vision.*

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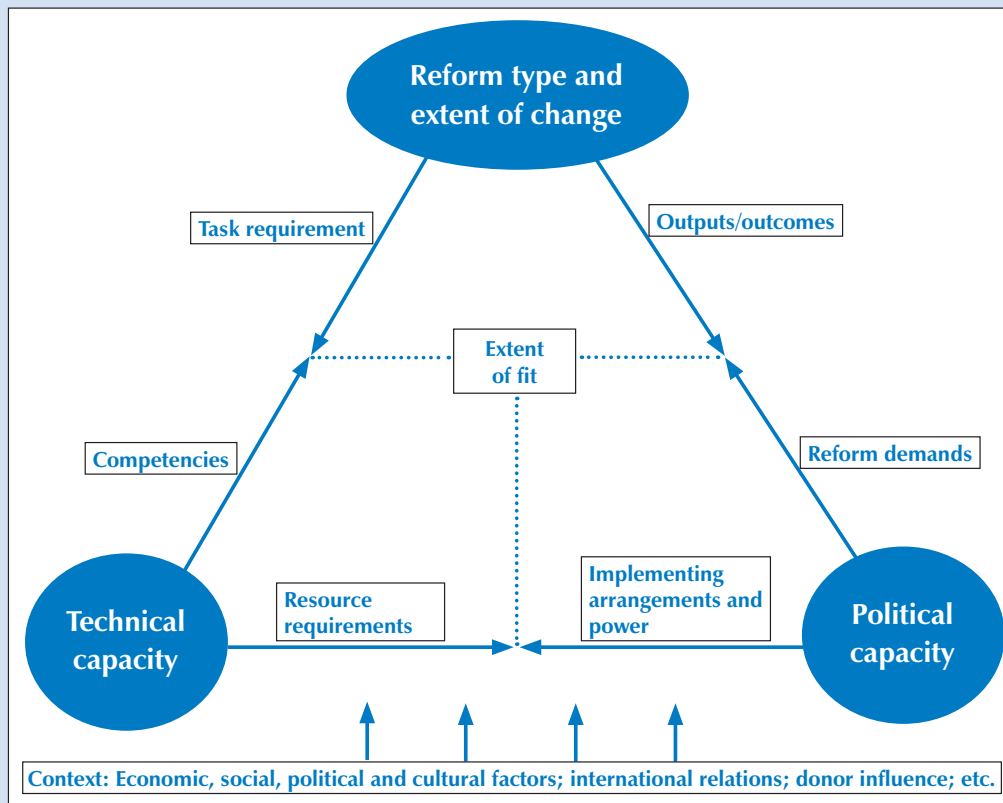
*State capabilities should be built up over time through a strategic incrementalist approach.*

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Chart 7

## Schematic representation of fit requirements in public sector reform



Source: Therkildsen (2008).

(a) Political capacity

*A defining characteristic of successful developmental States is the existence of a developmentally-oriented elite committed to national economic development rather than personal enrichment.*

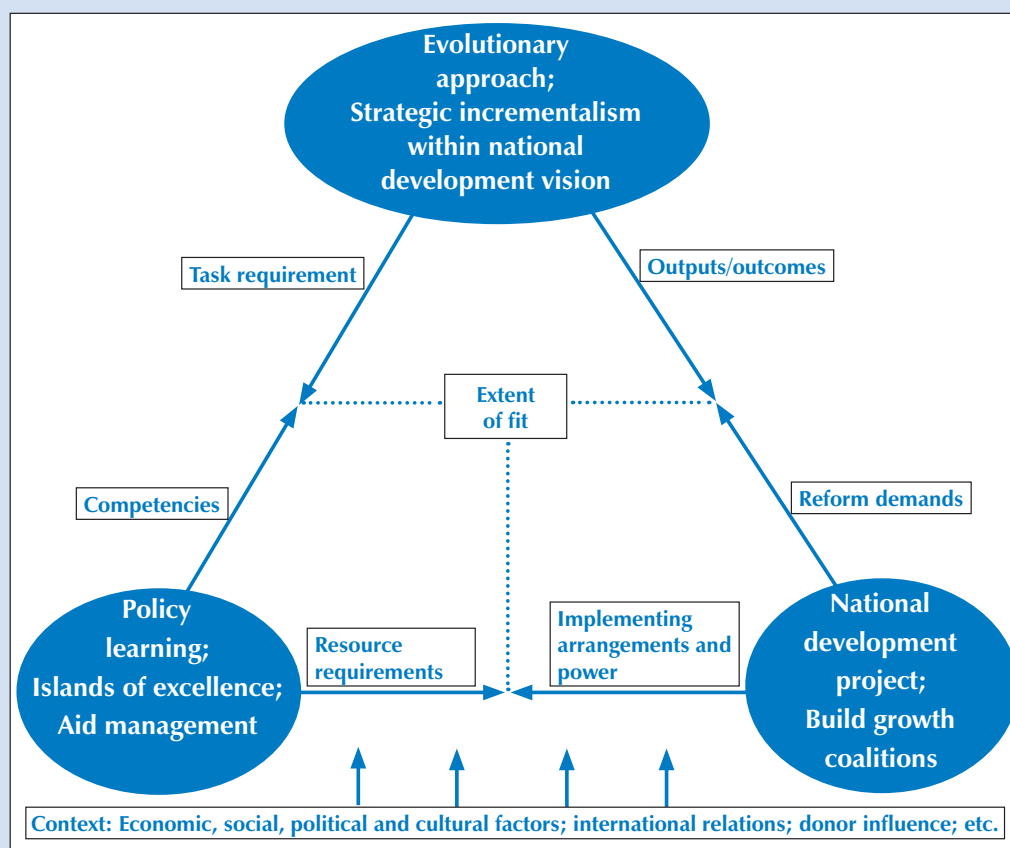
In terms of political capacity, a defining characteristic of successful developmental States is the existence of a developmentally-oriented elite, often consisting of "a small cadre of developmentally determined senior politicians and bureaucrats, usually close to the executive head of Government who was instrumental in establishing the development regime and its culture" (Leftwich, 1995: 405). This elite provides vision and leadership for the achievement of national development goals. Unless it exists, there is no possibility of creating developmental State capabilities. If the elite is simply committed to personal enrichment and perpetuation of its own privileges rather than national economic development, the latter will be impossible.

As noted earlier however, the developmental elite cannot carry out a national development project in isolation. Solving development problems and creating development opportunities requires the participation of a wide range of informed and interested stakeholders. As indicated earlier, democratic processes, which might take various forms, can provide the basis for a more inclusive societal mobilization behind a national development project. However, it is likely also that there is a need to forge growth coalitions.

Growth coalitions arise when relations between business and Government elites take the form of active cooperation towards the goals of fostering investment

Chart 8

## Building developmental State capabilities in LDCs: an approach to public sector reforms



Source: UNCTAD secretariat, based on Therkildsen (2008).

and increasing productivity. They have not been deeply studied. However, research on business associations in poor developing countries (Brautigam, Rakner and Taylor, 2002; Garforth, Phillips and Bathia-Panthaki, 2007; Moen, 2003; and Arthur, 2006) suggests that growth coalitions are most likely to form:

- When the business class has matured in number and experience and broadened to the point when it represents a sizeable portion of the productive economy;
- When its associations broadly represent the range of business interests in the country (possibly with a peak association) and have technical capacity, credibility and a resource base; and
- When the government and business associations have institutionalized regular consultation.

From this perspective, the creation of mechanisms for business–Government cooperation through business associations should be an important element of building developmental State capabilities.<sup>10</sup> However, although business associations are important institutions, “there is no clear evidence that strong business associations or democratization on their own further growth coalitions. They require active state nurture.” (Therkildsen, 2008: 21) Thus, sustaining growth coalitions depends on State leadership, ideology, capacity, and the actual choice and sequencing of the chosen policies. A national policy of developing productive

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*Growth coalitions arise when business and government elites cooperate to foster investment and increasing productivity.*

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*The creation of mechanisms for business–Government cooperation through business associations should be an important element of building developmental State capabilities.*

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#### Box 4. Mushtaq Khan's approach to building growth-promoting governance capabilities: the example of the Bangladesh garments sector

In general terms, Khan suggests that building governance capabilities should focus on sectors where growth is already present but could be accelerated or where there is a challenge to move up into higher value products or up the value chain, or to increase the productivity and competitiveness of machinery. There are likely to be a number of obvious growth sectors. If success is achieved in one sector, the capabilities and lessons learned can be transferred to strategies in other sectors. In making the selection, it is necessary that "the priorities for capacity-building are selected in such a way that the political capacity for exit is assured if results are not satisfactory" (Khan, 2008: 15), and the potential for linkage effects that promote policy learning are maximized.

The ready-made garments sector in Bangladesh is an example. It has been very successful but the sector faces significant competition both from countries higher up the value chain with higher productivity and quality and better links with buyers, and also countries with lower wages that are aggressively seeking to enter the same markets as Bangladesh. Through discussion with entrepreneurs, efforts were made to identify market failures in the allocation of key resources — namely investment funds, labour skills and land — and which governance reforms might help resolve these problems.

With regard to investments, banks were willing to lend to producers so access to capital was not a problem, but the conditions attached to loans (high level of interest rates and collateral requirements) meant that investors were reluctant to borrow for investments in new technology that were inherently more risky. The governance challenge then was for "the government and the private sector to develop feasible governance capabilities that allow existing financial instruments or strategies or one similar to those used in other developing countries to be implemented to allow risk-sharing investments" (Khan, 2008: 20).

Two possibilities are discussed. The first is Bangladesh's Equity and Entrepreneurship Fund, which was set up in 2001 to address precisely this market failure. With this instrument, the Government buys up to a 49 per cent stake in companies engaging in investments in new areas, relieving the entrepreneur of immediate and onerous interest payments, with an option to buy back the equity in three years at face value or after eight years either at face value or at a vaguely defined break-up value to be determined from the balance sheet by accountants. But projects were poorly chosen and the fund has not been dynamic, with projects being adopted that were often straightforward and could have been financed in the traditional way and still have been viable. The governance challenge is, according to Khan, to create compulsions for firm management to perform and deliver a return on equity. This could be done through measures to improve the design of the fund in relation to the claims of the lender on subsequent profits and also the buyback option, and to be successful would need a dedicated agency that would monitor and enforce the terms of the specific funding arrangement under its remit.

The second possibility is a direct subsidy for the capital cost of acquiring pre-specified technologies. An example is the Technology Upgradation Fund Scheme in India in which investments in pre-specified machinery (deemed necessary for improving productivity in the Indian textile sector) are given a 5 per cent reimbursement on the interest charged on the purchase loans. Khan argues that scarcity of budgetary resources makes this more difficult to envisage in Bangladesh, but a more targeted interest rate subsidy may be possible. But this again would require the development of governance capabilities in the agency charged with monitoring the use of disbursed funds. There is a need "to start with very modest programmes with a small well-resourced agency charged with monitoring and implementation of a narrowly defined programme".

With regard to labour skills, the problem is that employers are unwilling to pay much for training their workforce because they are afraid they will later leave the firm, but if worker skills could be improved in a few critical areas this could provide an important boost to productivity growth. Khan suggests "relatively small subsidies for employers sending critical personnel to accredited private training institutes" (Khan, 2008: 24). But "this would only work if governance capabilities could be developed to provide accreditation to programmes in association with employers' associations", to ensure "maintenance of quality" and "to ensure exit from programmes that fail to deliver".

With regard to land, it was found that the acquisition of large pieces of uncontested land is a long and complex process that is a serious constraint on new projects and the achievement of economies of scale. The good governance solution to this is try to improve the land market as a whole by improving land records, the operation of the court system and fighting corruption, so that land transactions take place smoothly. The incremental approach would focus on the specific problem of land availability for the expansion and achievement of economies of scale in the garment industry. This would require the development of governance capabilities in agencies seeking to resolve the land acquisition problems faced by the sectors. One approach could be to prioritize the acquisition of land for a large industrial zone with adequate infrastructural amenities where the highly dispersed garment sector would be given incentives to relocate. In the mean time, "intermediate steps may be necessary to facilitate temporary expansion of critical facilities in firms who apply for assistance" (Khan, 2008: 26). This would require a land agency dedicated to the task and given powers to facilitate a temporary solution by negotiating the renting and acquisition of contiguous land (Khan, 2008: 26). As with other cases, the essential point is focusing on limited things that can be done, ensuring that the highest quality personnel with clear political support is made available for these agencies, and, as with the other cases, "the ability to change the policy and exit from strategies that are not working is critical for improving the chances of success" (Khan, 2008: 26).

Source: Khan (2008).

capacities would require the formation of growth coalitions, but also could be a key first step for their formation. This requires that the political and bureaucratic elites are able to articulate a vision and a viable and credible strategy to support growth. Economic crises may offer an important opportunity for building growth coalitions if it is possible to devise credible policies to deal with the crisis in a way that promotes unity. Dealing with the impact of the global financial crisis should thus be seized as an important opportunity to build growth coalitions in LDCs.

*(b) Technical capacity*

A pragmatic approach to build developmental State capabilities in LDCs not only requires political support but also resources for design and implementation, including funds, staff and skills. Skilled staff is in short supply. But as noted above, it is not necessary to have bureaucratic excellence everywhere. In building developmental State capabilities, it is important there is a pilot agency that is close to political power and that can provide overall vision and coordination. An institution dedicated to aid management is also critical. More emphasis should also be put on improving bureaucracies in ministries concerned with production sectors (chapters 3 and 4 of this Report).

Islands of excellence within the ministries and executive agencies of LDCs can provide lessons about what works and does not work in particular contexts and also models for spreading these practices. Such islands of excellences are hidden by the countrywide indicators of governance quality. But the few in-depth studies, based on interviews with civil servants, that have focused on this issue have found such islands of excellence in a number of LDCs including in Central African Republic and the United Republic of Tanzania (Grindle, 1997) and in Uganda and the United Republic of Tanzania (Therkildsen and Tidemand, 2007). These studies find that what makes these institutions work well are: (a) leadership and management — in well-performing organizations, staff have a clear sense of purpose, management gives clear signals about expected work effort and quality and rewards accordingly, and there is some degree of participation, flexibility, team problem-solving and equity; (b) prestige, professionalism and a sense of service to the country; and (c) merit in recruitment, promotion, demotion and dismissal. The effort to build ministries of finance under structural adjustment programmes also shows that deliberate political decisions to create capacity in key parts of the public sector bear results. Creating islands of excellence and spreading their ways of doing things to other parts of the public sector could thus be a viable approach to improving governance capabilities for development.

Policy learning is also important. Learning occurs by doing and in stages. As Therkildsen (2008: 44) states: “Learning what works precedes learning how to be efficient; and learning how to be efficient precedes learning how to expand what works to organizations beyond a limited number.” Errors will be made at all stages, but this is a key aspect of learning to improve. A focus on policy learning also implies a different style of planning. Rather than a linear planning approach to policy in which formulation precedes implementation, there should rather be sequential experimentation as policymakers learn what works and what does not (Justman and Teubal, 1995). Development projects that are undertaken should thus be chosen not simply on a static cost-benefit analysis but in terms of the new information they generate, the capabilities they develop and their demonstration effects. As Lall and Teubal (1998:1381) have put it: “Frequently, any one of several choices may work: what is important is not to identify the unique optimum but to assemble a smaller set of reasonable choices and implement them comprehensively and systematically. Since mistakes are inevitable (as with firms), the Government

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*Policy learning is also important. There should be sequential experimentation as policymakers learn what works and what does not.*

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has to be flexible and responsive to evolving characteristics — policy has to allow adjustment and learning”.

Therkildsen (2008) also notes the potential of an old reform tradition in some African LDCs, which existed before the public sector reform agenda became strongly donor-driven. This was done in campaign style with politicians mobilizing civil servants and the public to seek to bring significant change. This short-term intensive mobilization of resources and political energies invigorates technical capacities, focuses energies for short periods of time and also provides the basis for policy learning. The financial crisis could also be the basis for such societal mobilization.

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*Building developmental State capabilities will depend on political commitment by LDC elites, but also by their development partners.*

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### 3. THE CRITICAL ROLE OF DONORS

Building developmental State capabilities will not only depend on political commitment by LDC elites, but also by their development partners. Brautigam, Rakner and Taylor (2002) and Mkandawire (2001) point out that African States have in the past often failed to allow local business classes an effective voice in policy-making. Brautigam, Rakner and Taylor (2002: 540) relate this phenomenon to the belief by political leaders that growth coalitions could undermine their political and social power, beliefs that “are likely to be complicated by aspects of race, class and ethnicity”. However, a further factor in many cases has been the way in which Governments have been more responsive to donors’ demands than to the interests of the local business class. Mkandawire (2001: 309) has suggested that the weakness of development of the domestic private sector has been one of the basic contradictions, and a major irony, of the practice of structural adjustment policies. As he puts it:

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*The weakness of development of the domestic private sector has been one of the basic contradictions, and a major irony, of the practice of structural adjustment policies.*

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Wanton liberalization of markets without careful consultation with business classes, privatization that provides no special privilege to local capitalists, cessation of directed credit or “development finance”, high interest rates, all these underscore the distancing of the State from local capitalist interests and the preeminent position of IFIs’ [international financial institutions] interests and perceptions in policy-making.

More recently, the PRSP process has continued this marginalization of the business perspective in policy formulation and implementation. The shift from aid to support production sectors towards aid to support social sectors, noted in earlier *LDC Reports*, is an aspect of this marginalization. More broadly, the effort to mobilize the voices of civil society in the PRSP preparation process has not sufficiently incorporated a domestic business perspective.

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*The shift from aid to support production sectors towards aid to support social sectors is an aspect of the marginalization of the business perspective.*

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A further problem that all LDCs face, as mentioned earlier, is their very weak financial resource base. A simple indication of this is provided in table 5, which shows a number of indicators of the challenge of financing governance in a number of LDCs. One general indicator is the domestic resources available for financing governance and investment (DRAF). The scale of these resources is estimated by subtracting household consumption expenditure per capita from GDP per capita. What is left covers all the domestic resources available for financing investment and running vital public services, including the public administration. In 2006, the DRAF in the LDCs, when measured at current prices and market exchange rates, was on average 41 cents per capita per day. There are quite large variations amongst the LDCs in the sample. But the median value is equivalent to 18.4 cents per capita per day. In other words, half the LDCs had less than 18.4 cents a day available per capita to spend on private capital formation, public investment in infrastructure, the running of vital public services such as health, education

Table 5

**The challenge of financing governance in LDCs:  
GDP per capita, Government current expenditure and domestic resources  
available for financing governance and investment (DRAF), 2006**

	GDP per capita (in current 2006 \$)	Government final consumption expenditure (as % of GDP)	Government final consumption expenditure per capita	DRAF per capita	DRAF per capita per day (in cents)
<b>Total LDCs</b>	<b>462.1</b>	<b>12.9</b>	<b>59.8</b>	<b>150.5</b>	<b>41.2</b>
<b>LDCs: Africa and Haiti</b>	<b>493.7</b>	<b>15.5</b>	<b>76.6</b>	<b>180.7</b>	<b>49.5</b>
Angola	2 998.7	21.2	636.3	2 050.5	561.8
Benin	537.9	12.1	65.0	127.6	35.0
Burkina Faso	418.9	21.1	88.3	105.0	28.8
Burundi	117.3	29.4	34.5	21.8	6.0
Central African Republic	346.3	10.6	36.8	40.5	11.1
Chad	634.0	24.0	152.3	481.5	131.9
Democratic Republic of the Congo	140.9	8.8	12.4	16.7	4.6
Djibouti	940.4	29.4	276.4	389.1	106.6
Equatorial Guinea	16 747.5	2.9	494.0	15 106.5	4 138.8
Eritrea	258.1	35.6	92.0	53.6	14.7
Ethiopia	164.0	12.4	20.3	32.8	9.0
Gambia	305.3	9.3	28.3	60.8	16.6
Guinea	357.8	7.5	26.9	59.4	16.3
Guinea-Bissau	185.0	15.6	28.8	40.3	11.0
Lesotho	749.2	18.1	135.3	23.2	6.4
Liberia	170.9	9.5	16.3	14.8	4.1
Madagascar	287.9	8.7	25.2	52.0	14.2
Malawi	234.6	9.6	22.6	5.6	1.5
Mali	511.6	17.3	88.4	177.4	48.6
Mauritania	874.3	19.5	170.8	333.2	91.3
Mozambique	325.8	13.0	42.2	59.7	16.4
Niger	258.9	15.4	39.8	67.3	18.4
Rwanda	312.5	18.0	56.3	52.4	14.4
Senegal	767.7	13.1	100.8	168.5	46.2
Sierra Leone	288.2	13.3	38.2	43.5	11.9
Somalia	299.8	8.7	26.0	82.8	22.7
Sudan	1 163.9	16.2	188.7	353.1	96.7
Togo	342.8	13.4	45.9	15.1	4.1
Uganda	339.8	14.3	48.6	74.4	20.4
United Republic of Tanzania	339.5	7.3	24.9	59.5	16.3
Zambia	930.7	20.0	186.4	382.7	104.9
Haiti	503.7	8.5	43.0	-3.5	-1.0
<b>LDCs: Asia</b>	<b>406.5</b>	<b>7.4</b>	<b>30.2</b>	<b>100.2</b>	<b>27.5</b>
Afghanistan	285.2	10.9	31.0	-28.9	-7.9
Bangladesh	386.6	5.5	21.4	99.7	27.3
Bhutan	1 421.9	22.0	312.8	728.3	199.5
Cambodia	512.4	5.3	27.0	97.5	26.7
Lao People's Democratic Republic	605.1	7.3	44.2	263.9	72.3
Myanmar	284.0	4.6	13.0	56.2	15.4
Nepal	357.8	8.4	30.2	63.7	17.4
Yemen	878.0	13.8	120.8	343.3	94.1
<b>LDCs: Islands</b>	<b>927.1</b>	<b>32.5</b>	<b>301.0</b>	<b>318.2</b>	<b>87.2</b>
Comoros	492.6	12.6	62.1	-6.8	-1.9
Kiribati	659.3	64.3	424.0	-60.0	-16.4
Maldives	3 020.0	37.9	1 145.4	2 120.5	581.0
Samoa	2 425.1	22.1	537.1	199.5	54.7
Sao Tome and Principe	788.0	46.3	364.7	176.1	48.2
Solomon Islands	877.0	31.9	279.8	451.7	123.7
Timor-Leste	316.5	53.8	170.3	24.4	6.7
Tuvalu	2 427.4	54.2	1 316.6	216.4	59.3
Vanuatu	1 763.1	22.7	400.3	625.5	171.4
<i>Low-income countries</i>	673.0	11.0	73.7	248.6	68.1
<i>Lower-middle-income countries</i>	2 167.4	13.6	294.5	1 165.4	319.3
<i>Upper-middle-income countries</i>	6 571.0	16.0	1 050.9	2 736.6	749.7
<i>High-income countries</i>	36 048.0	18.2	6 561.1	14 007.4	3 837.7

Source: UNCTAD secretariat calculations based on data from GlobStat database (April 2009).

Notes: General Government Final Consumption Expenditure (formerly general Government consumption) includes all Government current expenditures for purchases of goods and services (including compensation of employees). It also includes most expenditures on national defense and security, but excludes Government military expenditures that are part of Government capital formation. DRAF is the amount of domestic resources available for financing governance and investment, which is calculated as the difference between GDP per capita and household final consumption expenditure per capita. Countries' classification by income groups follows the standard criteria set by the World Bank. Economies are divided according to 2007 GNI per capita (Atlas method), and the groups are as follows: low income, \$935 or less; lower middle income, \$936 – \$3,705; upper middle income, \$3,706 – \$11,455; and high income, \$11,456 or more.



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*In 2006, half the LDCs had less than 18.4 cents a day available per capita to spend on private capital formation, public investment in infrastructure, the running of vital public services and public administration, as well as the provision of law and order.*

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*In 2005–2007, on average 20 per cent of aid disbursements to LDCs were for Government and related purposes.*

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*Aid for improving governance capabilities should be refocused from the current good governance reform agenda to supporting good development governance and building developmentally capable States in LDCs.*

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and public administration, as well as the provision of law and order. For the sake of comparison, the average sum of domestic resources available for financing development in lower–middle income countries in 2006 amounted to \$3.2 per capita per day, whilst in high–income countries it was \$38.4 per capita per day.

Data on government revenue and expenditure is very patchy. But as indicated in past *LDC Reports*, the general pattern is that in terms of GDP share, government revenue and final consumption expenditure do not appear to be significantly different from what they are in other developing countries (UNCTAD, 2002). But because their GDP per capita is lower than that of other countries, the levels of government expenditure per capita are also inevitably much lower. This has been discussed earlier in the chapter, but it is worth repeating that the average annual government final consumption expenditure per capita in LDCs in 2006 was just \$60 compared with \$295 in lower–middle income countries. This difference occurred even though as a share of GDP, government final consumption expenditure in LDCs is not significantly different from that of lower–middle income or high–middle income countries (13 per cent and 16 per cent respectively). The \$60 has to cover all government current expenditures for purchases of goods and services (including compensation of employees). This is equivalent to 16 cents per person per day.

From all this it is clear that an important priority for LDC Governments in building developmental State capabilities should be to improve domestic resource mobilization (UNCTAD, 2007). However, in the immediate future donors will be vital in the building developmental State capabilities in most LDCs.

In fact, donors are at present heavily involved in supporting the process of building State capabilities in LDCs. In 2005–2007, on average 20 per cent of aid disbursements to LDCs were for Government and related purposes (table 6). Out of the almost \$5 billion disbursements for Government and related purposes,<sup>11</sup> 63 per cent went to government administration and policy management, with policy management and administration in social sectors, infrastructure and production sectors receiving 16 per cent, 8 per cent and 7 per cent respectively. Sixteen per cent of the gross official development assistance (ODA) disbursements for Government and related purposes went to political development and 15 per cent to conflict prevention, peace and security. Less than 1 per cent went to building statistical capacity, creating a major gap in policy-making capacities in LDCs (table 6).

Those LDC Governments that are seriously committed to building developmental State capabilities should be supported in this task. This would mean that aid for improving governance capabilities should be refocused from the current good governance reform agenda to supporting good development governance and building developmentally capable States in LDCs. Building developmental State capabilities should be the central thrust of a proactive response to the financial crisis.

**Table 6**  
**Gross aid disbursements to LDCs for Government and related purposes by main categories in 2005–2007**

	Average annual disbursement 2005–2007 (constant 2007 \$ millions)	Share of total aid disbursed (%)	Share of total aid for government and related purposes (%)
<b>A. Policy management</b>	<b>2 426.63</b>	<b>9.83</b>	<b>48.79</b>
<i>General</i>	762.71	3.09	15.34
15110: Economic and development policy/planning	553.24	2.24	11.12
15120: Public sector financial management	175.10	0.71	3.52
16062: Statistical capacity building	34.37	0.14	0.69
<i>Social sectors</i>	785.55	3.18	15.80
11110: Education policy and administration management	281.46	1.14	5.66
12110: Health policy and administration management	343.61	1.39	6.91
13010: Population policy and administration management	86.48	0.35	1.74
16020: Employment policy and administration management	70.81	0.29	1.42
16030: Housing policy and administration management	3.20	0.01	0.06
<i>Infrastructure</i>	382.72	1.55	7.70
14010: Water resources policy/administration management	90.32	0.37	1.82
21010: Transport policy and administration management	213.67	0.87	4.30
22010: Communications policy and administration management	8.77	0.04	0.18
23010: Energy policy and administration management	69.96	0.28	1.41
<i>Productive sectors</i>	329.63	1.34	6.63
31110: Agricultural policy and administration management	201.83	0.82	4.06
31210: Forestry policy and administration management	27.96	0.11	0.56
31310: Fishing policy and administration management	37.81	0.15	0.76
32110: Industrial policy and administration management	4.41	0.02	0.09
32210: Mineral/mining policy and administration management	7.53	0.03	0.15
32310: Construction policy and administration management	4.08	0.02	0.08
33110: Trade policy and administration management	36.93	0.15	0.74
33210: Tourism policy and administration management	9.08	0.04	0.18
<i>Environment</i>	132.54	0.54	2.66
41010: Environmental policy and administration management	132.54	0.54	2.66
<i>Financial sector</i>	33.48	0.14	0.67
24010: Financial policy and administration management	31.01	0.13	0.62
24020: Monetary institutions	2.47	0.01	0.05
<b>B. Government administration</b>	<b>716.13</b>	<b>2.90</b>	<b>14.40</b>
15140: Government administration	716.13	2.90	14.40
<b>C. Legal and judicial development</b>	<b>299.10</b>	<b>1.21</b>	<b>6.01</b>
15130: Legal and judicial development	299.10	1.21	6.01
<b>D. Political development</b>	<b>797.96</b>	<b>3.23</b>	<b>16.04</b>
15150: Strengthening civil society	314.29	1.27	6.32
15161: Elections	285.36	1.16	5.74
15162: Human rights	127.94	0.52	2.57
15163: Free flow of information	21.10	0.09	0.42
15164: Women's equality organisations and institutions	49.27	0.20	0.99
<b>E. Conflict prevention and peace building</b>	<b>733.56</b>	<b>2.97</b>	<b>14.75</b>
15210: Security system management and reform	69.25	0.28	1.39
15220: Civilian peace-building, conflict prevention and resolution	362.55	1.47	7.29
15230: Post-conflict peace building (United Nations)	122.14	0.49	2.46
15240: Reintegration and Small Arms and Light Weapons control	43.39	0.18	0.87
15250: Land mine clearance	127.38	0.52	2.56
15261: Child soldiers (prevention and demobilisation)	8.85	0.04	0.18
<b>Total ODA disbursement for government and related purposes</b>	<b>4 973.38</b>	<b>20.14</b>	
<b>Total ODA disbursement</b>	<b>24 691.30</b>		
<i>of which:</i>			
<i>Bilateral from DAC countries</i>	19 481.22		
<i>Multilateral</i>	5 210.08		

Source: UNCTAD secretariat calculations, based on OECD/CRS database, online (June 2009).

## F. Conclusions

This chapter has five basic messages.

*There is a need to move beyond the good governance institutional reform agenda now and to institute good development governance.*

Firstly, the role of the State in many LDCs is currently being defined through the good governance reform agenda. This involves the introduction of a particular set of institutional reforms, notably private sector styles of public administration (including using market mechanisms, client orientation and performance management to increase efficiency), electoral democracy and a limited role for the State. The key role of the State in these reforms is to support markets rather than to promote economic development directly. There is a need to move beyond this institutional reform agenda now and to institute good development governance. This means injecting a much stronger and direct developmental dimension into governance reforms to enable a more active role of the State in promoting development.

*The developmental State model can be adapted to provide a viable and useful approach to development governance in the LDCs if lessons about development governance are adapted to the twenty-first century.*

Secondly, the developmental State model can be adapted to provide a viable and useful approach to development governance in the LDCs. However, not all developmental States have been successful. The developmental State model can provide a useful and viable model for LDCs if lessons about development governance are drawn from successful developmental States in the late twentieth century and if these experiences are adapted to the twenty-first century. This is not a return to "old style" development planning.

*Adapting the developmental State to the twenty-first century involves redefining the nature of developmental States away from the authoritarian forms that have been more typical of East Asian developmental success.*

The main lessons from development governance in successful developmental States are that national policies were oriented to promoting structural transformation, and this was achieved through a mixed economy model that sought to discover the policies and institutions that would harness the pursuit of private profit to the achievement of national development. This was achieved through a mix of macroeconomic and sectorally specific productive development policies, including an industrial policy. These policies aimed to promote capital accumulation and technological progress as the basis for dynamic structural change. In the language that UNCTAD has used in past *LDC Reports*, they were geared to develop productive capacities, expand productive employment and increase labour productivity with a view to increasing national wealth and raising national living standards. Success was achieved through the construction of competent bureaucracies in a few key strategic agencies and policy learning. Governments also devised policies in close cooperation with the business sector.

*Building developmental State capabilities in the LDCs will take time and public sector reforms oriented to this end should be adapted to actual technical and political capacity.*

Adapting the developmental State to the twenty-first century involves redefining the nature of developmental States away from the authoritarian forms that have been more typical of East Asian developmental success. This can draw on other types of developmental State, including for example the Nordic model or the Celtic Tiger. Building democratic developmental States should involve, in particular, ensuring citizens' participation in development and governance processes. The twenty-first century developmental State will also apply new knowledge on modern governance practices that promote multiple forms of interaction between public and private actors.

Thirdly, building developmental State capabilities will take time and public sector reforms oriented to this end should be adapted to actual technical capacity and also actual political capacity. Developmental State capabilities can be built incrementally through policy learning and institutional experimentation, focusing initially on extending the experience of islands of excellence within the public administration and executive agencies and aiming to build the governance

capabilities required to relax binding constraints on the development of productive capacities. Policy space is necessary to allow policy pluralism and experimentation.

Fourthly, building developmental State capabilities in LDCs will only be possible if there is a developmentally-oriented elite of politicians and bureaucrats. Moreover, it will be most successful if this elite establishes a social compact through which broad sections of society support the development project. This should include both rural and urban interests and thus developmental policies should be directed to include both developmental agricultural policies and developmental industrial policies. The financial crisis should also be used as an opportunity to build growth coalitions between Governments and the domestic business community.

Finally, it will be very difficult to realize a domestically-owned developmental vision and programme without the support of donors. This is due to domestic financial resource constraints on governance and the potential for aid to undermine the formation of domestic growth coalitions. LDC Governments must focus more on domestic resource mobilization. But development partners can best support genuine country ownership in LDCs, and also achieve mutual goals, by supporting the realization of national developmental aspirations. Approximately 20 per cent of aid to LDCs now goes to improving government capabilities. This should be refocused from the broad good governance agenda to support development governance and building developmentally capable States in LDCs.

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*The developmentally oriented elite of politicians and bureaucrats should establish a social compact through which broad sections of society support the development project, including both rural and urban interests.*

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## Notes

- 1 For a reply to this analysis and also subsequent response to the reply, see Kaufmann, Kraay and Mastruzzi (2007a) and Kurtz and Schrank (2007a), and for a broader response to critiques see Kaufmann, Kraay and Mastruzzi (2007b).
- 2 For a discussion of the implementation of the good governance agenda in island LDCs see Roberts, Wright and O'Neill (2007).
- 3 For UNCTAD's analysis of the bases of East Asian success, see: UNCTAD (1994), UNCTAD (1996) and also Akyuz, Chang and Kozul-Wright (1998). Gore (1994) provides a detailed discussion of the Japanese model of "catch-up" growth.
- 4 There are various sources of market failure, including externalities, goods that have characteristics that make private suppliers unwilling to supply them (e.g., non-rival and non-excludable public goods, monopolies and asymmetric information), and these different types of market failure lead to different kinds of public intervention.
- 5 Refer, for example, to Leftwich (1993).
- 6 For the importance of societal cohesion, see Kohli (2004).
- 7 For an important discussion of the role of the state in an evolutionary approach, see Moreau (2004).
- 8 Strategic incrementalism – between big bang and "muddling through" – is also advocated in World Bank (2005).
- 9 LDCs which are rich in mineral resources, for example, felt difficult context-sensitive development governance challenges. See Jourdan (2008).
- 10 For discussion of some experiences in some African LDCs see Kalema and Nsonzi (2008).
- 11 Between 2005 and 2007, ODA disbursements averaged almost \$5 billion in constant 2007 dollars.

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# Meeting the Macroeconomic Challenges

## A. Responses to the current global economic crisis

## Chapter

# 2

As discussed in the introduction to this Report, least developed countries (LDCs) are going to be severely affected by the current global financial crisis and global recession. The main channel of impact is not likely to be through the financial system, as LDCs' financial sectors are weak and not tightly integrated with those of advanced countries, and they receive only modest inflows of private financial capital. However, LDCs are bound to be adversely — though differentially — affected by the slowdown in the real global economy, particularly through falling export revenues and declining workers' remittances, as well as falling inflows of net private capital, particularly foreign direct investment (FDI).

How should the macroeconomic policies of LDCs be modified in light of the global deterioration in real and financial conditions? What should be the role, for example, of counter-cyclical fiscal and monetary policies? And can LDCs continue some of the growth momentum that they achieved prior to late 2008, based on maintaining the financing of public investment and the stimulus of private investment?

It will be important for LDC Governments to continue to devote a significant share of their budgets to public investment, which will enable them to maintain some degree of momentum in their previously achieved growth trajectories, which were brought about by the global boom in the export of primary commodities. It would be a mistake for LDCs to reduce taxes in order to provide a fiscal stimulus to their economies. Their taxes are already low. Reducing them further would undermine their long-term basis for domestic resource mobilization. Also, such reductions would be unlikely to provide much short-term stimulus, because part of the tax relief would be saved instead of spent. This is why public expenditures tend to have a larger multiplier impact on an economy than tax reductions.

Despite the economic slowdown, Governments should continue to invest in building up their capacities to raise domestic revenues. While tax revenues will surely decline in the coming period, as incomes drop, there is no reason why the capacities to raise more revenue in the future cannot be strengthened in the near term.

The central challenge for LDCs will be to balance the need for short-term counter-cyclical measures — to provide a needed stimulus to their economies — with the longer-term priority of financing public investment as the basis for expanding their productive capacities. The debate on the relative weights of current expenditures and capital expenditures is reflected in the proposed composition of the annual budgets of many of the industrialized countries. While recognizing the need for a short-term stimulus, these countries are also insisting on devoting a significant share of their budget resources to long-term investment projects, such as projects for improved healthcare and education, expanded infrastructure, and greater self-sufficiency in energy.

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*Donor countries should stick to their previous commitments to ODA and increase financing to offset the negative impact of the global recession on LDCs.*

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*Reducing significant subsidies to domestic agriculture in donor countries would be a win-win solution.*

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*Improving the capacities of LDCs to raise domestic revenues will pay significant dividends by lessening the reliance of LDCs on ODA.*

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*National policymakers' ability to choose the most suitable fiscal policies for the conditions of their own country is often constrained, as they are highly aid-dependent.*

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Needless to say, the industrialized countries, and the United States in particular, have the option of borrowing (selling government securities) in order to finance their fiscal deficits. Unfortunately, LDCs cannot market their securities internationally without incurring high costs for debt servicing, and they have shallow domestic bond markets. In order to borrow domestically, they are charged extremely high real rates of interest. Hence, one of the frequent sources of finance for the fiscal deficits of LDCs is official development assistance (ODA).

One problem in this regard is that ODA may decline as the industrialized countries grapple with their own domestic financial crises and recessions. It is imperative that donor countries stick to their previous commitments to ODA and also increase donor financing to offset the negative impact of the global recession on LDCs. Continuing to provide debt relief, where it is necessary, would also make a great deal of sense, particularly because this is unlikely to have a large short-term impact on donor-country budgets. In some cases, a debt moratorium should be considered. Complementary measures, such as reducing significant subsidies to domestic agriculture in donor countries, would be a win-win solution — reducing the expenditures of rich countries while also brightening the export prospects of poor countries.<sup>1</sup>

The case for continued external assistance could be reinforced by devoting greater emphasis to the transparency and predictability of aid, and above all, to improving the capacities of LDCs to raise domestic revenues and mobilize resources for development finance (section B.4 of this chapter). Over the long term, such capacity-building will pay significant dividends by lessening the reliance of LDCs on ODA, and laying a solid foundation for achieving self-sustaining processes of rapid capital accumulation, improved technical progress, and accelerated catch-up growth and development.

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## B. Fiscal policies

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### 1. INTRODUCTION

Among macroeconomic policies, fiscal policies play the central role in helping LDCs to achieve more rapid and sustainable growth and development. They should also play the leading role in providing counter-cyclical stimulus during periods of economic downturn, as LDCs are likely to experience in the current period. But one problem facing national policymakers is that their ability to choose the most suitable fiscal policies for the conditions of their own country is often constrained, as their investment programmes are highly aid-dependent (box 5).

The current macroeconomic consensus focuses on maintaining macroeconomic balance, and in particular on containing the public debt and fiscal deficit. It also favours adopting clear fiscal rules and avoiding the use of discretionary interventions.<sup>2</sup> Fiscal interventionism, it believes, contributes mainly to widening deficits, creating unsustainable levels of debt and exacerbating inflation.

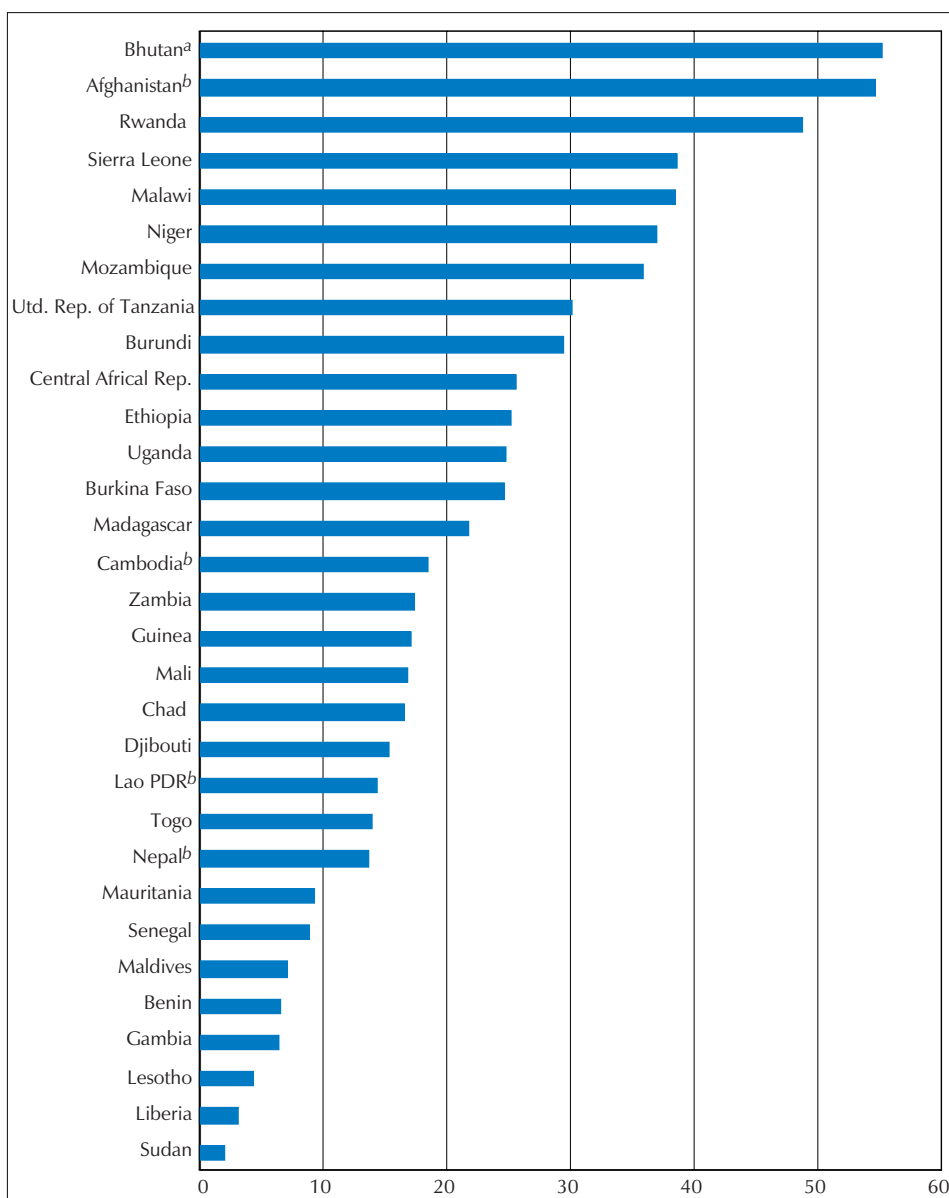
In general, the macroeconomic consensus argues against a leading role for fiscal policy and prefers monetary policy to assume this function. However, except in crises, monetary policy should be bound by “policy rules”, such as trying to maintain a low inflation target in order to anchor inflation expectations and create a conducive environment for investment. There is little room left for “discretionary” monetary policies (Weeks and Patel, 2007).



### Box 5. The macroeconomic policy space in LDCs

Most LDCs have low levels of domestic resource mobilization, owing to generalized poverty and to the low levels of development of the formal economy as well as of productive capacities. As a result, they are highly aid-dependent. In 11 African LDCs, for example, grants financed between approximately a quarter and a half of total government spending in 2008 (box chart 1).

**Box chart 1**  
**Government spending financed by grants in selected LDCs, 2008**  
*(Grants as a share of total Government expenditure, per cent)*



Source: UNCTAD secretariat calculations, based on data from OECD-AfDB-UNECA, *African Economic Outlook 2009* (for African LDCs); and on data from IMF, *International Financial Statistics* online and *Government Finance Statistics* online (May 2009) (both for Asian LDCs).

Notes: For African LDCs, grants as a share of total expenditure and net lending.  
 For Asian LDCs, grants as a share of cash payments for operating activities plus net acquisition of non-financial assets.  
 a 2004; b 2007.

To raise much-needed funding, national Governments must negotiate with donors and creditors, giving both of them influence in formulating policies. National macroeconomic policy space is thus limited by the conditionalities that

## Box 5 (contd.)

international financial institutions and bilateral donors attach to the disbursement of resources, and by donors' choices. The nature of these conditionalities has changed over time, and efforts are being made to make them more flexible, as is analysed in *The Least Developed Countries Report 2008* (UNCTAD, 2008a: 93–134). However, conditionalities can still be attached to specific aspects of macroeconomic policies (e.g. quantitative targets for monetary and credit aggregates and inflation, limits to government spending and to the budget deficit, exchange rate adjustment, foreign debt management, and elimination of price controls), to aspects of structural policies (e.g. social security reform, measures to improve financial sector operations, trade liberalization, privatization, and capital flows liberalization), and increasingly, to good governance (e.g. changes in Governments' administrative structures and processes). Typically, these conditionalities steer borrowing countries towards policies in the spirit of the Washington Consensus, and frequently, towards restrictive macroeconomic policies.

In March 2009, the International Monetary Fund (IMF) announced a new approach to its conditionality framework, foreseeing a more flexible use of structural performance criteria and a greater shift towards ex ante conditionality. This revision may change the modalities in which the framework operates, but it is not clear that the types of conditions that LDCs must meet will change.

Apart from multilateral institutions, bilateral donors can also exert strong influence on the policies adopted by LDCs, particularly on the LDCs that are more aid-dependent. Donors can weigh on the content of macroeconomic policies chiefly through decisions on the allocation of their funds, choosing from alternative priorities, areas and programmes. This can happen even when aid is devoted to budget support (UNCTAD, 2008a: 93–134). Since the 1990s, ODA to LDCs has been increasingly allocated to social spending (particularly health and education), rather than to economic infrastructure and production sectors (section B.4 of this chapter; UNCTAD, 2008a: 26–32). However, the poverty reduction strategy papers (PRSPs) are increasingly concerned to develop production and economic infrastructure.

As can be seen from the recent policy changes in advanced countries, in times of crisis, maximum flexibility is required.

Mainstream macroeconomics also warns against large public expenditures partly because it believes that they would serve chiefly to “crowd out” (displace) private expenditures. This would result from increased borrowing by the fiscal authorities in order to finance the resultant deficit. The heightened competition with the private sector for the available pool of finance would drive up the rate of interest.

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*Orthodoxy has not adequately highlighted the importance of mobilizing domestic resources.*

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The current macroeconomic consensus also downplays the central importance of public investment, because it believes that such investment competes with private investment and is prone to be more inefficient since it is not driven by market incentives.

On the revenue side of fiscal policy, orthodoxy has not adequately highlighted the importance of mobilizing domestic resources. This might be attributable, in part, to a bias towards maintaining a small State, or to a lack of emphasis on the necessity of creating essential economic and social infrastructure, or simply to poor advice on tax policies. In any case, LDCs have not been able to mobilize sufficient domestic revenue, even during the recent years when both growth and trade were accelerating.

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*LDCs have not been able to mobilize sufficient domestic revenue, even when both growth and trade were accelerating.*

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The issue of revenue generation is addressed in the second part of this section on fiscal policies. First, the role of public expenditures and investment is discussed.

## 2. ALTERNATIVE FISCAL POLICIES — EXPENDITURES AND INVESTMENT

This chapter advances an alternative view on more growth-oriented and inclusive macroeconomic policies. Fiscal policy plays the central role in this approach, driving the development process primarily through public investment, while monetary and financial policies are designed to stimulate private investment, and exchange rate policies are tailored to support export growth.

Because of their structural underdevelopment, LDCs are especially in need of such alternative macroeconomic policies. The advocacy on behalf of strategies based on the Millennium Development Goals (MDGs) has helped to focus greater attention on the need to dramatically increase public investment. Gross fixed capital formation in LDCs did increase during the period from 2000 to 2007 — compared to its level in the 1980s and 1990s — but it remains insufficient to address their needs. During the period from 2000 to 2007, gross fixed capital formation averaged 19.9 per cent of gross domestic product (GDP) for all LDCs (chart 9A). This was an increase from its levels of 17.1 per cent in the 1990s and 16.1 per cent in the 1980s.

However, gross fixed capital formation has been continuously lowest among the African LDCs. During 2000–2007 it was 18.7 per cent of GDP for this group, whereas for Asian LDCs it was 21.6 per cent (chart 9B). Fixed investment was far higher in island LDCs (27.5 per cent of GDP in 2000–2007), but this is mostly explained by size effects, as these economies are relatively small in terms of GDP.

As global growth has slowed in late 2008 and early 2009, greater efforts must be mounted to mobilize development finance and to maintain progress towards the MDGs. Fiscal policy will also need to be used increasingly, both as a counter-cyclical tool to stabilize LDC economies, and to sustain a medium-term growth trajectory.

Until late 2008, much of the growth in LDCs was driven by the export of primary commodities — not by internal demand resulting from increased public and private investment. Much of the financing of domestic investment was provided by ODA. Hence, the growth of LDCs was not sustainable, even before the onset of the financial crisis in the industrialized countries and the ensuing global economic slowdown (UNCTAD, 2008a: 1–44).

In the face of a collapse in domestic aggregate demand, policymakers in the industrialized countries have resorted to Keynesian stimulus policies. This has resulted in far more expansionary fiscal and monetary policies, as well as direct measures to stabilize these countries' banking systems. Accordingly, the intellectual

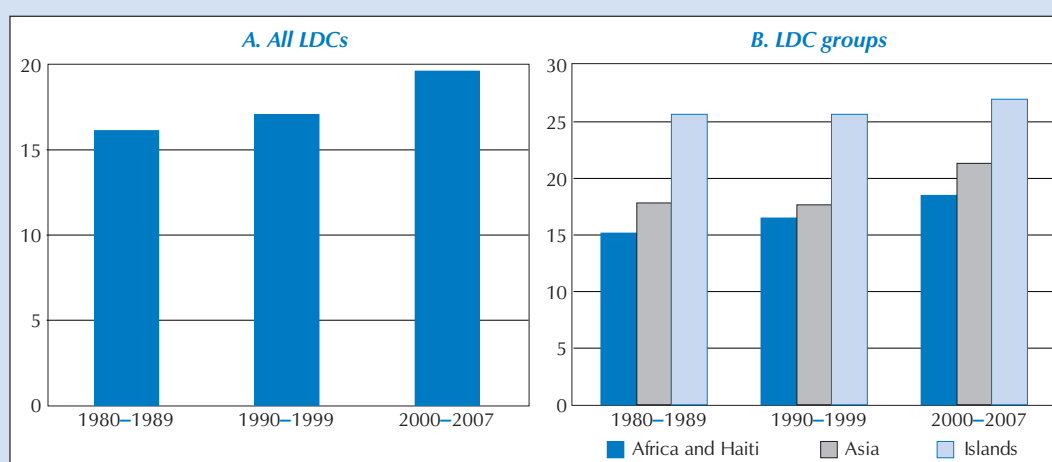
*Gross fixed capital formation in LDCs increased in 2000–2007, but it remains insufficient to address their needs.*

*Much of the financing of domestic investment was provided by ODA.*

*The growth of LDCs was not sustainable, even before the global economic slowdown.*

Chart 9

### Gross fixed capital formation in the LDCs, 1980–2007 (Per cent of GDP)



Source: UNCTAD secretariat calculations, based on data from the United Nations/DESA Statistics Division.

environment is much more conducive to building a case for longer-term use of expansionary policies. For LDCs in particular, the debate has to move beyond “crisis Keynesianism”; it must introduce, in addition, a more structuralist analysis that emphasizes the developmental role of macroeconomic policies.

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*For LDCs the debate has to move beyond “crisis keynesianism” to emphasise the developmental role of macroeconomic policies.*

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LDCs will need financing to continue running fiscal deficits, the bulk of which will have to come from external sources. LDCs have been able to run significant fiscal deficits because a large proportion of their deficits is covered by ODA. This has become, in fact, one of the major purposes of ODA financing — to enhance the ability of Governments in LDCs to expand public expenditures for development-related purposes. Such external financing will now become even more critical, when LDC Governments have to implement counter-cyclical fiscal policies in order to maintain aggregate demand.

It is important to stress that deficits can be justified on two major counts. Firstly, government expenditures can compensate for falls in private spending during economic downturns. This is the standard Keynesian rationale for boosting aggregate demand in order to support economic recovery. Insisting inflexibly on containing fiscal deficits during a recession will make fiscal policy “pro-cyclical”. In other words, it will require government spending to fall as private incomes drop, because government revenues will be adversely affected.

More generally, running deficits can be justified, even in normal times, if the resources are used to support public investment. Indeed, the additional future revenues expected from the investment will pay off the debt that the Government incurred. This could be called the “growth rationale” (box 6).

#### **Box 6. The role of public investment**

##### **(a) The three functions of public investment**

Public investment is of central importance, because it can perform three essentially different functions: (a) expanding the productive capacity of an economy; (b) helping to stimulate aggregate demand; and (c) differentially allocating resources across an economy, whether for the purposes of generating employment, reducing inequalities or combating poverty.

For the purposes of long-term growth and development, the first function is paramount. It is through this function that public investment can help stimulate private investment and raise labour productivity. This is based on building the essential economic and social infrastructure on which private investment depends. Examples are roads, electrical grids, dams, irrigation works, and an educated, skilled and healthy workforce.

Public investment also stimulates aggregate demand, and may well play a counter-cyclical role in this regard. However, current expenditures are more easily adapted to counter-cyclical objectives, since they can be activated in a quicker and timelier fashion. Investment projects usually take longer to initiate and are carried out over a longer time frame.

Some capital projects can be used, however, for counter-cyclical purposes during an economic downturn. Classic examples are what the International Labour Office calls “labour-intensive public works”, in which unemployed workers are mobilized to construct small-scale infrastructure and the capital equipment that they use is fairly rudimentary. Since wages are a major component of the project’s costs, they can help to stimulate greater current expenditure.

The third function of public investment — differentially allocating resources across the economy — can be used to serve various objectives. In the case of LDCs, it would be important to promote and support industrial policies that are geared to diversifying the economic structure of these countries and to supporting a self-sustaining process of continuous capital accumulation (chapter 4 of this Report).

However, fiscal policies alone will not be adequate to allocate the resources necessary for an effective industrial strategy. Financial policies will have to be enlisted too, in order to influence the allocation of credit for private investment. This point is discussed in section D of this chapter.

If raising employment is the objective, then public investment could be allocated disproportionately to those sectors that are the most employment-intensive or that have the largest employment multipliers. Lastly, public investment could be focused on reducing inequality or poverty, for example by financing infrastructure in poorer urban or rural areas.

##### **(b) Critiques of public investment**

As has already been mentioned, one of the standard critiques of public investment has been that it will not have a net beneficial impact on the economy because it “crowds out” private investment. This is highly unlikely, however, in LDCs,

## Box 6 (contd.)

because there is a widespread underutilization of resources. As a consequence, there is usually ample “economic space” for increasing all types of expenditure.

The crowding-out argument only becomes relevant under conditions of full employment, but the logic would then apply to any element of expenditure, whether private or public. In fact, the crowding-out of private investment by public investment would have a net negative effect on economic growth only under very restrictive assumptions. Firstly, the crowding-out would have to be complete — a highly unlikely outcome in countries that have far from full employment. Secondly, public investment would be likely to depress growth prospects only in so far as it is more “capital-using” than private investment (Weeks and Patel, 2007).

Under conditions of less than full employment, it is much more likely that public investment will “crowd in” (stimulate) more private investment, because of the presence of externalities and complementarities between different forms of capital accumulation. This holds true particularly if public investment is concentrated on building basic economic and social infrastructure. A proactive public investment programme should be able, in fact, to stimulate private investment in the sectors of the economy that national policymakers consider to be of strategic importance.

Another standard critique of public investment (particularly in developed countries) is that it tends to be inflationary. This is also not very likely to be the case in LDCs, since public investment should expand the aggregate supply of goods and services, along with stimulating more aggregate demand for them.

There is, in fact, very little plausible evidence to suggest a strong correlation between deficits in LDCs arising from the financing of public investment, and inflation. One of the reasons for the lack of correlation is that inflation in such countries is usually more structural in nature (for example, being due to low domestic productivity) or externally determined (for example, by higher import prices for food or fuels). This topic is discussed further in section C.1 of this chapter.

The effect of deficits on inflation depends, of course, on how they are financed. If they are monetized, then there is a higher probability that they will be inflationary. But this depends on whether the resulting increase in the money supply exceeds the growth of output. So, the overall impact depends on several variables, such as the size of the deficit, the extent of monetization and the rate of economic growth (which affects the demand for money).

Some degree of monetization of fiscal deficits can be justified. Governments in LDCs confront a limited set of options when they run deficits, whether for the purposes of countering recession or of financing public investment. They could sell bonds domestically, but the real rate of interest that most LDC Governments face is relatively high, and the maturity of such securities tends to be short. In comparison, monetization — within strict limits — may be the preferred option. Governments could also borrow internationally, but the interest rate for such borrowing is also likely to be high, since foreign banks will seek to incorporate a sizeable risk premium. The other option is to borrow at concessional rates from regional or multilateral financial institutions or to use the grant component of ODA to finance their deficit. This, in fact, should be a major purpose of ODA — to allow countries to run or expand their fiscal deficit in order to finance development-related expenditures.

### 3. ALTERNATIVE FISCAL POLICIES — DOMESTIC REVENUE MOBILIZATION

There has been much discussion of the problems of “aid dependency” in many LDCs, and while it is clear that reducing it significantly (or entirely) will depend on a take-off into sustainable growth, it is still useful to explore ways of raising domestic revenues as a means of reducing the need for outside help. Revenue generation in LDCs is a significantly correlated with the levels of income per capita and economic growth. A low level of income per capita is a major constraint on raising revenue, primarily because it reflects the underdeveloped economic structure of low-income countries. Such a structure usually contains a large agricultural sector, as well as a substantial informal sector. Formal employment is customarily available only to a small minority of the workforce.

As economic growth increases, revenue should rise as a ratio to GDP. This has generally been the case in LDCs since the year 2000, however the current global economic slowdown is bound to have already reduced this ratio and is likely to lower it even further in the foreseeable future.

But growth alone cannot explain revenue performance. Revenue can be significantly boosted either through better tax policies or through more effective tax administration. In this section, the focus is on tax policies — a topic that has generally been pushed to the sidelines of discussion in development circles in recent years.

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*Revenue generation in LDCs is correlated to the levels of income per capita and economic growth.*

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*Revenue can be boosted through better tax policies or through more effective tax administration.*

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*Little attention has been paid to mobilizing domestic revenue, even though this is widely recognized as the primary long-term financing solution.*

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*Mobilizing domestic resources on a longer-term basis is necessary in order to sustain a process of rapid capital accumulation and catch-up growth and development.*

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*As VAT has been introduced across many developing countries, it has generally failed to significantly boost revenue from the levels that had been achieved by previous indirect taxes.*

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Much of the recent discussion has focused on the need to increase ODA in order to promote growth and development in low-income countries, and in LDCs in particular. This has been linked, of course, to the Millennium Development Goals and to MDG-based national development strategies. However, far less attention has been paid to mobilizing domestic revenue, even though this is widely recognized as the primary long-term financing solution.

It is necessary to examine revenue policy in more depth and to determine how ODA can be used to strengthen the revenue-mobilizing capacity of LDCs. The major problem that many such countries face is that they remain stuck in the short term, with uncertain and unreliable forms of finance.

If these countries are to finance long-term development, they need to mobilize resources on a longer-term basis. This is necessary in order to sustain a process of rapid capital accumulation and catch-up growth and development.

#### *(a) Conventional advice on taxation*

Much of the conventional wisdom on taxes has shifted in the last 20 years. Instead of being regarded as a necessity for State-building, taxes are assumed to be a disincentive to private-sector initiative and a net loss to household welfare. The emphasis has been on the loss of private income, but not on the ensuing benefit of revenue-financed public expenditures and investment.

Concern for an equitable taxation structure has receded, too. Tax theorists now emphasize the negative effects on work and profit-taking from progressive personal and corporate taxes. Therefore, top tax rates on personal income and corporate profits have been falling and the spread of rates has been reduced, from the top downwards.

Trade taxes have also fallen into disrepute, as countries have been urged to become increasingly open to trade and financial flows. Tariff rates have often been radically reduced or eliminated.

Since taxes on trade and corporate profits have been two of the most reliable sources of revenue for Governments in LDCs, their reduction has exerted considerable pressure on Governments to find alternative sources of revenue.

Conventional tax advice has highlighted the need for value-added tax (VAT) as the principal way to offset the losses from trade liberalization and the lowering of direct tax rates. There has also been a presumption among supply-side tax theorists that lowering what they regard as high rates of direct tax will expand the tax base, by encouraging more households or businesses to pay taxes.

But there is no persuasive evidence of a correlation between lowering rates and expanding the tax base. Moreover, in the context of low-income countries — and LDCs in particular — VAT is not likely to be as efficient as in developed countries, in part because of the need for extensive bookkeeping and the prevalence of a large informal sector.

As VAT has been introduced across many developing countries, it has generally failed to significantly boost revenue from the levels that had been achieved by previous indirect taxes, such as sales taxes. Nor has it compensated, in many cases, for the losses incurred from reducing or eliminating tariffs.

The results of tax reforms for a sample of 22 LDCs in sub-Saharan Africa can be examined on the basis of revenue data collected by IMF for these countries. The

data are derived directly from the statistical appendices of Article IV Staff Reports (and the appendices prepared by IMF for the periodic consultations with each country); they begin from the early 1990s and cover a period of approximately a decade and a half. The data are grouped into three periods in order to identify broad trends: 1990–1994, 1995–1999 and 2000–2006.

Although IMF has supplied data on total revenue for LDCs in sub-Saharan Africa for 2007, as well as estimates for 2008, these are not used here, as it is not possible to separate tax revenue from non-tax revenue, or to disaggregate tax revenue into its major components (IMF, 2008). The data indicate that total revenue was clearly rising through 2008. However, since the analysis here stretches only to 2006, the estimates could be more conservative.

Even though there appears to have been a discernible upward trend in total revenue around 2005 and 2006 compared with estimates for earlier periods, it is likely that this was a short-lived trend. Moreover, it is also likely that it was heavily influenced by the rise in commodity-related revenue (Gupta and Tareq, 2008). The estimates here appear to be in line with those of the IMF study of Africa by Gupta and Tareq, which investigated the period 2005–2006.

#### (b) Revenue trends in African LDCs

The analysis begins with an examination of overall trends in total revenue — this includes both tax and non-tax revenue. During 1990–1994, average total revenue was 12.3 per cent of GDP in the African LDCs. By 1995–1999 it had risen very slightly, to 12.5 per cent. But by 2000–2006, it had increased to 14.8 per cent of GDP (chart 10). This represents an overall increase of about 20 per cent (in terms of percentage points of GDP), almost all of it since the year 2000.

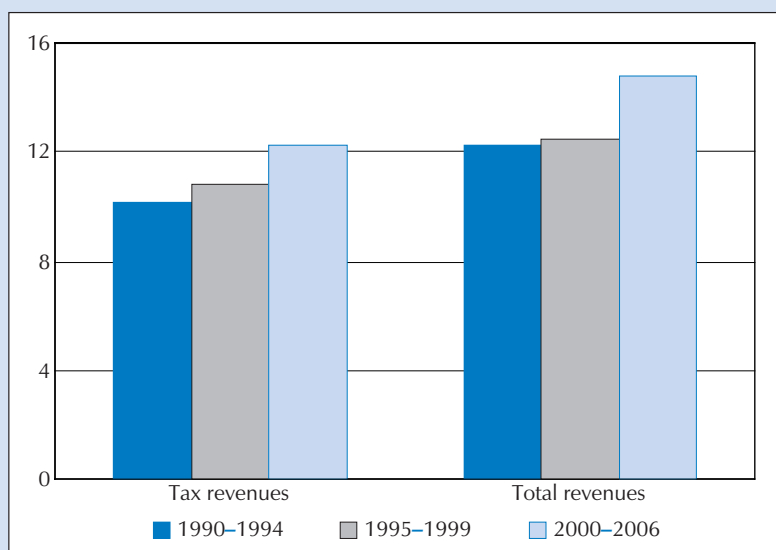
Average total tax revenue during 1990–1994 in the African LDCs was 10.1 per cent of GDP; it edged up to 10.8 per cent during 1995–1999, but there was a

*During 1990–1994, average total revenue in African LDCs was 12.3 per cent of GDP..*

*... but by 2000–2006, it increased to 14.8 per cent of GDP.*

Chart 10

#### Fiscal revenue trends in African LDCs, 1990–2006 (Per cent of GDP)



Source: McKinley (2009), based on data from the IMF.

Note: Based on a sample of 22 LDCs.

bigger increase to 12.2 per cent during 2000–2006. So, overall, there was almost a 21 per cent increase in the share of tax revenue in GDP. Taking the average for just 2004–2006, the level of tax revenue is basically the same, i.e. 12.2 per cent, so there was no evidence of significant progress for LDCs in the later years of our sample.

*Indirect domestic taxes in African LDCs increased 65 per cent in their share of GDP between 1990 and 2006 ...*

Disaggregating total tax revenue into its three major subcomponents may help to explain the modest increase in tax revenue over the period. Any residual percentages are accounted for by “other taxes”. Indirect domestic taxes (i.e. taxes on goods and services) rose significantly in the African LDCs, from 2.9 per cent of GDP during 1990–1994 to 3.7 per cent during 1995–1999, and then to 4.8 per cent during 2000–2006 (chart 11). In other words, there was an overall increase of about 65 per cent in their share of GDP.

*... while direct taxes increased by about 30 per cent.*

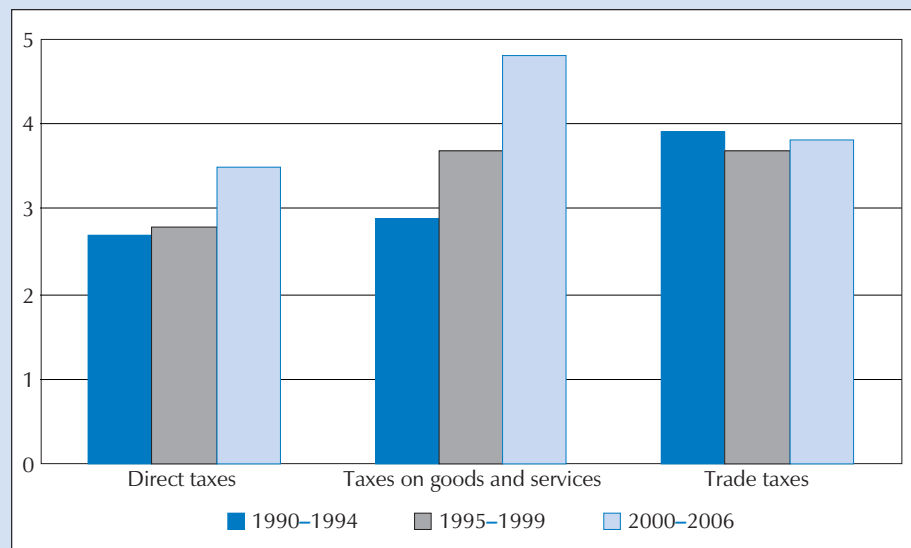
Direct taxes (such as taxes on personal income and corporate profits) rose more moderately than indirect domestic taxes. They increased very slightly from 2.7 per cent of GDP during 1990–1994 to 2.8 per cent in 1995–1999, and then rose more significantly to 3.5 per cent during 2000–2006. Overall, their share increased by about 30 per cent.

Trade taxes fell slightly over the whole period. During 1990–1995 they amounted to 3.9 per cent of GDP — higher than either direct taxes or indirect domestic taxes. But by the 1995–1999 period, they had slipped down to 3.7 per cent. Then, during 2000–2006, they edged back up to 3.8 per cent; this occurred mainly between 2004 and 2006.

During 2000–2006, trade taxes accounted for 31.1 per cent of all tax revenue — substantially down from their 38.6 per cent share in the early 1990s. Consequently, trade taxes slipped from first to second place in terms of generating tax revenue. By contrast, indirect domestic taxes rose from 28.7 per cent of total tax revenue in 1990–1994 to 39.3 per cent in 2000–2006, thus surpassing trade

Chart 11

**Trends in tax components in African LDCs, 1990–2006**  
(Per cent of GDP)



Source: McKinley (2009), based on data from the IMF.

Note: Based on a sample of 22 LDCs.

taxes in importance. Direct taxes rose only marginally, from 26.7 per cent to 28.7 per cent of total tax revenue, and remained in third place.

Between 1990–1994 and 1995–1999, direct taxes increased only slightly, and trade taxes declined. Only domestic indirect taxes showed any real improvement, rising from 2.9 per cent to 3.7 per cent of GDP. But comparing 1995–1999 with 2000–2006, improvements are noticeable in the rates of increase both of direct taxes and of indirect domestic taxes, although the pace slowed between 2004 and 2006. Trade rose marginally from 1995–1999 to 2000–2006.

However, these tax trends have to be placed within the general context of trends in growth and trade. Between 1990–1994 and 1995–1999 there was not a significant increase in trade, as measured by imports and exports. But imports rose significantly between 1995–1999 and 2004–2006. So, the fact that the share of trade taxes in GDP remained the same implies that tariff rates and/or coverage were significantly lowered.

Growth also increased between 1990–1994 and 1995–1999, and more so between 1995–1999 and 2000–2006. Therefore, indirect domestic taxes would be expected to increase as they did, based to a large extent on the corresponding increases in expenditures. But the sluggish increases in direct taxes did not match the faster increases in incomes that took place in the early years of the new millennium. It is likely that the tax reforms involving reductions in the rates of direct taxes, especially on corporate profits, slowed the rise in the share of direct taxes.

These findings cover the period 2000–2006, when both growth and trade were increasing, relative to the trends in the 1990s. So, one would expect less promising findings from the IMF study that only examined tax data from 1990–1991 to 2000–2001 (Keen and Simone, 2004). The IMF study is not directly comparable to the figures given here, because it covered all low-income countries, not just those in sub-Saharan Africa. The value of this study, however, is that it was able to presage some of the trends in tax components that continued until approximately 2005–2006.

In low-income countries in general, the IMF study found that during this period, tax revenue only rose from 14.5 per cent of GDP to 14.9 per cent. The share of direct taxes basically remained stagnant, only edging up from 3.8 per cent of GDP to 3.9 per cent. Indirect domestic taxes rose only modestly, from 5.3 per cent of GDP to 5.9 per cent, and trade taxes fell from 4.3 per cent to 3.7 per cent.

When the IMF study disaggregated the main categories of taxes, it found that corporate taxes had fallen from 2.6 per cent of GDP to 2.0 per cent, which is consistent with the efforts to cut tax rates. At the same time, however, revenue from personal income taxes rose — from 2.8 per cent of GDP to 3.5 per cent. It is also important to note that revenue from property taxes — a source of revenue that is often neglected — declined slightly, from 0.3 per cent of GDP to 0.2 per cent.

Within the category of indirect domestic taxes, revenue from sales taxes and VAT rose moderately, from 2.8 per cent of GDP to 3.5 per cent. Meanwhile, excise taxes — the other main component of indirect domestic taxes — declined slightly, from 2.1 per cent to 2.0 per cent. Since the rise to prominence of VAT, excise taxes have been relatively neglected as a source of revenue.

The IMF results suggest that the share of total taxes in GDP stagnated during the 1990s. This is consistent with the above results for LDCs in sub-Saharan Africa.

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*Imports rose significantly between 1995–1999 and 2004–2006...*

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*... but the fact that the share of trade taxes in GDP remained the same implies that tariff rates and/or coverage were significantly lowered.*

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*The sluggish increases in direct taxes did not match the faster increases in incomes that took place in the early years of the new millennium.*

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*International competition to lower taxes to attract FDI has led to the erosion of corporate tax revenues in many developing countries.*

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Statutory rates for corporate taxes were dramatically reduced, but the IMF study finds that the tax base did not increase. In fact it decreased, and thus corporate tax revenue fell overall. The study highlights this as an area of concern, since international competition to lower rates (in an attempt to attract FDI) has led to the erosion of corporate tax revenues in many developing countries.

The IMF study concludes that VAT was indeed effective, but that its efficiency gains, in comparison with previous sales taxes, remain to be substantiated, especially in sub-Saharan Africa. An earlier IMF study (Baunsgaard and Keen, 2005) found that in low-income countries, VAT had not compensated for the loss of trade taxes, as had been widely expected. In fact, VAT was found to have recouped only about 30 per cent of the revenue lost in low-income countries by lowering trade taxes.

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*Countries should refrain from further reducing import tariffs until domestic indirect and direct taxes are able to substantially boost revenue.*

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So, the Keen and Simone study concludes that in many developing countries, especially low-income countries or LDCs, further trade liberalization is likely to reduce revenue. Consequently, there is a greater need to sequence the reduction of tariffs with the introduction and strengthening of VAT. Now that VAT has been introduced in many countries, the study notes that the chief tasks ahead are to improve its design and strengthen its administration. These tasks, however, are likely to require more time than was originally assumed.

The Keen and Simone study also cautions against the widespread view that tax rates on corporate profits should be lowered further. They have already noted the significant decline in tax revenue from this source, and underlined the weakening of this convenient tax handle.

#### *(c) Implications for tax policies*

The above results — taken together with further examination of the experience of individual countries — point towards general outlines for the kinds of tax policies that LDCs both in sub-Saharan Africa and elsewhere could usefully adopt.

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*Domestic indirect taxes need to be increased at a faster rate than has been the case hitherto.*

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Firstly, countries should refrain from further reducing tariffs until domestic indirect and direct taxes are able to substantially boost revenue. Recent increases in imports, as has already been mentioned, should have increased revenue from trade taxes. Worryingly, tariffs can be expected to fall further in the coming years, as countries join free trade areas and customs unions and revenues could also fall as the global recession affects trade flows. Since trade taxes still account for a significant share of tax revenue, the revenue losses from further liberalization, especially under conditions of declining trade, could be significant.

Domestic indirect taxes need to be increased at a faster rate than has been the case hitherto. Reducing VAT exemptions could contribute to this goal. Raising VAT rates on luxury consumption items would help to augment revenues and to enhance the equity of the tax structure. Such a change in policy would also help to move some of the tax burden onto higher-income households that can better afford to pay such rates during the global recession.

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*Particular attention should be paid to strengthening excise taxes, such as those on alcohol, tobacco and vehicles.*

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Particular attention should be paid to strengthening excise taxes, such as those on alcohol, tobacco and vehicles. Such taxes have been relatively neglected during the introduction of VAT. Targeting excise duties on luxury consumption items would make the most sense. In recent years, countries have reduced excise taxes on food and petroleum, in order to mitigate the impact of rising prices. Keeping such rates at low levels is sensible for the purposes both of poverty reduction and of growth, especially now that growth is slowing in many developing countries.



But this stance would imply instituting — in compensation — greater curbs on the consumption of luxuries or non-essential items.

Increases in revenue from direct taxes have been too modest. High-income taxpayers, who often provide the majority of direct tax revenue, could be covered more effectively. This would improve equity without necessarily raising rates. Setting up special units for high-income taxpayers has produced significant results in a number of countries.

Reducing tax holidays and exemptions for corporations would contribute to increased revenue. Governments should withdraw from the self-defeating international competition to lower rates on corporate profits. Doing the same for personal income taxes would also make sense.

Statutory rates of corporate income tax fell significantly in sub-Saharan Africa in the 1990s, but the revenue from this source either remained unchanged or fell as a share of GDP. So the supply-side theory that posited a consequent increase in the tax base has not proved to be valid.

Further declines in tax rates on corporate profits should be resisted. In fact, in a significant number of cases in which corporate profits have been based on the extraction of natural resources, such as minerals or oil, a strong case can be made for raising the rates of taxes and royalties.

LDCs should also reconsider the widespread policy of exempting high-income expatriates from paying income taxes. This exemption creates an unfortunate demonstration effect for high-income nationals, encouraging them to believe that it is legitimate for them not to pay taxes (Di John, 2008).

An area of tax policy that has been neglected in LDCs is property taxes, which often finance local Government. Such taxes mainly cover urban areas, where most of the rich and the middle class are concentrated. Strengthening property taxes would help make the general tax structure more progressive. Property taxes can also help to boost domestic production, if they are used to finance the urban infrastructure on which many countries' manufactured export sectors rely.

Some analysts argue that concentrating on property taxes will not produce fruitful results, because of the need to set up a system of property registration. But this argument could just as well work in the opposite direction: stressing the importance of property taxes would lead to greater efforts to set up credible databases of property registration (Di John, 2008). One reason that property taxes are underutilized is that collecting them would require long-term investments in the administrative capacities of the State.

Many analysts point to the severe constraints on mobilizing revenue posed by the structural features of the underdeveloped economies of the LDCs. Widespread informality is one such problem. Many informal-sector enterprises pay negligible tax. Theoretically, VAT should tax the final consumption that such enterprises contributed to, provided that they were part of the value chain that produced the consumption item. But the formal bookkeeping that would be necessary to account for their contribution often fails to capture it.

Moreover, such firms face a disincentive to becoming part of the formal economy, since they would then become subject to corporate taxes. And yet, they also face the problem of lack of access to formal-sector credit, training, and output markets. So, one way of bringing them into the formal sector, and into the tax net, would be for the State to implement an explicit production strategy

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*Governments should withdraw from the self-defeating international competition to lower rates on corporate profits.*

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*Reducing tax holidays and exemptions for corporations would contribute to increased revenue. Doing the same for personal income taxes would also make sense.*

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*Strengthening property taxes would help make the general tax structure more progressive.*

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*One way of bringing informal firms into the tax net would be for the State to implement an explicit production strategy that provides them with attractive incentives to register.*

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that provides them with attractive incentives. These could include investment in relevant infrastructure, support for marketing and distribution, and microcredit. Based on enhanced access to such benefits, informal-sector enterprises would have greater motivation to register with the tax authorities (Di John, 2008).

The recent upheaval in the financial markets underscores the possibility of taxing the financial sector, especially in order to rein in excessive speculation. Although capital markets are not well developed in LDCs, especially in sub-Saharan Africa, they are developing rapidly in some countries. Imposing a nominal securities transaction tax — for example at 0.1 per cent — could help to raise revenue, and could also stem speculative activities and market volatility. Such a tax could cover — for example — equities, bonds, derivatives and government securities. Various controls on foreign exchange outflows could also help check the volatility of “hot money”, which often contributes to destabilizing a country’s exchange rate (section E.2(b) of this chapter).

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*Imposing a nominal securities transaction tax could help to raise revenue, and could also stem speculative activities and market volatility.*

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#### 4. THE ROLE OF ODA IN DOMESTIC RESOURCE MOBILIZATION

The continuance of sizeable inflows of ODA to LDCs will be critical to their success in maintaining a dynamic rate of long-term growth and development in spite of the deteriorating conditions associated with the global financial crisis and recession.

Unfortunately, ODA earmarked for government and related purposes has neglected critical objectives, such as building national capacities to mobilize domestic savings and raise domestic revenue. Consequently, public and private investments continue to languish in these countries, where substantial investment is most needed.

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*Increased public investment could “crowd in” private investment, instead of “crowding it out”.*

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From the mid-1960s until recently, public investment received little emphasis in development circles. Poverty alleviation programmes did not appreciably improve its status in the 1990s, except perhaps for some investments in social infrastructure.

The MDG framework, however, has put a sizeable expansion of public investment squarely on the development agenda. There has also been a growing acknowledgement that increased public investment could “crowd in” private investment, instead of “crowding it out”. This positive impact is more likely when the capital stock has been allowed to deteriorate over decades, as has been the case in many LDCs (UNCTAD, 2006: 193–220). Under such conditions, initial investments could produce dramatically high returns.

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*It is important to try to direct ODA more towards building the domestic capacities of LDCs to mobilize domestic sources of development finance.*

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As global conditions deteriorate, it is crucial to try to maintain the development impetus imparted by the MDG agenda, even as fiscal policies have to concentrate more on counter-cyclical interventions.

In this context, it is important to try to direct ODA more towards building the domestic capacities of LDCs to mobilize domestic sources of development finance. This implies much greater emphasis on mobilizing domestic savings. In turn, such an emphasis implies a greater concentration on reforming and strengthening domestic financial institutions, so that they can more effectively perform the function not only of mobilizing savings but above all, of channelling them into productive investment.

Mobilizing more domestic sources of finance also implies greater attention to mobilizing domestic revenue. In fact, instead of dampening the incentives for mobilizing revenue — as some analysts have claimed — ODA should be channelled into strengthening national capacities to mobilize much more domestic revenue.

Until recently, however, much of the debate on the effectiveness of aid has focused on the danger to macroeconomic stability of the aid upsurge that was projected to accompany the adoption of MDG-oriented national development strategies. Such debate has only served, however, to focus attention on short-term stabilization issues, to the neglect of how ODA could be reformed to contribute effectively to long-term development.

The 2007 report entitled *The IMF and Aid to Sub-Saharan Africa*, by the IMF Independent Evaluation Office, is pertinent to the condition of LDCs (IMF-IEO, 2007). The report evaluated the impact of ODA on low-income Poverty Reduction and Growth Facility (PRGF) countries (many of them LDCs) in the period from 1999 to 2005. It found that 36 per cent of ODA to these countries went, at the margin, into reserve accumulation (i.e. was not absorbed) and another 37 per cent was used to retire domestic debt (i.e. was not spent). That left only a modest 27 per cent of the increase in ODA that was programmed to be used to finance fiscal expansion, and growth-enhancing public investment in particular.

For the promotion of long-term growth and development, such an allocation is clearly suboptimal. In the short term, since absorption (100 per cent – 36 per cent = 64 per cent) exceeded government spending (27 per cent), the potential growth of aggregate demand was being constrained. As a result, such a constraint should have tended to dampen any rise in inflation.

Undoubtedly, domestic and external financial liberalization has exposed developing countries to recurrent financial crises. They therefore needed a credible stock of reserves to counter the effects of potential terms-of-trade or capital-outflow shocks. Those that have amassed a stock of reserves are in a relatively stronger position at the onset of a global recession and slowdown in trade.

Concentrated mostly in middle-income countries and energy exporters, reserve accumulation has been considerable. It has contributed to channel global savings to the United States, rather than to poor countries that were badly in need of capital to finance the expansion of public and private investment. LDCs have also greatly increased their accumulation of reserves, which amounted to 12.4 per cent of their GDP in 2006, up from 7.1 per cent in 1995–1999 (UNCTAD, 2008a: 24–25).

In addition to the large stockpiling of reserves, the IMF study also found that 58 per cent (37/64) of the non-reserve financing available for fiscal expansion had been diverted to paying off domestic debt. During the 1990s, when ODA was falling, low-income countries — and LDCs in particular — understandably had to resort to other means to finance government expenditures. Domestic debt was a major option. But it provided only short-term relief, and it exacted high interest payments.

Even when ODA was rising, domestic debt was still demanding to be paid off, and so a significant proportion of ODA was apparently used for that purpose. It is ironic that ODA has been, in effect, merely compensating since the turn of the millennium for its decline during the 1990s.

If paying off domestic debt could have lowered real rates of interest in LDCs in sub-Saharan Africa, this would have certainly been an improvement. But interest rates remained high. The proportion of all countries in sub-Saharan Africa that have real rates of interest higher than 6 per cent has risen since the year 2000 to about 80 per cent. Moreover, the spread between deposit and lending rates of interest has remained wide.

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*Only a modest 27 per cent of the increase in ODA to low-income Africa during 1999–2005 was programmed to be used to finance fiscal expansion, and growth-enhancing public investment in particular.*

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*Domestic and external financial liberalization has exposed developing countries to recurrent financial crises.*

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*Even when ODA was rising since the turn of the millennium, it was merely compensating for its decline during the 1990s.*

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*The proportion of all countries in sub-Saharan Africa that have high real rates of interest has risen since the year 2000 to about 80 per cent.*

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Risk is one explanation for such wide spreads. The market power exercised by the small number of large and often foreign-owned banks that dominate the financial sector in LDCs is another. Unfortunately, as long as such high real rates of interest prevail and interest rate spreads remain wide, there is little prospect for accelerated capital accumulation, which has to be the driving force for long-term growth and development.

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*As long as high real rates of interest prevail, there is little prospect for accelerated capital accumulation, which has to be the driving force for long-term growth and development.*

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Thanks to externalities and complementarities associated with capital accumulation, ODA could play a pivotal role in helping countries break this gridlock. If it is allocated to key economic infrastructures with large spillovers, ODA may crowd in additional investment and trigger large supply responses. In turn, this would spur income growth, thereby strengthening the capacity of financial institutions to mobilize domestic savings.

Many LDCs remain highly dependent on ODA, particularly for financing public investment. But the extent to which ODA can influence domestic investment in developing countries depends on a number of factors.

There is continuing debate, for example, on whether ODA actually displaces domestic savings, and thus either has no net positive effect on domestic investment or serves to reduce it. Empirical investigation of this issue indicates that the impact of ODA depends, to some extent, on whether it is provided as grants or loans.

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*The impact of ODA depends, to some extent, on whether it is provided as grants or loans.*

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The thrust of empirical results suggests that ODA does not completely displace domestic savings. In other words, when savings are regressed on a set of independent variables, which usually include income per capita and the dependency ratio, as well as ODA, the parameter of the ODA variable ranges between -1 and 0. This implies that ODA is used to boost both consumption (which will lower savings) and investment.

However, such analysis neglects the fact that a significant proportion of ODA might not even be converted into the domestic financing of consumption or investment. A recent study of this issue, which was commissioned by the International Policy Centre for Inclusive Growth and which complemented the earlier findings of the IMF evaluation, found that a significant proportion of ODA was simply converted into a reverse capital outflow, either for debt repayments or for the accumulation of foreign exchange reserves (Serieux, 2009).

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*ODA does not completely displace domestic savings.*

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Based on panel data for 29 sub-Saharan African countries for the period 1965–2006, the Serieux study finds that 35 per cent of ODA was converted into capital outflows, while 24 per cent financed domestic investment and 41 per cent financed domestic consumption.

From 1974 to 1994, when ODA was continuously increasing, the percentage of ODA converted into capital outflows rose to 48 per cent, while 31 per cent of ODA financed domestic investment and 21 per cent financed domestic consumption.

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*ODA should be much more directly tied to the financing of domestic investment.*

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The study does not draw out the possible policy implications of these findings. But it is important to do so, because ODA should be much more directly tied to the financing of domestic investment, particularly in order to expand productive capacities and generate higher rates of growth.

The study speculates that in the 1990s, a significant proportion of ODA was being used to finance the payment of principal or interest on external debt (most of it being concessional debt). In more recent years, it appears that ODA has been increasingly directed into the accumulation of foreign exchange reserves, as the IMF study of the 1999–2005 period suggests.

In order for LDCs to be able to mobilize sufficient resources to finance investment and development-oriented expenditures and to continue making progress towards the MDGs, it is necessary that current levels of ODA not be reduced. In addition, since the current crisis has heightened the risks on many LDCs' remaining debt, they should receive more debt relief. Providing such relief is not likely to have a significant immediate impact on the budgets of donor countries. However, further debt relief should not simply be a substitute for additional ODA, nor should additional ODA be a substitute for needed debt relief.

Since a portion of ODA results in reverse capital outflows, it is important for Governments to institute some forms of management of the capital account in order to safeguard the resources that are made available, theoretically, for domestic investment. "Capital flight" is a serious problem for many LDCs. Therefore, some management of capital outflows (probably more than capital inflows) should be a priority. This issue is discussed in section E.2(a) of this chapter.

On the issue of whether the proportion of ODA available for domestic expenditures is used for consumption or investment, it is important to press for a number of reforms in the allocation of ODA. In recent years, in conjunction with the rise of national poverty reduction strategies, donors have skewed ODA towards the social sectors — towards health and education in particular. In the process, the proportion of ODA commitments devoted to financing essential economic infrastructure has nearly halved (UNCTAD, 2006: 28–32).

It is misguided to try to pit ODA financing of social infrastructure against ODA financing of economic infrastructure. The MDG agenda should be building a consensus for increasing public investment in both areas. Nevertheless, it is true that economic infrastructure has been underfunded by Western donors in recent years, and this is part of the explanation for the lack of expansion of productive capacities in many developing countries. Without such expansion, economic growth is unlikely to accelerate to the levels that are necessary to generate the public revenue needed to finance both social services and economic services.

It has also been well documented that ODA is a variable and unpredictable source of development financing, especially compared to domestic revenue. Disbursements of ODA are even more variable than allocations. These problems point to the need to institute longer-term commitments of aid from both bilateral and multilateral donors.

Lengthening the time frame of the commitment of ODA would be necessary in order to help strengthen government capacities to mobilize domestic revenues. A "matching funds" approach could be a useful part of such a reform. Currently, donors often provide budget support when a Government specifies its expenditure needs and calculates the financing gap to be filled by ODA. Donors then promise to finance the revenue shortfall that is identified. But such an approach can lead to government disincentives to raise domestic revenue. It is also likely to lead to the downscaling of ambitions for national development plans with respect to the potential represented by the promised higher ODA inflows (UNCTAD, 2008a: 119–120).

A better option would be to have donors agree to match a percentage of the funds collected by the Government, up to a fixed limit (Di John, 2008). This limit could be reduced over time, as the Government increases its capacity to raise domestic revenue. One of the advantages of such an approach is that Governments would have an incentive to raise more revenue, since that would lead to additional inflows of ODA.

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*Further debt relief should not simply be a substitute for additional ODA, nor should additional ODA be a substitute for needed debt relief.*

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*In recent years, the proportion of ODA commitments devoted to financing essential economic infrastructure has nearly halved.*

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*Lengthening the time frame of the commitment of ODA would be necessary in order to help strengthen government capacities to mobilize domestic revenues.*

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## C. Monetary and financial policies

### 1. ALTERNATIVE MONETARY POLICIES

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*Monetary policy has tended to dominate all other macroeconomic policies, and have been focused on maintaining macroeconomic stability, not on promoting growth, employment or exports.*

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Conventional macroeconomic policies give the leading role to monetary policies, over both fiscal and exchange rate policies. This is surprising, since monetary policies tend to be congenitally ineffective in the absence of developed financial sectors, as found in many developing countries and, most of all, in LDCs.

For conventional macroeconomics, the overriding function of monetary policies is to contain inflation at low levels. This is considered to be essential in order to foster a conducive business climate. Until recently, the prevailing target for inflation rates tended to be set at below 5 per cent. More recently, in discussing low-income countries in Africa, IMF has acknowledged that inflation in the range of 5–10 per cent is unlikely to have an adverse impact on growth.

The main policy tool to influence the inflation rate has been the policy interest rate of the central bank. In practice, interest rate policies have tended to dominate all other macroeconomic policies, and have been focused on maintaining macroeconomic stability, not on promoting growth, employment or exports.

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*A spiral of output prices and wages is highly unlikely in LDCs, where surplus labour is abundant, trade unions are weak, and the economy operates at well below full capacity.*

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This stance derives in part from worries about raising expectations of even higher rates of inflation, which it is believed would lead to a self-reinforcing upward spiral of output prices and wages. However, such a spiral is highly unlikely in LDCs, where surplus labour is abundant, trade unions are weak, and the economy operates at well below full capacity.

For conventional macroeconomics, inflation is assumed to originate in the monetization of fiscal deficits. It is not assumed to have any structural roots that the market cannot resolve. Hence, there is a bias towards maintaining high real rates of interest and containing wage pressures (particularly those of public sector workers).

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*The great majority of LDCs have only moderate rates of inflation.*

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Between 2000 and 2007, LDCs from all regions for which data are available do not suffer from inordinately high rates of inflation. Out of 47 LDCs, for which data are available, the average consumer price index (CPI) inflation rate for 2005–2007 was above 15 per cent in only five countries — Angola, Eritrea, Guinea, Myanmar, and Sao Tome and Principe (table 7). The great majority of LDCs have only moderate rates of inflation (less than 15 per cent). Thirty-four of them had average rates for 2005–2007 that were below 10 per cent. The average CPI inflation rate for all LDCs during 2005–2007 was 9.8 per cent. It reached similar levels in African and Asian LDCs, while island LDCs had the lowest average (4.5 per cent).

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*There is virtually no empirical evidence that an inflation rate below 15 per cent has any adverse impact on economic growth.*

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There is virtually no empirical evidence that an inflation rate below 15 per cent has any adverse impact on economic growth (Pollin and Zhu, 2006). Above 15 per cent, there is some dispute as to whether growth will be adversely affected. But it is somewhat misleading to focus the argument on such threshold levels. For practical purposes, what is often more important is the source of inflation. Does it, for example, originate from the monetization of fiscal deficits? Is it accompanying a period of rapid growth, in which investment demand is driving the momentum? Or is it due to supply shocks, whether domestic or external?

It is important to understand the sources of inflation because the policy responses might differ. A recent study of 28 countries in sub-Saharan Africa



Afghanistan	8.2
Angola	15.8
Bangladesh	7.5
Benin	3.5
Bhutan	5.1
Burkina Faso	2.8
Burundi	7.4
Cambodia	5.4
Central African Republic	3.8
Chad	2.6
Comoros	3.2
Djibouti	3.4
Equatorial Guinea	5.3
Eritrea	17.4
Ethiopia	14.3
Gambia	3.0
Guinea	30.0
Guinea-Bissau	3.2
Haiti	13.2
Kiribati	-0.4
Lao People's Democratic Republic	6.5
Lesotho	5.8
Liberia	8.3
Madagascar	12.9
Malawi	12.5
Maldives	3.6
Mali	2.9
Mauritania	8.3
Mozambique	10.2
Myanmar	20.9
Nepal	6.9
Niger	2.3
Rwanda	9.0
Samoa	2.6
Sao Tome and Principe	19.5
Senegal	3.1
Sierra Leone	11.5
Solomon Islands	8.6
Sudan	7.5
Timor-Leste	3.8
Togo	3.2
Tuvalu	2.3
Uganda	7.3
United Republic of Tanzania	7.5
Vanuatu	2.4
Yemen	14.8
Zambia	12.2
<b>LDCs<sup>a</sup></b>	<b>9.8</b>
<i>Africa and Haiti</i>	9.7
<i>Asia</i>	10.0
<i>Islands</i>	4.5

Source: UNCTAD secretariat calculations, based on data from the GlobStat database and the United Nations/DESA Statistics Division.

a Countries weighted by GDP for all groups of countries.

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*A policy bias towards raising interest rates stubbornly persists among central bankers.*

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found, for example, that inflation arose mostly from supply shocks, the inertial momentum of initial increases in inflation, and sharp exchange rate depreciations (Heintz and Pollin, 2008). The sharp increases in food and oil prices in 2008 are a recent example of an external supply shock. Responding effectively to such shocks is likely to require policies that are not focused on interest rates or on inflation targets. Such shocks frequently cause prices to breach the low inflation targets set by central banks. So, inflexibly attempting to maintain such targets will be counterproductive. Policymakers should look for other means.

For example, if there were an external shock to food prices, LDC Governments could respond with food relief if they had maintained a buffer stock of strategic grains — or had access to international stocks. If there were a shock to oil prices, Governments could provide temporary subsidies for electricity supply or public transportation (Pollin et al., 2006).

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*Interest rates in the great majority of LDCs significantly exceed what would be conducive to investment-driven growth...*

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Would raising interest rates under such circumstances improve economic performance? It is more likely that such a response would not only slow economic growth further, but would also exacerbate inflation in the short term by making credit more expensive. And yet, a policy bias towards raising interest rates stubbornly persists among central bankers. This bias often goes hand in hand with an effort by finance ministries to contain fiscal deficits to low levels. Both policies would dampen aggregate demand.

High real rates of interest still prevail in low-income countries and LDCs in sub-Saharan Africa. In the period from 2004 to 2006, for example, 27 out of a sample of 32 LDCs had *real* rates of interest of 6 per cent or above (table 8). Given that the real rate of interest is supposed to be roughly equivalent to the long-term sustainable rate of economic growth, the interest rates in the great majority of LDCs significantly exceed what would be conducive to investment-driven growth.

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*... and tend to be growth-dampening, because they raise excessively the cost of credit for both public and private investment.*

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For all LDCs during 2004–2006, the average real rate of interest was 9.0 per cent. For African LDCs it was significantly higher, at 10.1 per cent. For Asian LDCs, the average real rate was 7.6 per cent, and for island LDCs it was 9.2 per cent. For the sake of comparison, in high-income OECD countries, the corresponding real interest rate over the same period was lower than 4 per cent in 12 out of a sample of 16 countries.

Such high rates as those in place in LDCs tend to be growth-dampening, because they raise excessively the cost of credit for both public and private investment. During a global economic slowdown, when many industrialized countries have already slipped into recession, such high real interest rates will surely worsen the economic conditions in LDCs.

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*The general stance of monetary policy should be to accommodate more expansionary, investment-focused fiscal policies.*

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The general stance of monetary policy should be to accommodate more expansionary, investment-focused fiscal policies. In general, monetary policies are simply ineffective at playing the leading role in macroeconomic management in the context of low-income countries or LDCs. This role should be played by fiscal policies.

The primary responsibility of monetary policy is to ensure that there are adequate increases in liquidity — i.e. growth of the money supply — to meet the growing demand for money as a result of rising incomes. This implies trying to maintain moderately low real rates of interest that will help alleviate the borrowing costs of both the private sector and the Government.

**Table 8**  
**LDCs with high real interest rate,<sup>a</sup> 2004–2006**  
*(Per cent, period averages)*

Group	Country	Real interest rate
Africa and Haiti	Gambia	24.5
	Haiti	23.2
	Angola	19.1
	Malawi	15.6
	Central African Republic	15.4
	Mozambique	11.8
	Uganda	11.6
	Madagascar	11.2
	Zambia	8.8
	Burundi	8.3
	Sierra Leone	8.1
	Lesotho	7.9
	Djibouti	7.8
	Liberia	7.5
	United Republic of Tanzania	6.8
	Mauritania	6.4
Rwanda	6.2	
Asia	Lao People's Democratic Republic	19.6
	Cambodia	11.3
	Bhutan	9.5
	Bangladesh	9.4
Islands	Sao Tome and Principe	19.2
	Maldives	12.0
	Comoros	8.4
	Solomon Islands	6.7
	Vanuatu	6.2
	Samoa	6.1

Source: World Bank, *World Development Indicators 2008*, CD-ROM.

<sup>a</sup> The lending rate is the bank rate that usually meets the short- and medium-term financing needs of the private sector. Real interest rate is the lending rate adjusted for inflation as measured by the GDP deflator. High real interest rates are those above 6 per cent per annum.

Such a policy stance, however, runs counter to the practice of inflation targeting, which, in either explicit or implicit form, prevails as the favoured option for central bankers in LDCs as well as in other low-income countries.

During the current global and economic slowdown, inflation in LDCs is not a major danger. Commodity prices have been declining, and they are projected to remain subdued for a few years. Price inflation is falling dramatically in many industrialized countries, and there is a distinct concern in some of them that deflation, i.e. falling price levels, will soon set in.

Under such circumstances, monetary policies should support the leading role of fiscal policies in trying to prevent a substantial fall in aggregate demand. In other words, monetary policies should operate in a counter-cyclical fashion. If, instead, central banks insist on maintaining high rates of interest, monetary policies will operate pro-cyclically and will make any downturn even sharper and more protracted.

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*During the current global and economic slowdown, monetary policies should support the leading role of fiscal policies in trying to prevent a substantial fall in aggregate demand.*

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## 2. WHY IS MONETARY POLICY INEFFECTIVE?

The initial contention of this section was that monetary policies are particularly ineffective in low-income countries, and in LDCs in particular. Many such countries might nominally possess the flexibility to use standard monetary instruments (such as open market operations, foreign exchange operations and interest rate policies), but they are unable to achieve their goals because of the underdevelopment of their financial systems (section D.1 of this chapter). The situation in most of the LDCs is that they have monetary policy in form but not in essence.

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*The situation in most of the LDCs is that they have monetary policy in form but not in essence...*

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Monetary policy can be represented, in simplified form, as the activity of the monetary authority (the central bank) to influence the amount of wealth invested in financial assets and to determine its distribution between money and public bonds. The central bank does this by buying and selling bonds and by acting as a price setter, through its policy interest rate.

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*... since they are unable to achieve their goals because of the underdevelopment of their financial systems.*

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For this activity to be effective, a viable market for public bonds must exist. Even in the most developed countries, relatively few households own bonds. In general, the vast majority of bonds are held by private banks and corporations (both national and international). Hence, an efficient bond market — the necessary prerequisite for an effective monetary policy — requires a burgeoning financial and corporate sector.

LDCs, however, do not have these sectors. Financial sectors in LDCs tend to be dominated by a few banks, which are usually foreign-owned. Large non-financial corporations are typically restricted to the extractive sectors — especially petroleum and minerals. In some countries, there might also be a limited number of large non-extractive enterprises, as well as high-income households, seeking financial forms in which to hold their wealth.

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*LDC financial sectors tend to be dominated by a few banks, which are usually foreign-owned.*

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In LDCs, the banks (even if they are nationally owned), corporations, and wealthy households will not, taken together, create the basis for an efficient bond market. Foreign bonds — especially from the developed countries — offer a more secure form of wealth, and they can be easily exchanged in world markets, whereas LDC bonds cannot.

There are two mechanisms that the central banks in LDCs could use to create a market for bonds, but both of them undermine the effectiveness of monetary policy. The first is to set the interest rate on government bonds high enough to induce large financial and non-financial corporations to purchase them. This mechanism negates the use of monetary policy to reduce fluctuations in the economy and to lay the preconditions for long-term growth. In effect, the bond rate is dictated by what is necessary to sell the bonds, not by growth or development objectives.

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*In LDCs, the banks, corporations, and wealthy households will not, taken together, create the basis for an efficient bond market.*

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The second mechanism, which is very common, is to have regulations that compel banks to hold a specified portion of their assets in the form of government bonds. But this creates an involuntary demand for bonds, not a market. If the two mechanisms are used together, the central bank could discover that it faces the worst of all worlds: a non-functioning bond market with interest rates that both discourage private investment and create a large debt service burden for the public budget.

The central bank could seek to affect interest rates directly, but with an inefficient bond market this is unlikely to be successful. For example, the purpose of lowering the central bank rate is to lower the cost for banks when they borrow from the central bank. This should induce the banks to pass on the reduced rate to their borrowers. In turn, the borrowers should increase their planned investments and borrowing and so stimulate an expansion of the real economy.

There are several reasons why this sequence of events is unlikely to occur in LDCs, or in many low-income countries. The commercial banks might not borrow from the central bank when they need additional funds, but rather from abroad. The banks often have excess funds, which they do not lend because they consider the rate of return to be too low or the risks of lending too high. Or else, most businesses and households are unable to borrow from the banks because they lack the formal characteristics that banks require (such as business records in standard accounting form).

In summary, financial institutions in LDCs tend to mirror their environment: they are underdeveloped and ineffective. Their revenue derives disproportionately from holding government bonds, not from lending for productive investment. Consequently, when they do lend, they ration credit to the “most creditworthy” and they tend to charge relatively high rates of interest.

The restrictive monetary policies of the central bank — which are likely to be wedded, for example, to targeting low inflation — only exacerbate the underlying structural constraints on financial institutions in LDCs.

## D. Reforming financial institutions to provide development finance

### 1. THE FINANCIAL SECTOR IN LDCs

The state of development of financial intermediation and of financial systems in LDCs was analysed in *The Least Developed Countries Report 2006* (UNCTAD, 2006: 230–246). It showed that banks in LDCs tend to hold large amounts of excess liquidity, charge high lending rates of interest, and prefer short-term, risk-free government securities. They are not inclined to engage patiently in long-term development-oriented lending at moderate rates of interest (Stallings and Studart, 2006). But it is precisely these forms of development finance that least developed countries need in order to maintain public and private investment, as well as some momentum in their growth rates.

Households in LDCs are generally reluctant to hold their wealth in the form of financial savings. This is partly due to a lack of confidence in banking institutions. Hence, a major contribution of fiscal policy could be to finance financial reforms, such as instituting some form of deposit insurance to help instil such confidence.

Government policies would have to work on strengthening the capacities of financial institutions to support investment through the appropriate extension of credit, and to mobilize savings. The two functions could reinforce each other at the macroeconomic level. At present, however, there is a disjuncture between the two. Much of LDCs’ investment is financed by ODA (or enclave FDI, such as that for oil extraction). At the same time, there is little motivation or capacity in the financial institutions to mobilize domestic savings.

### 2. MOBILIZING DOMESTIC SAVINGS IN LDCs

Macroeconomic policies can play an important role — both directly and indirectly — in boosting income growth, thereby generating more domestic savings. Fast-growing developing economies typically have large investment ratios and improving current account balances, which translate into rising saving ratios

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*Banks often do not lend because they consider the rate of return to be too low or the risks of lending too high.*

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*Banks in LDCs tend to hold large amounts of excess liquidity, charge high lending rates of interest, and prefer short-term, risk-free government securities...*

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*... and are not inclined to engage patiently in long-term development-oriented lending at moderate rates of interest.*

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*Government policies should strengthen the capacities of financial institutions to support investment through the appropriate extension of credit, and to mobilize savings.*

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(UNCTAD, 2008b). The relatively good economic performance of LDCs during 2000–2007 implied rising domestic savings. However, with the onset of the global financial crisis and economic downturn, savings levels are likely to contract, along with incomes.

*During 2000–2007, domestic savings rates in African LDCs rose appreciably — to over 16 per cent of GDP — double the levels of the 1980s and 1990s.*

During 2000–2007, domestic savings rates in African LDCs did rise appreciably — to over 16 per cent of GDP — double the levels of the 1980s and 1990s (chart 12). The savings rate in Asian LDCs was slightly lower, at 15.5 per cent of GDP, but the rate in island LDCs dropped precipitously to under 5 per cent, from almost 15 per cent in the 1990s. However, behind all these averages, there was a mixed performance. The big jump in domestic savings in the period 2000–2007 was driven by trends in oil- and mineral-exporting LDCs (UNCTAD, 2008a: 9).

There is much that Governments in LDCs can do to strengthen the institutional and policy foundations for stimulating aggregate demand and income growth. While fiscal policies can have an indirect effect on savings through crowding in investment and boosting incomes, Government can also affect the real cost of investments by strengthening the intermediation role of credit and financial institutions. In most cases, LDCs have weak financial institutions, or have financial sectors that are dominated by a small set of foreign banks unwilling to undertake broad-based lending.

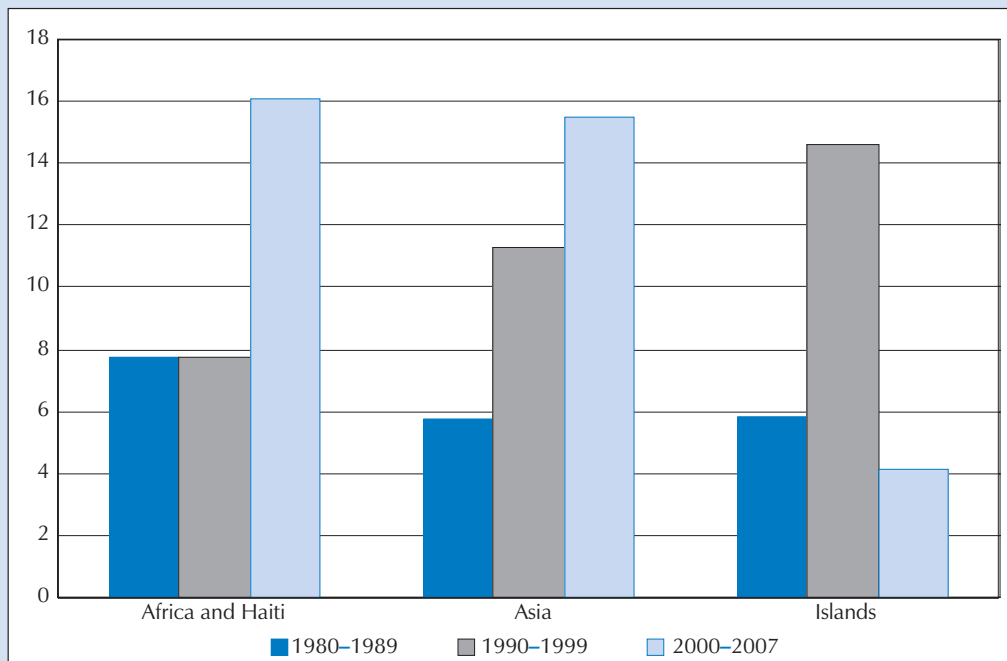
*The savings rate in Asian LDCs was slightly lower, at 15.5 per cent of GDP.*

### 3. IMPROVING DEVELOPMENT FINANCE

The major approaches to strengthening domestic financial institutions can be categorized in three ways. The first is to improve the market incentives of financial institutions to mobilize savings and channel them into public and private

Chart 12

Domestic savings in LDCs, 1980–2007  
(Per cent of GDP)



Source: UNCTAD secretariat calculations, based on data from the United Nations/DESA Statistics Division.

Note: Domestic savings are estimated as the differences between GDP and final consumption expenditure.

investment. The second is to link formal financial institutions with informal financial institutions, in order to broaden the base for both savings and lending. The third is to create or revive public institutions such as agricultural banks or development banks.

*(a) Market incentives*

If Governments choose to rely on market incentives, one option would be to provide public guarantees for a proportion of the loans offered by commercial banks. Hence, such loans could carry a somewhat lower rate of interest. But, in return, borrowers would have to be held accountable for repaying such concessional loans. This would imply requiring borrowers to supply some form of collateral, and instituting monitoring and performance targets. To this end, borrowers could also be required to deposit part of the loan in an escrow account, which would be returned to the borrower upon repayment of the loan.<sup>3</sup>

The terms of such loans could be adjusted in order to ensure that the Government does not shoulder any substantial fiscal burden in backing them. A recent study in South Africa calculated that if one quarter of domestic investment were financed by such loans — and if the government guarantee covered only three quarters of each loan and the default rate were assumed to be 15 per cent — then the Government would face a cost of only 1–2 per cent of its annual budget (Pollin et al., 2006).

An alternative approach, which could achieve similar objectives, would be to institute differential asset-based reserve requirements on lending to different economic sectors. Such requirements would enable Governments to motivate banks to lend to sectors that had strong growth or employment potential. The basic idea is that for loans to priority sectors, banks would be required to hold a smaller proportion of their assets as required reserves that have to be deposited in non-interest-bearing accounts at the central bank. Such latitude would enable banks to lend more to designated sectors. Frequently, differential reserve requirements have been used to correct general sectoral imbalances in investment; this means reducing loans to sectors with overinvestment, or increasing them to sectors with underinvestment.

A complement to such incentives could be explicit restrictions on lending to certain sectors or for certain economic activities. For example, some countries have established ceilings on the percentage of bank loans that support “non-priority” activities, such as real estate, securities trading, and offshore investments.

Banks in LDCs and other low-income countries often prefer to hold short-term government securities, because they are risk-free and pay a relatively high rate of interest. As well as exerting pressure on the budgets of LDC Governments, these instruments are inappropriate for financing public investment because of the high risk resulting from maturity mismatch over the medium term. One way of addressing this problem is to develop a market for longer-term government bonds. These would have longer maturities, and hence they would lower the liquidity risk. Such bonds would be more suited, for example, to financing public investment in infrastructure, which requires a longer gestation period and thus only generates revenue over the medium and the long term.

If lowering the average interest rate is a primary government objective, then the Government could attempt to enhance the competitiveness of the process by which its debt is marketed. One such method would be to institute public auctions of securities.

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*Governments can strengthen domestic financial institutions by providing public guarantees for a proportion of the loans offered by commercial banks.*

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*An alternative approach would be to institute differential asset-based reserve requirements on lending to different economic sectors.*

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*Developing a market for longer-term government bonds would allow financing public investment in infrastructure.*

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*(b) Linking formal and informal institutions*


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*A second approach to strengthening domestic financial institutions is to link formal institutions with informal ones, which could improve opportunities to mobilize a larger pool of savings and to increase the amount of lending in LDCs.*

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A second approach to strengthening domestic financial institutions in order to mobilize savings for investment is to link formal institutions with informal ones. Although commercial banks frequently have excess liquidity, they are reluctant to lend because borrowers are perceived to be too risky or the transactions costs are too high. By contrast, informal financial institutions, such as rotating savings and credit societies, have more accurate information on borrowers' risks and can operate with lower transaction costs. But they lack the resources for extensive lending. A similar problem confronts many microfinance institutions and other small-scale financial institutions. In order for the linking of institutions to be successful, only well-established informal lenders, such as recognized lending associations, cooperatives or credit unions, should be involved in such programmes. Linking commercial banks with such institutions would also require formulating a broader regulatory framework that could incorporate informal institutions.

If these two sets of institutions were linked in partnership, there could be improved opportunities both to mobilize a larger pool of savings and to increase the amount of lending in LDCs. A larger pool of private savings, drawn from lower-income households, could be monetized, and in turn, more loans could be extended to small-scale entrepreneurs and businesses. Commercial banks could extend their deposit base, and informal credit institutions could extend more loans to low-income borrowers.

*(c) Organizing public finance institutions*


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*A third approach to strengthening the capacities of financial institutions in LDCs is to revive public financial institutions.*

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A third major approach to strengthening the capacities of financial institutions in LDCs — particularly in order to direct credit to sectors with considerable growth and employment potential — is to revive public financial institutions. One such type of institution would be development banks, which used to be prevalent across developing countries.

Despite reported inefficiencies, they were often effective at performing the essential function of mobilizing and allocating long-term investment-focused development finance. Domestic commercial banks have been unwilling to undertake this function, particularly in the wake of financial liberalization.

Development banks were publicly financed and managed in countries such as Brazil, Japan and the Republic of Korea. They can also be organized as public-private partnerships, which could conceivably facilitate the raising of capital on international markets. Historically, such institutions have been the spearhead of the industrial policies and public investment programmes that have been critical to the accelerated growth of "late developing" countries. Where they have been successful, they have harnessed substantial domestic financial resources for development objectives.

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*Development banks can be organized as public-private partnerships, which could conceivably facilitate raising capital on international markets.*

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Their success was often attributable to the support of "developmental" central banks. Nowadays, most central banks focus on a narrow range of stabilization goals, and utilize a similarly narrow range of instruments, such as the short-term interest rate or the money supply. However, in earlier decades, central banks in many developing countries played a greater developmental role, helping development banks to promote sectoral and industrial development, and enabling the Government to foster a more rapid rate of economic growth (Epstein and Gabel, 2007). In China and India, for instance, the central bank was linked to the planning apparatus, in order to facilitate the allocation of medium- and long-term credit to industrial sectors. Consistent with the view that monetary policy is only

one part — and not necessarily the leading part — of economic policy, central banks were not established as independent institutions.

Agricultural banks are another public institution that it is worthwhile considering strengthening. Previously, they frequently offered an extensive network of rural outlets that could draw in savings from rural households, which enabled them to extend numerous agricultural loans. Commercial urban-based banks had little interest in financing agricultural activities, as these were regarded as being too risky. The financial liberalization undertaken by LDCs and other developing countries over the last 25 years has swept away much of the rural infrastructure associated with agricultural banks.

Postal savings banks are a third type of public institution that could usefully be built up and expanded. Given that in many cases, post offices are a widespread institutional network in rural areas, they are a promising basis, especially in LDCs, for the mobilization of small-scale household savings.

#### *(d) Investing in institutional capacities*

Carrying out any of the three approaches outlined above would require a significant commitment of budgetary resources. In a sense, the resources could be regarded as financing investment in institutional capacities. Since such capacities would eventually enable the mobilization and allocation of a greater pool of domestic savings, the corresponding investment could have a relatively high social rate of return.

A similar logic could apply to the deployment of ODA. Many LDCs will remain reliant on ODA for the foreseeable future, particularly during the current recession. But the medium- to long-term goal of LDCs — and also of external assistance — should be to progressively diminish such reliance on aid. With this in view, there is a compelling case for directing more ODA towards the strengthening of domestic financial institutions in LDCs along the lines presented above. In conjunction with helping Governments to mobilize more domestic revenue, assisting financial institutions to mobilize more savings would make a critical contribution to eventually eliminating the widespread aid dependency of LDCs.

## **E. Exchange rate and capital management policies**

### **1. THE NEED FOR COMPLEMENTARY EXCHANGE-RATE MANAGEMENT**

Managing the exchange rate is a corollary of expansionary fiscal policies and accommodating monetary policies. One of the purposes of such management is to diminish the probability of a rapid depreciation of the exchange rate due to an increase in inflation prompted by the impact of expansionary policies on demand.

Generally, current orthodoxy favours a fully flexible exchange rate regime, in which the rate is fully determined by the play of market forces. This is usually justified by claiming that historically, Governments have maintained overvalued exchange rates. However, free-floating exchange rates have brought several difficulties to developing countries, including to LDCs.

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*Agricultural banks and postal savings banks are other public institutions worthwhile strengthening.*

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*Since institutional capacities would eventually enable the mobilization and allocation of a greater pool of domestic savings, the corresponding investment could have a relatively high social rate of return.*

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*Current orthodoxy favours a fully flexible exchange rate regime ...*

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*... however, free-floating exchange rates have brought several difficulties to developing countries, including to LDCs.*

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*Exchange rate volatility is particularly troublesome for the macroeconomic stability of small economies that are heavily dependent on external trade.*

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*Managing the exchange rate may allow countries to achieve broad-based export competitiveness and greater structural diversification of the economy...*

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*... which can be achieved through a "managed float" or a "loose peg".*

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*During 2004–2007, the great majority of LDCs continued to run current account deficits, and have now entered the global economic downturn at a distinct disadvantage.*

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Firstly, high degrees of exchange rate flexibility have led to an increased volatility of the nominal exchange rate, because of the inability of policymakers to respond effectively to frequent terms-of-trade or capital-outflow shocks. Containment of such shocks is an additional reason for reinstating some form of exchange rate management. Exchange rate volatility is particularly troublesome for the macroeconomic stability of small economies that are heavily dependent on external trade. By implication, it would be preferable for such countries to manage the exchange rate, instead of relying on domestic monetary policies to create an inflation anchor.

Secondly, when exchange rate flexibility is combined with inflexible inflation-targeting, the results can be especially destabilizing (Weeks, 2008). For example, when Zambia's exchange rate appreciated in the wake of its copper boom in 2005 and 2006, IMF conditionalities prevented the expansion of the domestic money supply because of the fear of rising inflation. But these conditionalities only exacerbated the negative fiscal effects of the appreciation, by lowering even further the domestic-currency equivalent of trade taxes and ODA. Hence, the Government's fiscal deficit widened unnecessarily.

Thirdly, managing the exchange rate may allow countries to achieve — over the medium term — a rate that can foster broad-based export competitiveness and can thereby lead to greater structural diversification of the economy. This is a strategic priority for LDCs, particularly because of their low level of export diversification. Achieving a stable and competitive exchange rate should take precedence over rigid monetary policy targets in such countries, because so much of their growth is dependent on both exports and imports.

Management of the exchange rate can take various forms. Countries can implement a "managed float", in which the exchange rate is allowed to oscillate in accordance with market forces but the central bank intervenes by buying and selling reserves in order to contain the oscillations within a predetermined band. Alternatively, a country could adopt a "loose peg", which implies that the monetary authorities fix their domestic currency to the value of another currency (such as the dollar) or to a basket of currencies, but periodically adjust the pegged rate in order to maintain a competitive exchange rate.

Maintaining the competitiveness of exports is of paramount importance to LDCs. This is particularly important when such countries enjoy a boom in resource exports, as they did in 2007 and in the first half of 2008.

Some LDCs have managed to improve their trade balance and their overall current account balance in recent years. During 2004–2007, for example, oil exporters such as Angola, Chad and Sudan, as a group, had a surplus of 4 per cent of GDP on their current account, whereas previously they had run deficits (table 9). Mineral exporters managed to reduce their current account deficits too, from 8.6 per cent during 2001–2003 to 6.4 per cent during 2004–2007.

However, with the exception of the small group of oil exporters, the great majority of LDCs continued to run current account deficits, and have now entered the global economic downturn at a distinct disadvantage. They will need greater capital inflows, principally of ODA, in order to finance such external deficits. Careful management of their exchange rates — in order to contain volatility and maintain some degree of export competitiveness — will therefore take on added importance.

**Table 9**  
**Current account and trade balances of LDCs, by groups, 1995–2007**  
*(Per cent of GDP, period averages)*

	1995–1997	1998–2000	2001–2003	2004–2007
<b>Oil exporters</b>				
Current account balance	-0.6	-6.3	-7.3	4.0
Balance of trade of goods and services	-4.2	-3.9	-0.1	9.8
<b>Mineral exporters</b>				
Current account balance	-4.9	-8.7	-8.6	-6.4
Balance of trade of goods and services	-10.1	-11.5	-11.9	-6.1
<b>Agricultural exporters</b>				
Current account balance	-5.6	-6.1	-7.1	-6.8
Balance of trade of goods and services	-13.2	-12.6	-13.3	-19.1
<b>Other LDCs</b>				
Current account balance	-3.5	-3.1	-1.6	-3.0
Balance of trade of goods and services	-10.0	-9.1	-7.2	-10.5

Source: UNCTAD secretariat calculations, based on data from IMF, *International Financial Statistics*, online (February 2009).

It has been argued that countries enjoying an increase of ODA could suffer from the effects of “Dutch Disease”. The standard argument is that the supply of foreign exchange originating from ODA would lead to greater domestic demand — mainly through government spending — for non-tradable goods and services, and would therefore drive up their prices. Subsequently, such price increases would spill over into the tradable sectors, chiefly by raising input prices.

Under a fixed exchange rate regime, the rate will appreciate in real terms as domestic prices rise relative to international prices. If the exchange rate is flexible, the greater demand for domestic currency — prompted by the increased supply of foreign exchange — would lead directly to an appreciation of the nominal exchange rate.

But higher inflation and appreciation of the exchange rate are not inevitable. Such effects depend on the extent of slack in the domestic economy and the success with which macroeconomic policies are managed and coordinated. In many LDCs, there is widespread underutilization of factors of production, particularly labour, so the increased demand generated by government spending need not lead to a significant rise in the domestic price level (McKinley, 2005).

Even if there were a rise in the price level, greater coordination of macroeconomic policies could succeed in managing any adverse effects. This implies that the increased government spending financed by the rise in domestic currency should be coordinated with the release of the corresponding foreign exchange reserves held by the central bank. Moreover, management of the exchange rate could also be used to mitigate any effects of appreciation on the competitiveness of non-resource exports.

## 2. MANAGING THE CAPITAL ACCOUNT

In 2008–2009, LDCs confronted a series of developments that reinforce the need for some management of the capital account. Although these countries have begun to experience increased inflows of FDI since the turn of the millennium, total capital inflows have remained modest. Moreover, as a consequence of the global financial crisis, FDI inflows are anticipated to decline. The chief problem that LDCs have to face is that of capital outflows originating in their own private sectors.

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*In many LDCs, there is widespread underutilization of factors of production, particularly labour, so the increased demand generated by government spending need not lead to a significant rise in the domestic price level.*

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*In 2008–2009, LDCs confronted a series of developments that reinforce the need for some management of the capital account.*

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*(a) The extent of capital flight<sup>4</sup>*


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*Sub-Saharan Africa is a net creditor to the rest of the world.*

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It is difficult to make precise estimates of the scale of capital flight. However, Ndikumana and Boyce (2008) show that for a sample of 40 countries in sub-Saharan Africa during the period 1970–2004, the real stock of flight capital, calculated in 2004 dollars and including imputed interest, stood at \$607 billion in 2004. That was \$398 billion more than those countries' combined external debt. In other words, sub-Saharan Africa is a net creditor to the rest of the world.

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*In 2007 and 2008, some LDCs enjoyed the benefits of the boom in primary commodity exports ...*

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Among the sample of 40 African countries were 26 LDCs. Their (unweighted) average stock of flight capital amounted to 129 per cent of their foreign debt. The stock of capital flight was considerably higher than the stock of foreign debt for most of them, particularly for oil producers and countries struck by conflict (table 10). By contrast, for six of the LDCs in the sample, the estimated capital flight was negative, which implies that inflows outweighed outflows during the period in question.

The authors of these estimates also identify strong links between the scale of capital flight and the extent of external borrowing by African countries, sometimes with the knowledge of the international lenders themselves. Their policy conclusions include a call for better management of debt by African Governments, measures to prevent capital flight and repatriation of African assets from abroad.

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*... however, in some cases, this led to short-term inflows of "hot money" speculating that an appreciation of the exchange rate would result from the export boom.*

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LDCs are also subject to periodic volatility of portfolio investment. In 2007 and 2008, for example, some LDCs enjoyed the benefits of the boom in primary commodity exports; however, in some cases, this led to short-term inflows of "hot money" speculating that an appreciation of the exchange rate would result from the export boom. This phenomenon has been well documented in the case of Zambia, in respect of its copper boom which occurred somewhat earlier (Weeks et al., 2007).

During the unfolding of the global financial crisis in late 2008 and early 2009, some LDCs were also subject to the "flight to safety" phenomenon, in which private capital fled the financial markets of developing countries in search of less risky havens in rich countries. Thus, for example, in the London market, foreign investors in Uganda have converted a significant amount of the public and private debt instruments denominated in Ugandan shillings, which they had purchased earlier, back into dollars. Speculative capital has been flowing back into United States financial assets, particularly government securities, and this led to an appreciation of the United States dollar in late 2008. Although this appreciation could benefit LDC exports, it also has an adverse effect on the external debt of LDCs, which is denominated in dollars. Moreover, 12 LDCs have de facto pegs to the dollar, or manage a floating currency with the dollar as anchor.

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*During the unfolding of the global financial crisis in late 2008 and early 2009, some LDCs were also subject to the "flight to safety" phenomenon.*

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In the instances cited above, LDCs could benefit from some limited management of their capital accounts,<sup>5</sup> especially with regard to instituting disincentives to capital flight. Such management could be complementary to the management of their exchange rates. It is difficult to implement an independent monetary policy (and even fiscal policy) without some management of the capital account. This is particularly appropriate when a Government is pursuing a growth-oriented set of economic policies, which imply more expansionary fiscal and monetary policies.

A frequent irony is that progressive-minded Governments end up implementing conservative macroeconomic policies because of their fear of a fall in business confidence, which they believe would lead to a surge of capital outflows and a rapid depreciation of the exchange rate.

**Table 10**  
**Stock of accumulated capital flight over the period 1970–2004**  
**in sub-Saharan Africa**  
*(Per cent of the foreign debt stock in 2004)*

	LDC	ODC
Angola	535.2	
Benin	-399.9	
Botswana		-207.4
Burkina Faso	369	
Burundi	185.3	
Cameroon		287.4
Cape Verde		523.6
Central African Republic	257.4	
Chad	137.9	
Comoros	-55.2	
Congo		299.8
Côte d'Ivoire		460
Democratic Republic of the Congo	310.3	
Ethiopia	342.6	
Gabon		289.1
Ghana		159.3
Guinea	29.6	
Kenya		93.3
Lesotho	117	
Madagascar	276.4	
Malawi	111.9	
Mali	-12.8	
Mauritania	174.4	
Mauritius		28.3
Mozambique	306.9	
Niger	-447.8	
Nigeria		670.9
Rwanda	355.7	
Sao Tome and Principe	292.4	
Senegal	-332	
Seychelles		485.7
Sierra Leone	406.6	
South Africa		176
Sudan	84.4	
Swaziland		285.6
Togo	-224.3	
Uganda	142.1	
United Republic of Tanzania	127.7	
Zambia	272.2	
Zimbabwe		511.9
Sample total	291.3	

Source: Ndikumana and Boyce (2008).

*(b) The rationale for managing the capital account*

It has been widely documented that the management of portfolio or other capital flows has contributed to the successful development of numerous emerging economies during their periods of take-off in growth. These include Brazil, Chile, China, Colombia, India, Malaysia, the Republic of Korea, and Taiwan Province of China.

In addition, nearly all the currently industrialized countries used capital management techniques at some point in their own development (Helleiner,

*The management of portfolio or other capital flows has contributed to the successful development of numerous emerging economies during their periods of take-off in growth.*

2003). In the two decades following the Second World War, for example, almost all industrialized countries (with the exception of the United States) tightly regulated inflows and outflows of portfolio investment. Continental European countries, as well as Japan, maintained stringent management of portfolio flows until the mid-1980s.

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*Since the experience with unregulated international flows of private capital during the Asian financial crisis in the late 1990s, multilateral and regional institutions have been more favourable to capital management techniques.*

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The following are some examples of specific measures that have been implemented by countries. Chile has established a one-year residence requirement for FDI or portfolio investment. Taiwan Province of China has tightly regulated FDI, foreign participation in its domestic stock market, and foreign borrowing by its residents. Singapore has had restrictions on swaps and other derivatives that could be used to speculate against its currency, and has refused to extend to non-residents credit that could be used for speculative purposes. Malaysia has restrictions on foreign borrowing, insists on a 12-month waiting period for repatriation of capital, and imposes graduated levies on capital outflows (which are proportional to the length of stay of capital in the country) (Epstein and Gabel, 2007).

Since the experience with unregulated international flows of private capital during the Asian financial crisis in the late 1990s, the International Monetary Fund and other multilateral and regional institutions have been more favourable to capital management techniques. Their preference, however, has been for market-based, temporary measures.

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*LDCs are subject to continuous capital flight.*

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Gabel (2004) has argued persuasively for a system of what she calls “trip wires” and “speed bumps”. “Trip wires” signal that a country is approaching high levels of risk on a particular dimension of private capital flows, such as the danger of a rapid outflow of portfolio investment. An example of a “trip wire” indicator would be the total accumulated foreign portfolio investment in a country expressed as a ratio to its gross equity market capitalization. When the ratio reaches a level that is considered to be too high, a graduated series of “speed bump” measures could be triggered — well before a crisis develops — and could check the inflow of new portfolio investment until the ratio recedes from critical levels.

Such an approach might prove to be applicable in LDCs. As Ndikumana and Boyce suggest, LDCs are subject to *continuous* capital flight, carried out mostly by their political and economic elites, and often associated with external borrowing. Since many LDCs are major exporters of primary commodities, including highly valued items such as oil, copper or other minerals, they can also be subject to periodic speculative inflows and outflows of portfolio capital.

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*The most appropriate capital management techniques for LDCs are those that can slow down the outflow of speculative portfolio investment.*

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Thus, the most appropriate capital management techniques for LDCs are those that can slow down the outflow of speculative portfolio investment. These could include residence requirements of one year (or even less) before such investment flows could be taken back out of the country. Stricter regulations, starting with transparency of accounting, would have to be applied to inflows associated with external borrowing. These would have to include provisions to ensure that the borrowed funds actually entered the country.

Another reason for much closer surveillance and control of the capital account is the evidence, quoted earlier, that a significant proportion of ODA, on which LDCs are critically dependent, is converted into outward capital flows in the form of debt repayment, accumulation of foreign exchange reserves and capital flight.

## Notes

- 1 In order for agricultural policy reform in donor countries to have generally positive impacts on LDCs, it would have to be sequential and take into account both LDCs' products of export potential, and the fact that two thirds of these countries are net food importers (UNCTAD, 2008a: 20-21). For a discussion on the prospects of trade and subsidy policy in the field of agriculture, see Stiglitz and Charlton (2005).
- 2 For instance, a similarly tight approach to fiscal policy informed the well-known Maastricht "parameters" of 60 per cent for the debt-to-GDP ratio and 3 per cent for the deficit-to-GDP ratio.
- 3 For instance, Benavente, Galetovic and Sanhueza (2006) present evidence about the public FOGAPE loan guarantee programme in Chile, suggesting that it has increased access to credit for high-quality firms.
- 4 "Capital flight may be defined as transfer of assets denominated in a national currency into assets denominated in a foreign currency, either at home or abroad, in ways that are not part of normal transactions." (OECD et al, 2002: 206). Boyce and Ndikumana (2008) estimate it as the change of a country's stock of external debt (adjusted for cross-country exchange rate fluctuations), plus net FDI, minus the current account deficit, minus the change in the stock of international reserves, plus net trade misinvoicing.
- 5 Capital account management is intended here as the set of regulations and measures implemented by public authorities aimed at reducing capital flows volatility, thus discouraging capital flight.

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# Setting the Agenda for Agricultural Policy in LDCs

## A. Agriculture: The heart of the LDC development problem?

Chapter

3

For many least developed countries (LDCs), food security<sup>1</sup> remains a major priority and policy objective. The global food crisis that erupted in the spring of 2008 served to highlight food insecurity as one of the most fundamental constraints on growth and development in LDCs. The United Nations World Food Programme estimates that the price hikes between late 2007 and the middle of 2008 resulted in an additional 100 million people having inadequate access to food. For LDCs, the impact of the food crisis has been exacerbated by the current global financial crisis and the damaging consequences of climate change, which, in turn, have led to a disturbing trend towards purchasing land for outsourced food production by non-LDC States. Most LDCs face multiple challenges, such as the global fragility of multilateral trade, volatility of growth, liquidity and credit shortages, and vulnerability to natural disasters.<sup>2</sup> Improved food security in LDCs could be realized through a combination of policies and measures, including the provision or enhancement of basic infrastructure, and the adoption of improved food production technologies and farming techniques.

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*The global food crisis of 2008 served to highlight food insecurity as one of the most fundamental constraints on growth and development in LDCs.*

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While agriculture is a major component of overall economic growth in most LDCs, the key policy challenge that most LDCs face is how to promote agricultural growth in a way that will enable a structural transformation, in which the relative importance of the agricultural sector declines as other sectors (particularly manufacturing) move onto a dynamic growth path. In order to enable this transition, policy issues in agriculture need to be addressed in terms of multiple intersectoral linkages, which often involve complex choices. Thus, the development of agriculture as the basis for a structural transformation of the national economy, leading to broad-based economic growth, food security and poverty reduction, requires extending the analytical and programmatic perspective beyond the narrow confines of farming. It requires a macroeconomic perspective that emphasizes the importance of generating an increasing agricultural surplus,<sup>3</sup> which requires agricultural labour productivity growth to exceed the growth of labour's own consumption requirements by an increasingly larger margin. Lack of agricultural surplus may constrain non-agricultural growth from the demand side (demand deficiency), but also from the supply side. In the latter case, missing agricultural surplus makes the system prone to food-price inflation, which: (a) erodes the real wages of non-agricultural workers and reduces their consumption; (b) erodes industrial profits, and hence investment; and (c) may lead to lower exports, due to loss of cost competitiveness. This chapter takes a view of the LDC food and agriculture system that encompasses an integrated approach to improving productivity and efficiency at every stage of the commodity chains, from research and development to input markets, and from farm-level production and distribution to the final consumer. The development of linkages among these stages and to other sectors is key to achieving an optimal contribution from the agricultural and food system to broad-based economic growth and transformation through increased value-added and employment linkages.

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*The LDC food and agriculture system encompasses every stage of the commodity chains, from research and development to input markets, and from farm-level production and distribution to the final consumer.*

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*The development of linkages among these stages and to other sectors is key to achieving an optimal contribution from the agricultural system to broad-based economic growth and transformation.*

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*The significant role of agriculture within the economy is more prominent and discernable in LDCs than in other developing countries.*

Above and beyond its contribution to food security and farmers' incomes, agricultural growth can have significant leverage on the wider economy, provided that an integrated approach is adopted to rural development that includes not just the provision of public goods (infrastructure, especially water and sanitation in rural areas) and social development, but also enhanced environmental practices, income generation through local growth, and the participation of the rural poor. This will enable what can be described as the agricultural transformation of LDCs — a structural transformation that encompasses the mobilization of all local sources of capital (human, physical, social, natural and financial) and comprises mutually reinforcing policies that take account of gender, regional specificities, and rural institutions, as well as environmental and social considerations.

*In 2006, 28 per cent of GDP in LDCs derived from the agricultural sector, compared with 12.8 per cent in ODCs.*

The significant role of agriculture within the economy is more prominent and discernable in LDCs than in other developing countries (ODCs). Of total gross domestic product (GDP), 28 per cent is derived from the agricultural sector in LDCs, compared with 12.8 per cent in ODCs in 2006. A similar contrast also applies to the percentage of people employed in the agricultural sector. Agriculture employed 68.6 per cent of the economically active population in LDCs in 2006, compared with 53.1 per cent in ODCs (table 11). The agricultural sector is central to any development strategy for LDCs, because most of the population is linked to agriculture and dependent on it either directly or indirectly.

*Agriculture employed 68.6 per cent of the economically active population in LDCs in 2006, compared with 53.1 per cent in ODCs.*

Yet the agricultural sector in LDCs is faced with ever-mounting and interacting long-term challenges, which include globalization, climate change (box 7), depletion of natural resources, poverty, biofuels, and population pressures. In addition, LDCs face key structural constraints on agricultural growth which have been long-standing — declining agricultural productivity, missing and imperfect factor markets, and limited access to producer-risk mitigation tools, as well as poor infrastructure and declining investment in the sector. Although agriculture in most LDCs is becoming less labour-constrained, increasing scarcity of land and high rates of urbanization require a more active government role than has been the case over the past 30 years (box 8).

Agricultural performance in LDCs has been very poor since 1970. Chart 13A shows that food production per capita in LDCs declined from 1970 to 2005. However, the level has stabilized since the first half of the 1990s. In general, food production has kept up with or very slightly exceeded population growth. However, there are significant regional variations in the trends. In many African LDCs, staple food production is largely rain fed and experiences large fluctuations caused by

**Table 11**

**Agricultural employment and share of GDP in LDCs and ODCs, 1980–2006**

	Agriculture employment as % total				Agricultural GDP as % of GDP			
	1980	1990	2000	2006	1980	1990	2000	2006
LDC real GDP > 6%	78.5	75.3	71.3	69.5	33.8	38.4	37.0	32.2
LDC real GDP 3 – 6%	80.6	77.5	73.4	71.7	38.5	33.4	31.1	29.9
LDC real GDP < 3%	71.5	69.0	67.2	65.6	37.2	38.7	27.9	22.0
LDC average	79.5	76.0	70.8	68.6	30.0	29.5	30.2	28.0
ODC average	66.4	61.6	55.5	53.1	20.3	19.1	13.6	12.8

Source: UNCTAD secretariat calculations, based on World Bank, *World Development Indicators 2008*, online.

Notes: LDCs are classified according to their real GDP growth rate in 2006 (UNCTAD, 2008b: 6), as follows: real GDP > 6% (Afghanistan, Angola, Bangladesh, Bhutan, Cambodia, Democratic Republic of the Congo, Ethiopia, Lao People's Democratic Republic, Malawi, Mauritania, Mozambique, Myanmar, Sierra Leone, Sudan, Uganda, Zambia); real GDP 3 – 6% (Burkina Faso, Central African Republic, Djibouti, Guinea, Guinea-Bissau, Madagascar, Mali, Rwanda, Samoa, Senegal, Tanzania, Vanuatu); real GDP < 6% (Chad, Comoros, Equatorial Guinea, Eritrea, Kiribati, Lesotho, Nepal, Timor-Leste).

The list of ODCs comprises: Argentina, Belize, Bolivia (Plurinational State of), Botswana, Brazil, Cameroon, Chile, China, Colombia, Costa Rica, Côte d'Ivoire, Dominican Republic, Ecuador, Egypt, El Salvador, Ghana, Guatemala, India, Indonesia, Kenya, Malaysia, Mexico, Morocco, Nigeria, Panama, Paraguay, Philippines, Republic of Korea, Sri Lanka, Thailand, Tunisia, Uruguay.

### Box 7. Climate change, agricultural growth and diversification

Agricultural productivity is highly variable within LDCs — the result of a combination of natural and locational factors that determine crop suitability and the accessibility of markets. However, climate change has potentially significant impacts on LDC agriculture and food security. Climate change through global warming impacts on producers (i.e. on the demand side through a rise in food prices especially of cereals; and on the supply side through opportunities in the burgeoning bioenergy markets) and these effects vary according to farm size, location and agroecology.

Climate models differ, but according to the United Kingdom's Hadley Centre for Climate Change, temperature increases in parts of sub-Saharan Africa could be double the global average increase. Given sub-Saharan Africa's heavy dependence on agriculture, the effects of climate change could put millions of people there at greater risk of poverty and hunger (IFPRI, 2007). Preparation for the potentially negative impacts of climate change and the exploitation of sub-Saharan Africa's vast biofuels potential faces important hurdles: the lack of infrastructure, the lack of basic agricultural inputs and the lack of a supportive regulatory environment and of sector policies and institutional capacities. The Stern Review (Stern, 2007) shows that if the developed countries do not radically reduce greenhouse gas emissions, parts of Asia and sub-Saharan Africa may suffer under heavy rains and increased flooding. Some parts of sub-Saharan Africa will face droughts and rising sea levels. Stern (2007) maintains that a radical switch from fossil fuels to biofuels can be one of the most effective strategies to reduce the impact of climate change on sub-Saharan Africa. However, the net effect of biofuel production based on the clearing of carbon-rich habitats (e.g. rainforests, grasslands and peatlands) as practised, for example, in Brazil, Indonesia and Malaysia, may increase food insecurity and CO<sub>2</sub> emissions in the long run, relative to fossil fuel use (Fargione et al., 2008). Biofuels grown from perennials on degraded farmland and derived from waste products (e.g. straw, timber, manure, rice husks, sewage, etc.) would enhance their environmental sustainability, reduce competition with food production and indirectly reduce the incentive to clear carbon-rich habitat land for biofuel production (Fargione et al., 2008). However, as UNCTAD (2007a) notes, some biofuel sources, such as jatropha, grow on degraded and semi-arid land and so may increase green cover and capture more of the atmospheric carbon dioxide that contributes to global warming. There needs to be a careful examination of the food security implications of greater biofuel production in LDCs.

In some LDCs, agricultural growth may be directly jeopardized by climate change. The relationship between land and labour productivity is crucial. In the early stages of the rural growth process, both land and labour productivity must rise, but land productivity must rise faster than labour productivity, in order to absorb surplus labour, to create employment, and to stimulate demand for non-farm goods and services. In light of the projected fall in the availability of agricultural land, and increases in the availability of land with low potential, this trigger for the rural growth process is endangered in the context of climate change.

Climate change may weaken the “multipliers” arising from agricultural-led growth. Increases in farm-based income are closely linked to increases in non-farm income, e.g. from vending, petty trading, services, etc. This is especially pronounced in broad-based, smallholder-led agricultural growth, as local labour is hired and income is spent locally. A dynamic, non-farm rural economy requires a steady growth of agricultural incomes. Thus, diversification into non-farm activities will be significant when demand for goods and services at the end of agricultural cycles is regular and constant. However, climate change has increased variability. Prowse and Brauholtz-Speight (2007) consider the prospects for sustainable rural non-farm growth where agricultural incomes are increasingly unpredictable. They suggest that there might be a limited window of opportunity to trigger the rural growth processes necessary if current strategies for agricultural growth and poverty reduction in LDCs are to succeed. If climate change impacts are greater and occur sooner than previous models have suggested, it may be only two or three decades until this becomes much harder. This is an obvious reason to redouble efforts now to stimulate smallholder-driven rural growth processes, and to improve technological innovation and productivity.

Sources: Prowse and Brauholtz-Speight (2007); Davis (2004); IFPRI (2007); Stern (2007); Fargione et al. (2008); German Advisory Council on Global Change (2008); UNCTAD (2007a).

climatic variability, which has contributed to a decline in per capita staple food production.<sup>4</sup> Where rapid increases in food production per capita exist, most often the reason is the development of new agricultural technologies that have allowed food production to outstrip population growth (e.g. the Green Revolution in Asia). Since the 1970s, the dissemination of the high-yield varieties, fertilizers and pesticides that were necessary to maximize Asian crop yields — known as the Green Revolution — has resulted in substantial growth in productivity (World Bank, 2008b). While there is a consensus that Green Revolution technology increased crop yields, these increases were distributed unevenly among regions and social groups, and were highly dependent on irrigation, land quality, government support and infrastructure. Concerns over whether the benefits of higher yields outweigh the costs of uneven distribution and the exclusion of other approaches to agricultural development remain to be addressed in most LDCs. Clearly, any future innovations must be more consistent with regional agricultural traditions,

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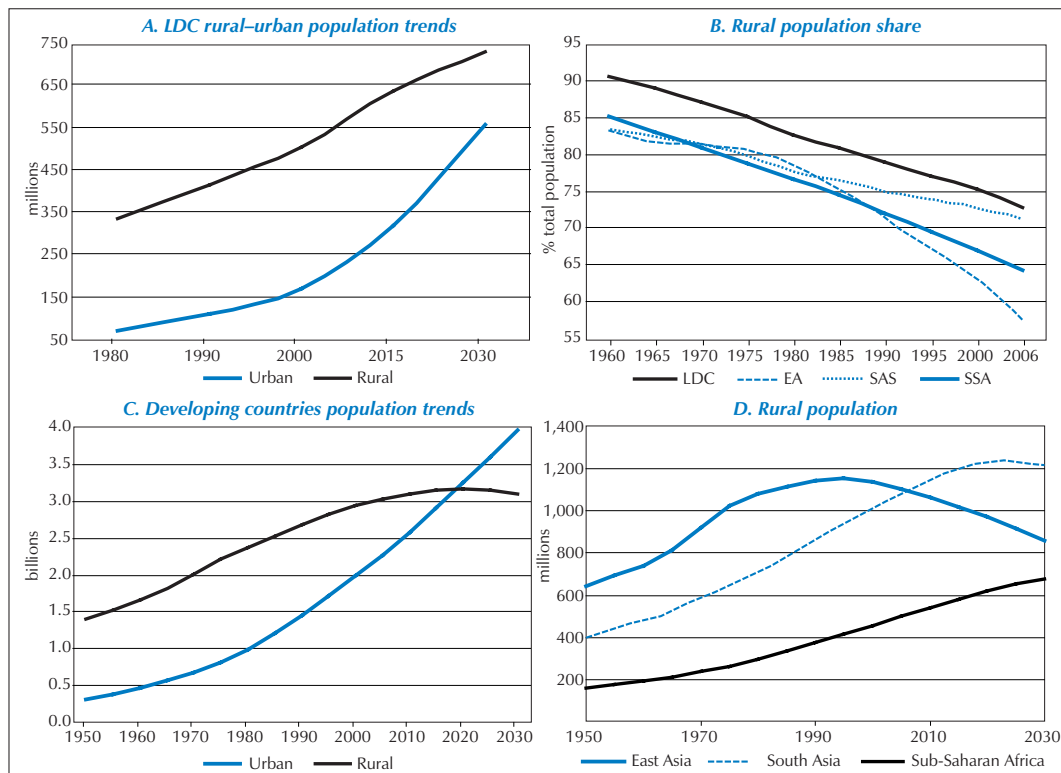
*Rapid increases in food production per capita are mostly caused by the development of new agricultural technologies that have allowed food production to outstrip population growth.*

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### Box 8. Rural–urban population trends in LDCs

Population dynamics are important determinants of future demand for agricultural commodities. Global population growth over the next decade (from 2008 to 2017) is forecast to decline relative to the last 10 years to an average of 1.1 per cent per annum and population is forecast to reach approximately 7.4 billion in 2017. The fastest population growth is expected in sub-Saharan Africa at around 2 per cent per annum (OECD and FAO, 2008). Box chart 2 shows LDC (panels A–B) and all developing countries' (panels C–D) rural-urban population trends. Although the size of rural population in LDCs is expected to continue growing (panel A), East Asia has seen a rapid decline in its rural population since 1995 (panels B and D). The LDC rural population as a share of the total population has also steadily declined since 1960 too, but it remains above the levels in sub-Saharan Africa, East Asia and the Pacific countries. Panel C shows that urban population growth in developing countries is forecast to continue over the next 20 years, reaching 4 billion by 2030. It also shows that the size of the rural population is forecast to grow until 2020 and to decline thereafter, primarily due to higher rates of urbanization. By 2030, more than half of sub-Saharan Africa's population will be urban. In 2000, 10 farm households in sub-Saharan Africa had the capacity to feed 7 non-farm households; by 2020, 10 farm households will need to feed 16 non-farm households (FAO, 2003). Demand for food is likely to rise rapidly in LDCs. Growing urbanization presents both opportunities and challenges for smallholder agriculture: in terms of potential markets in the newly urbanising centres; and integration into regional and international markets. However, unlike all other regions of the world, urbanization in sub-Saharan Africa has not contributed to the overall growth in GDP through economies of scale and specialized production chains.

Box chart 2  
Rural–urban dynamics in LDCs, 1950–2030



Source: UNCTAD secretariat calculations, based on World Bank, *World Development Indicators 2008*; and United Nations Population Prospects, online (January 2009).

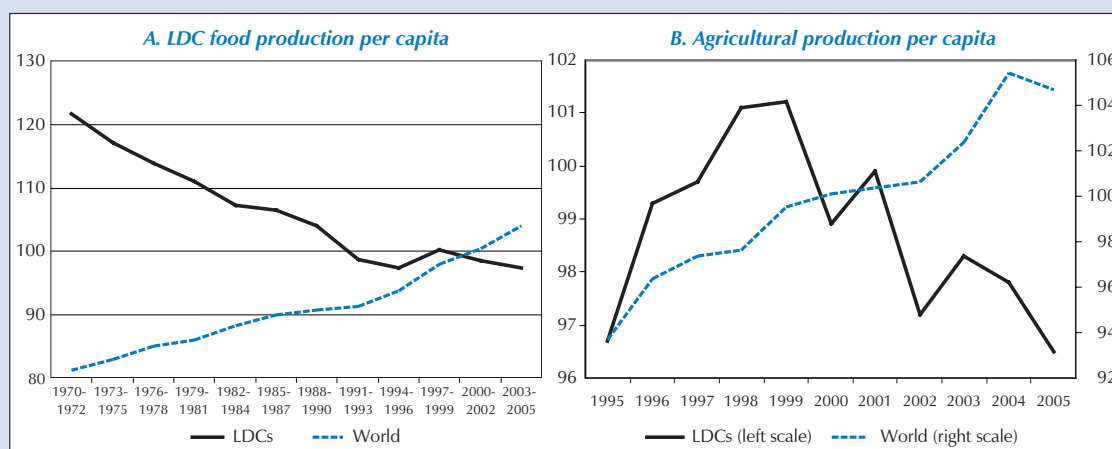
Notes: EA - East Asia; SAS - South Asia; SSA - sub-Saharan Africa. These regional groups include LDCs and ODCs.

and must avoid the environmental and social costs associated with the agricultural technologies utilized during Asia's Green Revolution.<sup>5</sup>

In terms of agricultural production per capita, the LDCs' performance has been relatively poor, with a significant decline in 2001–2002 (chart 13B). In LDCs, one of the major constraints to increasing agricultural production and domestic food supply is slow agricultural productivity growth, as well as a limited availability

Chart 13

Food production per capita index<sup>a</sup> and agricultural production per capita in LDCs,<sup>b</sup> 1970–2005  
(Index, 1999–2001 = 100)



Source: UNCTAD secretariat calculations, based on FAOSTAT, online (January 2009).

- a The food production per capita index presents net food production (after deduction for feed and seed) of a country's agricultural sector per person relative to the base period 1999–2001. It covers all edible agricultural products that contain nutrients; coffee and tea are excluded. The production values show not only the relative ability of countries to produce food but also whether or not that ability has increased or decreased over the period.
- b The agricultural production data are published by FAO for the period 1979–2005 as a volume index.

of water and arable land for food production. When the underlying data in chart 13B on agricultural production per capita for LDCs are disaggregated by export specialization, most LDC oil and mineral exporters are seen to have achieved steady rates of growth since 1999/2000. Among the oil exporters, Angola has achieved significant annual growth rates for its agricultural production since 1997. Among the mineral exporters, Sierra Leone — despite recently having been in a state of conflict — has rapidly increased its agricultural production per capita since the year 2000; by 2004 the country had reached its pre-conflict levels of 1995.

Access to water and food security in LDCs are increasingly interrelated. There are major challenges for sustainable food production in LDCs where water shortages affect both human and livestock consumption, and where potential for small-scale irrigation and water harvesting is limited. LDC farmers (especially in Africa) have the lowest rate of fertilizer use in the world. This needs to be improved, in order to raise soil fertility and productivity. Most of the fertilizer used in sub-Saharan Africa is currently imported, and bulk purchases could reduce the cost of fertilizer delivered to ports or entry points by about 15–20 per cent (Ngongi, 2008). Sub-Saharan Africa could also produce more of its own fertilizer, as it has large deposits of natural gas that can be harnessed to produce nitrogen fertilizer. International financial institutions and donors can assist in this endeavour. Some LDCs are now providing subsidies for seeds and fertilizers. Malawi, for example, provides a subsidy of up to 70 per cent of the cost of fertilizers (Ngongi, 2008). Subsidies alone may not be sufficient (box 9), but without some form of support, credit, or smart subsidies, the targets set by the African Union through the Comprehensive Africa Agriculture Development Programme (CAADP)<sup>6</sup> for progress in the agriculture sector and improved food security, especially in the production of staple foods, will not be achieved.

An appraisal of total and partial factor productivity<sup>7</sup> in LDCs and ODCs offers an insight into productivity (and hence development) trends within LDCs. Both total and partial factor productivity grew at a slower rate in LDCs than in

*Food production per capita in LDCs declined from 1970 to 2005. However, the level has stabilized since the first half of the 1990s.*

### Box 9. Fertilizer subsidies in Zambia

From 2004 to 2008, the Government of Zambia distributed approximately 45,000 tons of fertilizer per annum at a 50 per cent subsidy, under its Fertilizer Support Programme for use by smallholders on maize. Minde et al. (2008) shows that these fertilizer subsidies have not been effective in achieving more than a 0.6 per cent growth rate in maize production. In fact, the fastest growth is being registered among crops that are handled exclusively by the private sector, and to which no fertilizer subsidies are directed.

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*In many LDCs agricultural productivity has been stagnant since the 1960s.*

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*Between 1960 and 2006, total factor productivity in the agricultural sector rose by 0.19 per cent per annum in LDCs, compared with 1.27 per cent in ODCs.*

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*Repairing the broken links between agriculture and other sectors of the economy in the LDCs is essential, in order to meet the Millennium Development Goals (MDGs), ease the rural–urban transition, and support the rise of the rural non-farm economy.*

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*Productivity improvements in agriculture are critical for improved food security.*

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ODCs between 1960 and 2006. Over this period, there was an average annual increase in total factor productivity of 0.19 per cent in LDCs, whereas in ODCs it rose by 1.27 per cent per annum. While technical efficiency contributes to productivity growth in developing countries as they “catch up” technologically, the main source of improvements in agricultural productivity is technical change, i.e. technological progress. Indeed, the adoption of advanced technologies and increased productivity in different parts of the world may explain, in large part, the regional differences in growth and poverty reduction in recent decades. For example, agricultural performance in Asia between 1961 and 2001 was positive, with cereal production outstripping population growth, and this was achieved with a modest expansion of cultivated land from 1.0 to 1.4 billion hectares. This suggests that increased productivity has largely been due to the application of technological innovations (e.g. the Green Revolution). Amongst the LDCs, Bangladesh is notable for some success in this regard (box 13). During the same period, the production of cereals in sub-Saharan Africa did not keep pace with population growth. Similarly, cereal productivity increases in sub-Saharan Africa have been small, rising from 0.8 to 1.2 tons per hectares. Most of the productivity gain has been due to the deployment of more labour and the expansion of cultivated land (UNCTAD, 2006).

In many LDCs, agricultural productivity has been stagnant since the 1960s. Promoting productivity growth in basic staples should be a major regional priority for policymakers in Africa, and to some extent this is reflected in recent African Union and New Partnership for Africa’s Development (NEPAD) CAADP initiatives on fertilizer and productivity growth (African Union and NEPAD, 2006). To the extent that agricultural growth is best achieved through intensification, a greater focus on areas with the greatest potential could be a promising strategy. Moreover, given plausible assumptions about the potential of new technology development, farm sizes in most LDCs are too small for grain-based productivity growth to lift most rural households out of poverty (box 10). The role of the State in providing investment and credit and in productively mobilizing (surplus or unemployed) rural labour will be central to promoting the necessary diversification into higher-return activities. Critically, official development assistance (ODA) commitments to assist LDC agriculture in the medium to long term — especially within the context of the world economic crisis — must be maintained.

There is a need to refocus attention on the structural transformation of LDC agriculture by instituting policies and incentives for food production, increasing agricultural research and technical assistance, and reforming global agricultural markets. There is also a need for more ODA to be allocated to food programmes. There may also be potential for enhanced South–South cooperation, as a means to encourage food production and increase LDC productivity. The potential value and effectiveness of regional responses to mitigate the impacts of multiple crises should be further explored. This chapter sets out the key steps for repairing the broken links between agriculture and other sectors of the economy in the LDCs, in order to meet the Millennium Development Goals (MDGs), ease the rural–urban transition, and support the rise of the rural non-farm economy (incorporating the informal sector). It also argues that productivity improvements in agriculture are



### Box 10. Land governance in LDCs

The United Nations Human Settlements Programme (UN-HABITAT) (2008) defines land governance as “the process by which decisions are made regarding the access to and use of land, the manner in which those decisions are implemented and the way that conflicting interests in land are reconciled”.

In addressing land and governance, it is necessary to recognize that although land tenure raises important technical and procedural questions, it is also a socio-political issue, since rights over land cannot be isolated from rights in general. LDC land governance is a mixed picture comprising a continuously changing relationship between the State and the population. The codification and legalization of LDC land ownership should offer security of tenure, the motive to invest and an asset against which it is possible to borrow. While codifying land-holdings is an important objective, it should reflect traditional styles of tenure that accord with traditional social structures.

Since the 1990s, many LDCs have re-examined their land tenure policies, and a variety of new tenure reforms are under way, aiming to recognize and formalize established customary rights. In most cases, efforts centre on the development of new, decentralized bodies that bring local communities and customary leaders together with government officials in the management of land, land rights, and land disputes. In some countries, this is complemented by the devolution to the community level of authority and responsibility for common property natural resources. This type of approach is being implemented in many LDCs.

Emerging land pressures are generating fundamental challenges for poverty reduction, agricultural growth and investment strategies in LDCs. For example, box table 1 shows that farm size has declined in LDCs in sub-Saharan Africa since the 1960s. Jayne, Mather and Mghenyi (2006) notes that between 1985 and 2003, a population increase of 63 per cent in sub-Saharan Africa brought about a reduction of arable land per capita from 0.33 hectares to 0.25 hectares. In some semi-arid areas, cultivation has expanded into marginal (less favourable) areas with poor soils and lower rainfall. In more favourable areas with good market access, increased population pressure has led to the intensification of production. Where policy reforms to land tenure, property rights (as in Niger), leasing systems, female empowerment over the control of productive resources, and agricultural taxation have been introduced, intensification of agricultural production has followed (Staatz and Dembéle, 2008). Farm sizes are declining, and there remain huge disparities in terms of the demographic profile of rural communities and new demands on domestic food marketing systems.

**Box table 1**  
**Availability of cultivated lands to agricultural populations in**  
**selected sub-Saharan African countries, 1960–2005**  
*(Land to person ratio)*

	1960–1969	1970–1979	1980–1989	1990–1999	2000–2005 <sup>a</sup>
Ethiopia	0.508	0.450	0.363	0.252	0.197
Mozambique	0.389	0.367	0.298	0.249	0.277
Rwanda	0.215	0.211	0.197	0.161	0.202
Kenya	0.459	0.350	0.280	0.229	0.222

Source: Jayne, Mather and Mghenyi (2006); and FAOSTAT, online (February 2009).

Note: Land to person ratio = land cultivated to annual and permanent crops/population in agriculture.

a UNCTAD secretariat estimates (April 2009).

Jayne et al. (2006) rank the above smallholder farmers by household per capita land size, and divide them into four equal quartiles (box chart 3). Those households in the highest per capita land quartile controlled five times more land than households in the lowest quartile. An additional problem concerns the extremely low level of landholding per capita among the bottom 25 per cent of the sample. In Ethiopia and Rwanda, this quintile controls less than 0.20 and 0.32 hectares per capita, respectively. The range of computed Gini coefficients of rural household land per capita (0.50 to 0.56) from these surveys show land disparities within the smallholder sectors of these countries that are comparable to or higher than those estimated for much of Asia during the 1970s (Jayne, Mather and Mghenyi, 2006). If these countries' large-scale and/or state farming sectors were included, the inequality of landholdings would rise even further. Progressive agricultural change and development will be hindered until the State adequately addresses inequality in landholdings and access to basic health and education services.

In many LDCs, the performance of the State as a landowner and in regulating land use, access and tenure is a critical governance matter. In practice, State-owned land is often managed in unaccountable ways, and is subject to appropriation by political or allied economic elites. Land tenure issues often contain political and socio-economic tensions that are not

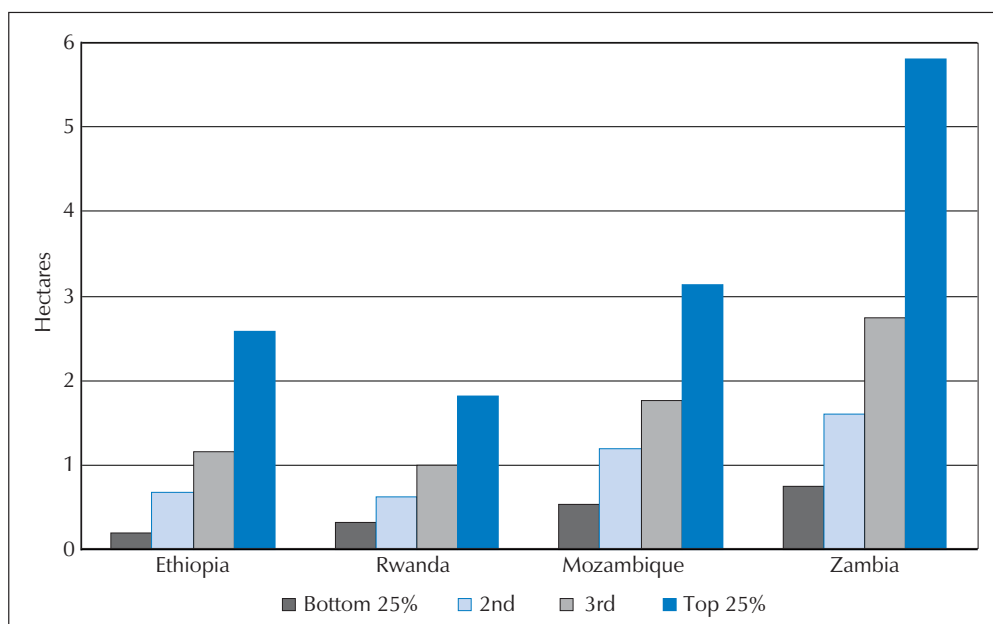


## Box 10 (contd.)

readily resolved simply as a matter of land rights. For example, rising inequity in landholding often becomes a source of conflict mediated through power, ethnic and class relations, which impact strongly on the negotiation of rights, on security of tenure, and on the accessibility of land. LDC governance paradigms that disregard or damage the socio-spatial context within which land is owned (registered or otherwise) may inadvertently foment discontent, leading to major and often ethnically defined territorial claims which obscure significant structural issues (such as the management of common property resources, pressures of land scarcity, legal aspects of indigenous land use and rights, etc.) (FAO, 2008).

Many empirical studies are unclear as to the direct impact of formal land titling on investment and agricultural productivity (Gavian and Ehui, 1999). Nonetheless, land rights and access in LDCs remain critical for development and food security. As long as the principle of divisible land inheritance is practised, the ensuing fragmentation may reinforce the need for an urban source of income. Population pressure on land is likely to increase the number of landless people who will have to become “urbanites”, requiring high economic growth rates and attendant creation of employment. Significant government action in partnership with the private sector will be required, in order to generate the growth that can absorb this labour (Toulmin and Quan, 2006).

**Box chart 3**  
Farm size distribution: small farm sector in selected African LDCs



Source: Jayne, Mather and Mghenyi (2006).

Notes: Samples include only agricultural households defined as households growing some crops or raising animals during the survey year. All numbers are weighted.

Land rights provide economic and social security as a safety net and as an asset to make human capital investments that otherwise would not be possible to make (Burns, 2007). Improved land policies are, de facto, an investment in people, and indirectly enhance their productive capacities. Similarly, improving land rights and access to land should strengthen the value of land as an economic asset, either for productive purposes (farming, collateral, etc.) or non-economic purposes (helping guarantee basic rights for home ownership, etc.). With transparent and enforceable legal rights governing land ownership, access and use, the economic value of land should rise over time and should encourage the sustainable use of land as a natural resource. Land is often overexploited when tenure rights have a short duration (e.g. in Brazil's Amazon rainforests), so that users have an incentive to exhaust all the economic value quickly. In the context of governance, increased food security in LDCs should result from improved productivity, especially where land rights and access are enhanced (Burns, 2007).

The recent food and economic crises may also have created new problems in land governance for LDCs. Wealthy, food-insecure countries such as China, Japan, Kuwait, the Republic of Korea, Saudi Arabia and others have been purchasing and leasing large tracts of LDC arable land for the production of crops for food or biofuels. This land is not intended to

## Box 10 (contd.)

produce crops to sell on the world market or to feed the local population, but rather to meet domestic food and biofuel demand in the country that acquired the land. Many of these countries face significant freshwater shortages (for agricultural production) and have large populations relative to available arable land. Similarly, given the current global financial crisis, commodity traders, agri-food corporations and private investors increasingly see investment in LDC farmland as an important new source of revenue. Although estimates are difficult to verify, recent evidence published by Von Braun and Meinzen-Dick (2009) and Grain (2008) suggests significant levels of activity and upward trends over the past five years in foreign investors acquiring large tracts of arable land in LDCs. Von Braun and Meinzen-Dick (2009) note that in four sub-Saharan African countries alone (Ethiopia, Ghana, Madagascar, Mali), land allocations to foreign investors since 2004 amounted to over 1.4 million hectares of land; this excludes allocations below 1,000 hectares. Since 2006 foreign investors have acquired or sought some 15–20 million hectares of farmland in developing countries (Von Braun and Meinzen-Dick, 2009).

LDC Governments should note, however, that if fertile farmland is increasingly privatized and concentrated in the hands of a few large firms, it could increase medium- to longer-term food insecurity as smallholder farmers are pushed out of business. Should current land practices continue, land will be restructured from smallholdings and forests into large corporate farms and plantations servicing external demand. Perhaps more positively, if most of the investment in LDC agriculture — which is desperately needed — were to promote greater South–South cooperation, it may help to generate mutual benefits for LDCs in terms of improved market access and trade.

Most LDCs are net food importers, and the land concessions increasingly granted to foreign countries may exacerbate food insecurity, create conflict, and undermine ongoing efforts at improved land governance through agrarian reform and the strengthening of indigenous land rights. Most LDCs remain agricultural economies with limited capacity to mobilize domestic resources or provide people with adequate means for their survival; more and more people are seeking work outside of agriculture, but employment opportunities are not being generated fast enough to meet the growing demand (UNCTAD, 2006). The food crisis in many LDCs is, in part, a result of this imbalanced development pattern. Thus, significant improvements in agricultural performance and productivity are central to long-term food security in LDCs.

There needs to be a careful examination of the terms of the agreements made between foreign investors and host countries, to help ensure that the promised technology transfers can be fulfilled, or that food production on local farms will also benefit.

critical for improved food security, and discusses policies to foster agriculture's linkages with other sectors to enhance food security and economic growth.

## B. Addressing the food crisis and food security in LDCs

### 1. THE CURRENT FOOD SECURITY SITUATION

At the beginning of this decade (2001–2003), there were 854 million people suffering from chronic hunger worldwide (FAO, 2008). However, in LDCs the proportion of undernourished people declined from 39 per cent in 1990–1992 to 34 per cent in 2003–2005 (box 11). That progress is seriously imperiled by the latest food crisis, which threatens to undermine the successes attained in the fight against hunger (especially in sub-Saharan Africa)<sup>8</sup> since 1990 (UNCTAD, 2008a). Since 2007, a further 40 million people have been pushed into hunger, primarily due to higher food prices, which brings the overall number of undernourished people in the world to 963 million, compared with 923 million in 2007 (FAO, 2008). The ongoing financial and economic crisis could push more people into hunger and poverty. Although global food prices have declined since early 2008, lower prices have not ended the food crisis in many LDCs.

There are several dimensions of food insecurity, reflecting a wide range of factors that contribute to its prevalence in the poorest developing countries. LDCs face

*Although global food prices have declined since early 2008, this has not ended the food crisis in many LDCs.*

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*Of the 31 countries listed by the FAO as being in substantial need of external food assistance, 21 are LDCs.*

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serious challenges related to food price inflation, climate change, conflict, market access constraints and natural disasters — factors that reduce both availability of and access to adequate food supplies. For LDCs, the multiple sources of food insecurity include climate-related factors (such as floods and drought) that make countries highly vulnerable to climate change (e.g. Bangladesh and Myanmar). In addition, a key element of food security in LDCs is the stability of domestic food production, which, as has already been noted, is influenced by many factors, including supply and demand, price variability, climate, soil degradation, and depleted water resources. An indication of the importance of this is the agricultural production instability index (UNCTAD, 2004). This is a measure which estimates annual fluctuations of agricultural output in relation to its trend value in a given country. In 1996–2001, the estimated instability index was high, at 11.7; in 2006, it was down to 8.1. This suggests that LDC domestic food production has been, on average, less variable since 1996–2001 (UNCTAD, 2008b).

The Food and Agriculture Organization of the United Nations (FAO) listed 31 countries in substantial need of food assistance in 2009. Of the 31 countries, 21 are LDCs. Most of the food-insecure LDCs (15) are in Africa, five are in Asia, and one is in the Caribbean (Haiti). It is noteworthy that 11 of the food-insecure LDCs are in the high-growth group (with GDP growth of 6 per cent and above), namely Afghanistan, Bangladesh, Burundi, Democratic Republic of the Congo, Ethiopia, Liberia, Mauritania, Myanmar, Sierra Leone, Sudan and Uganda; seven LDCs are in the low-growth cluster, and three are in the medium-growth category (FAO, 2009). The distributional impact of growth is thus an issue of concern: by implication, high GDP growth in these countries did not result in a reduction of hunger or in increased food security.

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*Given that most LDCs are net importers of cereals, they were hit hard by rising prices, as were the majority of LDC households, which are net food purchasers. LDC households, where food accounts for 40–80 per cent of consumer spending, are probably suffering the most from domestic food inflation.*

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#### *(a) Poverty and food security*

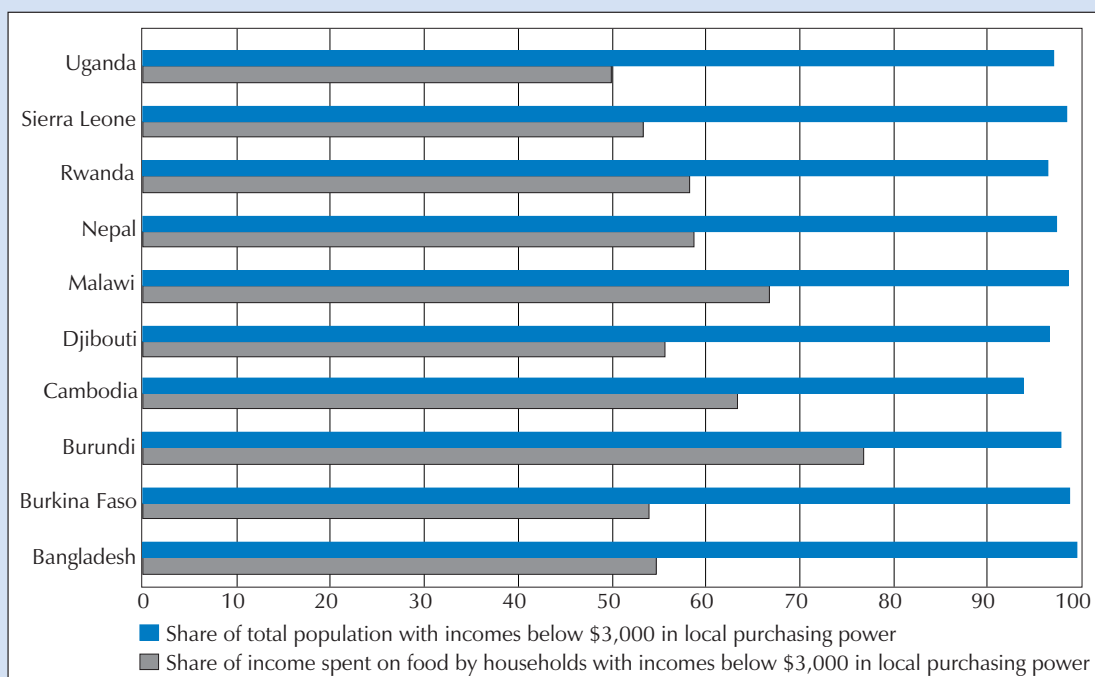
Determining the impact of the recent food price volatility in LDCs on food security and poverty indicators in a given developing country is problematic, given the array of country-specific conditions. Thus, net food exporters benefited from improved terms of trade, although some of them are missing out on this opportunity by banning exports to protect consumers. Net food importers, however, struggled to meet domestic demand. Given that most LDCs are net importers of cereals, they were hit hard by rising prices, as were the majority of LDC households, which are net food purchasers. LDC households, where food accounts for 40–80 per cent of consumer spending, are probably suffering the most from domestic food inflation. In Burundi, for example, around 97 per cent of the population have annual incomes of less than \$3,000 (in local purchasing power). Food expenditure for these households accounts for 78 per cent of household income (chart 14). Policy interventions have varied, but they include export bans on cereals and food subsidies targeted at the poorest consumers (e.g. in Ethiopia); the suspension and lowering of taxes on grains and basic foods (in Burkina Faso, Cameroon, Senegal and Uganda); soft loans from State banks to public and private grain-milling and storage firms (in Cambodia); and the promotion of production through the adaptation of high-yielding varieties (e.g. New Rice for Africa (NERICA) rice in Uganda and the United Republic of Tanzania).

#### *(b) Food price trends*

Both food and oil prices peaked in early 2008, and have declined sharply since June 2008 (chart 15). From January to December 2008, world grain prices declined by 50 per cent. Although still above their longer-term trends, international prices for vegetable oils, oilseeds and dairy products were also declining. The

Chart 14

### Food expenditure shares of low-income households in selected LDCs (Per cent)



Source: Hammond et al. (2008)

steady fall in food prices, although welcome, is not necessarily a portent of greater stability and food security into the medium term. The global stocks-to-use ratio for cereals in 2008–2009 remains low, and lower prices may divert more supply from food to biofuel production. In the future, higher fossil-energy prices may lead to agriculture becoming increasingly important as a supplier to the energy market.

The potential benefits of recent higher prices have not accrued to producers in many LDCs. Their supply response was small in 2007 and virtually zero in 2008, due to higher prices on key agricultural inputs such as fertilizers, seeds and energy (UNCTAD, 2008a). Furthermore, export taxes and other restrictions limited the transmission of international prices to domestic markets, burdening producers with higher costs and stagnant output prices. In addition, producer proximity to markets (which is often infrastructure-constrained) and the structure of the market (i.e. the role of traders, processors, etc., who captured the bulk of the price gains) contributed to the reduced supply response from LDC farmers. The gradual decline in prices was also due to slowing international demand arising from the current global recession, and reduced speculation, as almost all commodity prices were falling in unison towards the end of 2008 (chart 15).<sup>9</sup> Although international prices for most agricultural commodities declined during the second half of 2008, in most cases in LDCs, domestic food prices declined far less than international food commodity prices did (this is termed “price stickiness”). LDC domestic food prices remained on average 24 per cent higher in real terms by December 2008 than in 2006. For many of the poorest LDC staple food consumers (chart 14), this represents a significant reduction in purchasing power. As most LDCs are low-income, net food-importing countries, clearly the food crisis is continuing unabated. However, as discussed earlier, significant constraints on future production and productivity remain.

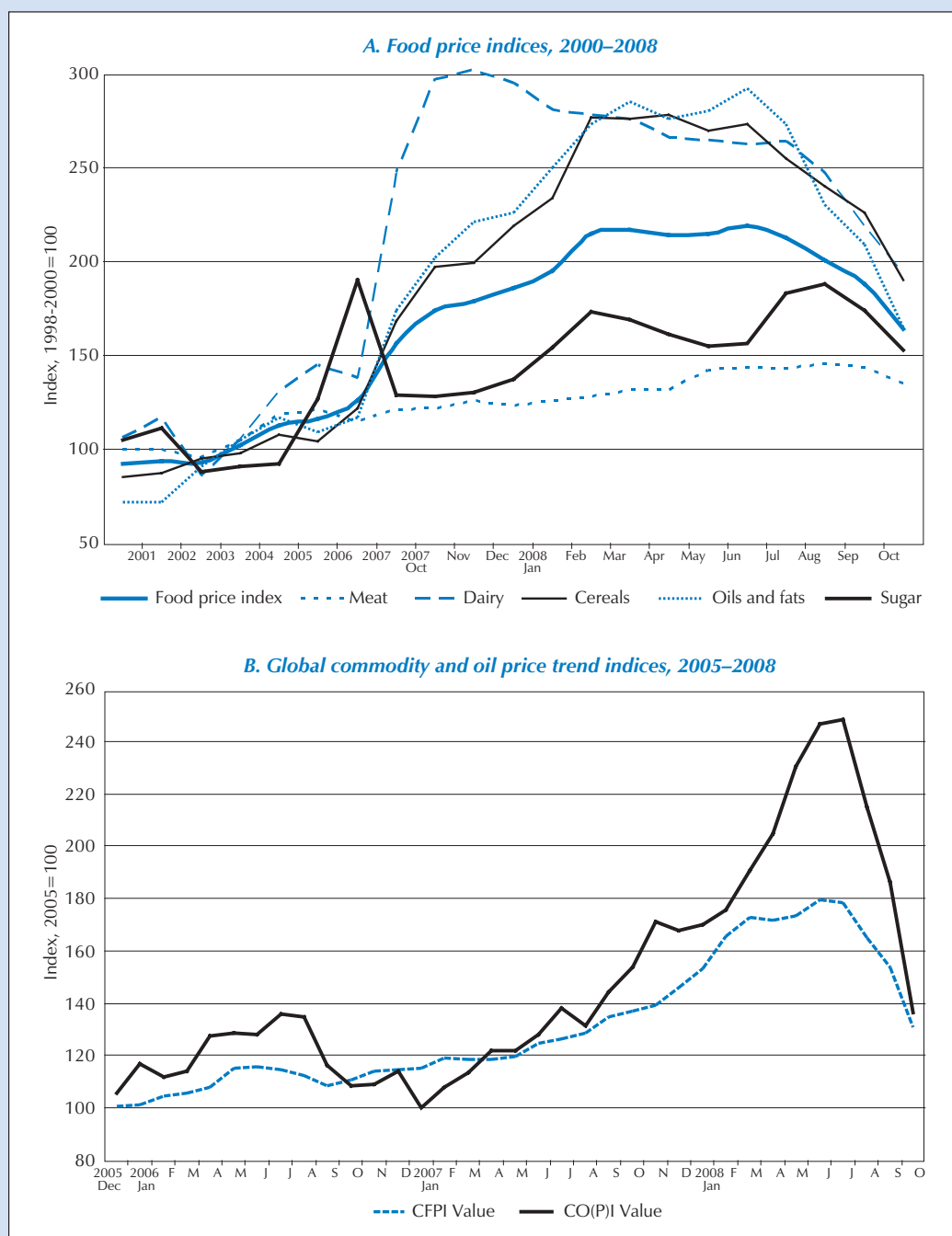
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*The potential benefits of the recent increase in prices have not accrued to producers in many LDCs.*

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Chart 15

## Food and global commodity and oil price trend indices, 2000–2008



Source: UNCTAD secretariat calculations; for Panel A based on FAOSTAT, online (December 2008), and for Panel B based on IMF, *Commodity Food Price Index Monthly Price*, and *Crude Oil (petroleum) Monthly Price*, online (December 2008).

Notes: FAO Food Price Index: Consists of the average of six commodity group price indices, weighted by the average export shares of each of the groups for 1998–2000.

CFPI (Commodity Food Price Index): Includes cereals, vegetable oils, meat, seafood, sugar, bananas and oranges price indices.

CO(P)I (Crude Oil (petroleum) Price Index): Simple average of three spot prices — Dated Brent, West Texas Intermediate and Dubai Fateh.

Recent price increases during 2009 are a part of a wider range of forces affecting commodities in general, including rapid economic growth in the emerging world, strains on world energy supplies, the weakness of the United States dollar, and reduced inflationary pressures culminating in the weak growth of global supply and a strong increase in demand. High food prices have powerful distributional effects, especially by squeezing the poorest the most. The consequence is already visible in increased levels of malnutrition and undernourishment in many LDCs (Box 11). Chart 16 shows recent forecasts, which suggest that food prices will remain at higher average levels over the medium-term than in the past decade (OECD and FAO, 2008). The factors underlying these trends until 2017 include: continued strong growth in food demand from ODCs and LDCs, growing feedstock demand from the biofuel industry, historically low global cereal stocks, and greater climate change risks in major cereal-producing areas prone to drought and/or flooding. These trends — combined with long-term natural resource constraints, increased contestation of land rights and access, and high rates of food demand and population growth — will remain major challenges to LDC food security.

The usual explanations (e.g. those provided by the International Food Policy Research Institute (IFPRI) (2008a) and the World Bank (2008a)) for higher prices are population growth, the diversion of food crops (such as maize and soybean) to biofuel production, growing Asian and Middle Eastern demand for high-value foods (cereals, dairy products and meat), higher transport costs and climate change (resulting in droughts and crop failures). To these can be added the role that speculation plays in commodity (especially food) markets. For example, on Chicago's CME Group<sup>10</sup> market, which deals in some 25 agricultural commodities, the volume of contracts during the period January–September 2008 increased by 20 per cent, and numbered a million per day. Similarly, hedge funds were active in commodities futures contracts and were also buying companies that stock grains and purchase prime agricultural land in developing countries. Futures purchases of agricultural commodities have traditionally been the means by which a limited number of traders have stabilized future commodity prices and enabled farmers to finance themselves through future sales. Speculators who hold their contracts to drive up current prices, with the intention not of selling the commodities

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*LDC domestic food prices in December 2008 remained on average 24 per cent higher in real terms by than in 2006.*

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#### Box 11. LDC undernourishment trends

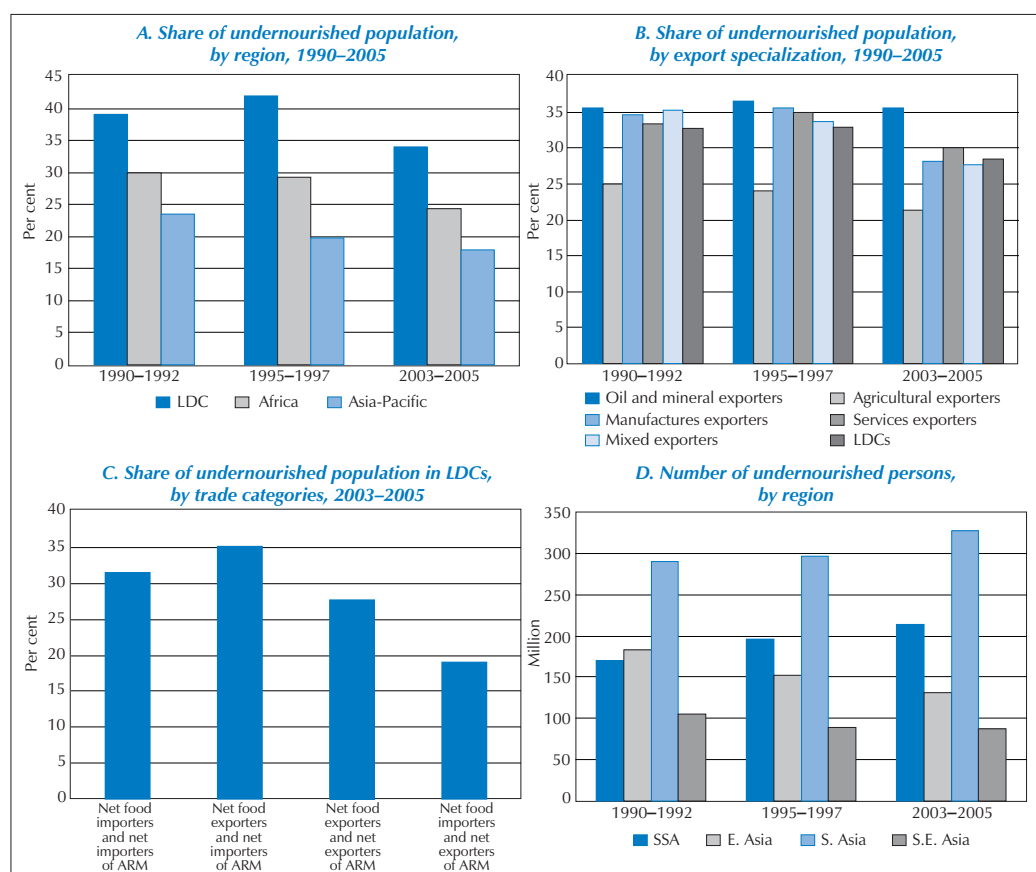
The term undernourishment is adopted by the FAO to refer to their indicator of progress towards the Millennium Development Goal for Hunger which aims to reduce by half the proportion of hungry people in the world by 2015. This indicator is based on national food production figures, and is basically a measure of food availability.<sup>11</sup> It should not be confused with undernutrition or malnutrition, both of which are a result of food intake of inadequate quantity and quality, poor health and sanitation. However, malnutrition in LDCs has increased since 2000. Food consumption per capita, measured as average calories per capita per day, decreased from 2,390 in 2004 to 2,215 in 2006 (UNCTAD, 2008b). Box chart 4 shows the number and share of the undernourished in LDC populations, by region and export specialization. Box chart 4A shows that the average share of the undernourished in the total LDC population, although declining since 1990, is still higher than the shares in sub-Saharan Africa and in the Asia-Pacific region. Box chart 4B shows that within the LDC group, mineral exporters, which are growing at the fastest rate, also have the highest proportion of undernourished people. Due to the capital-intensive nature of the extractive industries and their limited multipliers and linkages, these economies tend to be more dependent on food imports, and are therefore more vulnerable to food price inflation and food insecurity. The lowest undernourishment rates are in the “mixed” and agricultural exporter groups, comprising many LDCs which have improved productivity in agriculture (Nin Pratt and Diao, 2008). While agriculture remains a principal source of livelihood for the LDC poor, the worst performers (e.g. Haiti) failed to prevent a decline in capital stock per agricultural worker. This has been exacerbated by the financial crisis and a steep decline in the flow of ODA to the agricultural sector.

Box chart 4C shows that considering LDC agriculture as whole, import-dependent countries have the highest rates of undernourishment. During the period 1996–2001, all except seven of the LDCs were net food importers (UNCTAD, 2004). Major food-importing LDCs typically include oil-producing countries, and States where conflict has hindered the production of food and increased vulnerability to higher food prices. Similarly, small island developing States (such as Comoros, Maldives, Samoa and Sao Tome and Principe) tend to be major food importers, as they mainly export services (e.g. tourism) and import most of their needs, including food (chart 17B).



## Box 11 (contd.)

**Box chart 4**  
**Number and share of undernourished LDC population, by region and export specialization**  
*(Per cent, million)*



Source: UNCTAD secretariat calculations, based on data from the United Nations/DESA Statistics Division (November 2008).

Notes: See p. xii for the country group classification.  
 SSA - sub-Saharan Africa.

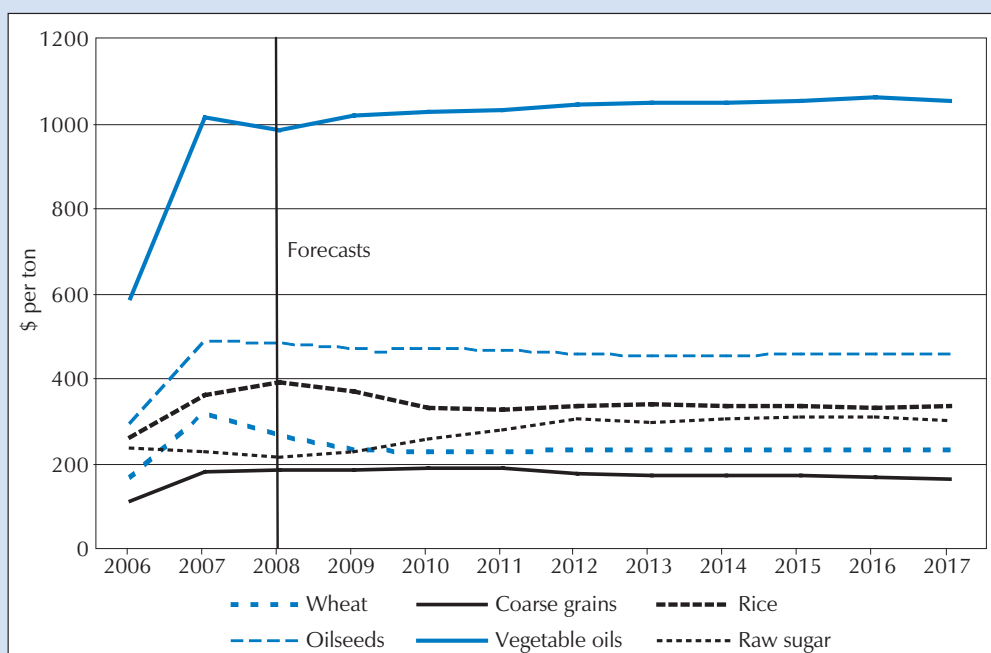
on the real futures market, but of unloading their holdings onto an artificially inflated market, at the expense of the ultimate consumer, destabilize both the market and production. This practice may grow, as many banks offer investment funds specializing in commodities, and increasingly, food products. Given the current financial crisis and the deepening world recession, international financial institutions, donors and LDC Governments will need to improve the regulation of these activities (UNCTAD, 2009a).

## 2. FOREIGN TRADE IN AGRICULTURAL PRODUCTS

Long-standing agricultural export subsidies and domestic support policies in developed countries remain a critical obstacle to agricultural development in LDCs. LDCs that were encouraged to liberalize trade too quickly have struggled under the pressure of low-price, subsidized food exports being dumped by developed countries. This situation has undermined production for both export and domestic

Chart 16

## Global long-term food price forecasts to 2017



Source: OECD-FAO (2008).

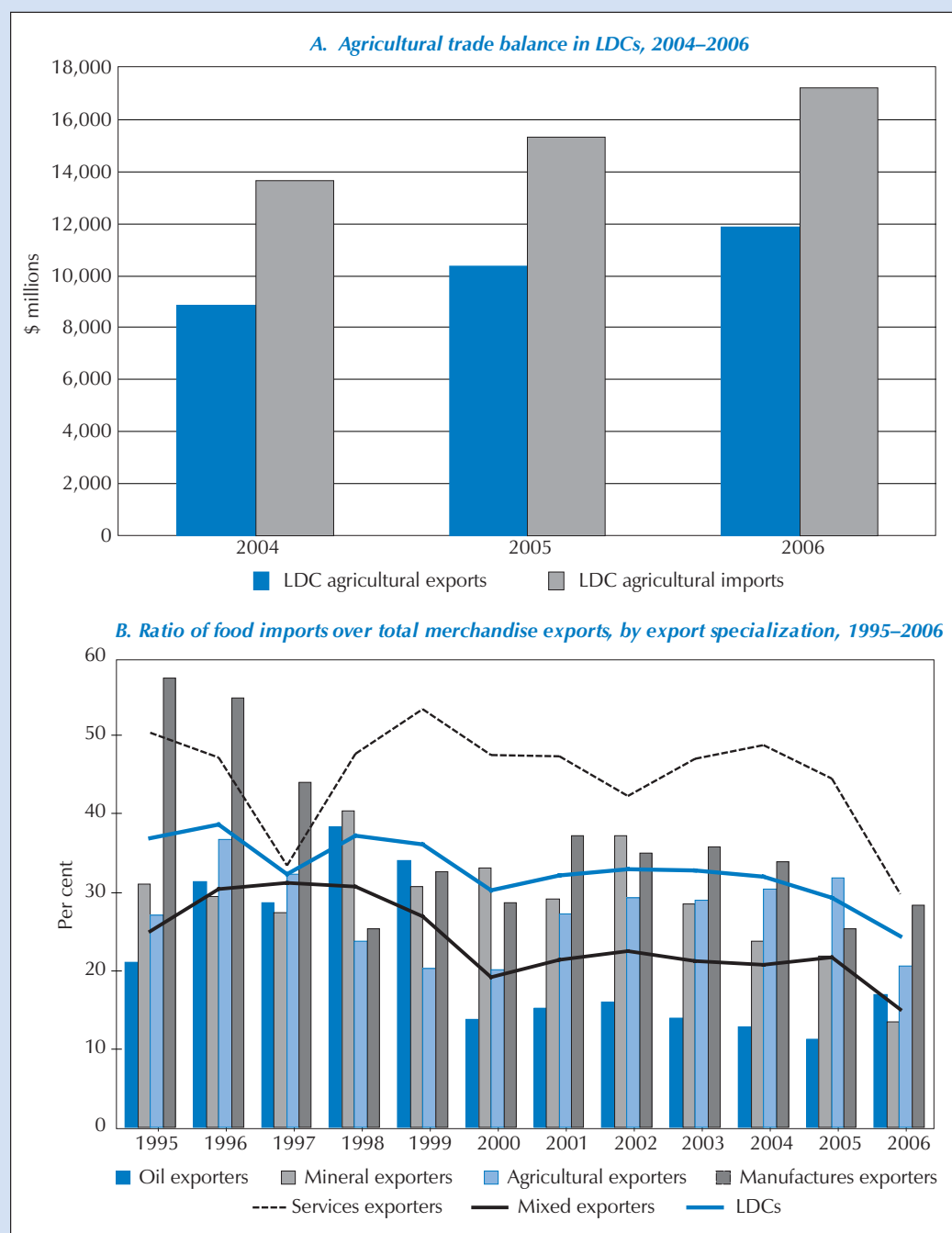
markets, and it therefore retarded the ability of farmers to generate the supply response that the food crisis required. Agricultural subsidies in developed countries are associated with rapidly increasing food imports in LDCs, alongside declines in agricultural production (chart 17A and chart 13B). Thus, many LDCs, which were traditionally food exporters, have become net food importers over the past 20 years. On average, 20 per cent of LDCs' food consumption was imported, and in some countries the share was much higher (for example, in Lesotho, 67 per cent; in the Gambia, 82 per cent; in Mauritania, 32 per cent; and in Malawi, 31 per cent). In 2006, 35 LDCs were net food importers, and in 19 of these countries, more than 30 per cent of the total merchandise export earnings was spent on food imports. As chart 17B shows, food imports as a share of total merchandise exports has tended to be highest in LDCs which export manufactures and services. Although during 2004–2006 the position marginally improved, LDCs remain major net importers of agricultural products (chart 17A). The situation is likely to have worsened since the 2007–2008 food price crisis. The macroeconomic impact of the \$23 billion food import bill in 2008 for these countries — which are also net importers of energy — has been further exacerbated by volatile oil prices.

*Many LDCs, which were traditionally food exporters, have become net food importers over the past 20 years.*

Following trade liberalization, major food import surges into LDCs occurred regularly — throughout the 1970s, 1980s, 1990s and early 2000s (UNCTAD, 2006). These were particularly acute in the case of African LDCs. Import surges have been increasing over time, largely owing to the inability of domestic producers to compete with cheaper imported food (UNCTAD, 2006: 271). Consequently, food imports have grown rapidly, but they now help to meet the nutritional requirements of the local populations. According to the World Bank (2008b), the demand for food in sub-Saharan Africa is expected to reach \$100 billion by 2015 — twice the level of 2000.

Chart 17

## Agricultural trade in LDCs, 1995–2006



Source: UNCTAD secretariat calculations, based on FAOSTAT, online (October 2008).

Note: See p. xii for the country group classification.

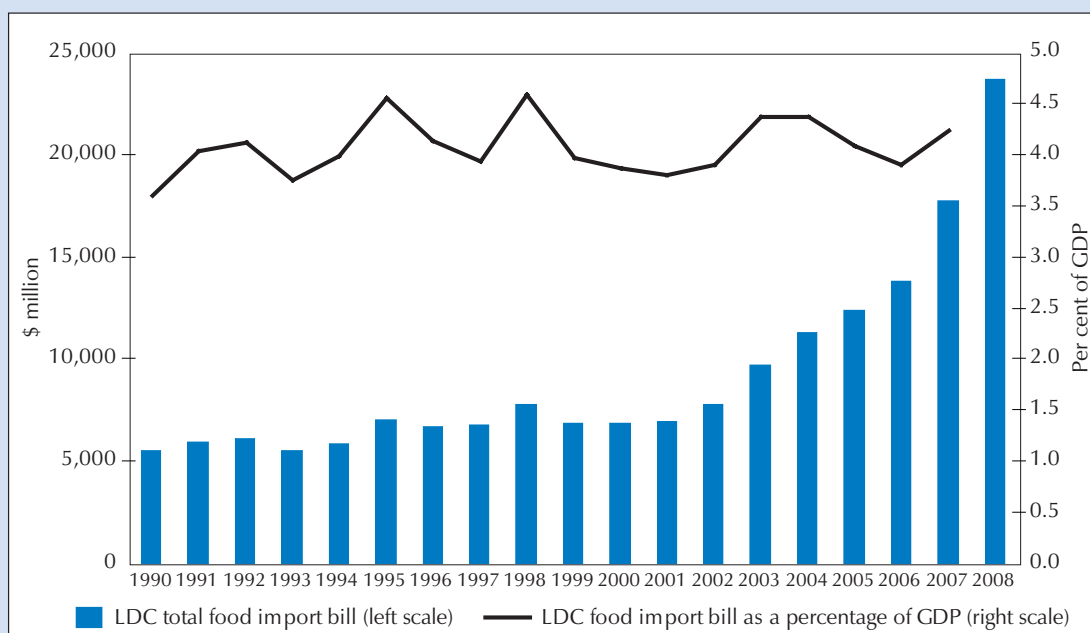
Paying for food imports can place a tremendous strain on the resources of the poorest LDCs, where foreign exchange earnings are limited and economic growth rates may be low. Currently, it is likely that for some LDCs, higher prices will reduce the demand for imported foods, or, if import demand is inelastic, lead to higher import bills. This could have a negative effect on short- to medium-term food security and on economic stability, and could increase the demand for emergency food aid. The LDC food import bill has grown from 3.5 per cent of GDP in 1990 to 4.4 per cent in 2007 (chart 18). In 2000, the food import bill totalled \$6.9 billion; in 2008, it reached \$23 billion (chart 18). Finding the resources to pay an import bill of this size is a major challenge for LDCs. Commercial food imports accounted for over 20 per cent of total merchandise imports in 19 LDCs in 2004–2006 (up from 13 LDCs in the period 1996–2001). Given declining food production per capita and low or declining growth in agricultural labour productivity, a reduction in food imports would have a negative impact on food security.

*The LDC food import bill increased from \$6.9 billion in 2000 to \$23 billion in 2008.*

Food-insecure LDCs spend a far higher proportion than the average of their export earnings on food imports; and this is covering a diminishing share of their food consumption needs. This suggests that food-insecure LDCs would import even more food to cover shortfalls in domestic production and to ensure food security, if they were not constrained by their limited export earnings. Moreover, the need to spend such a high proportion of their foreign exchange earnings on food imports has reduced the ability of food-insecure countries to invest in areas that would stimulate development and reduce their long-term vulnerability.

Chart 18

#### LDC food import bill, 1990–2008 (\$ million, per cent of GDP)



Source: UNCTAD secretariat calculations, based on data from FAOSTAT, online (January 2009) and from the United Nations/DESA Statistics Division (for GDP data).

In addition to increased spending on food imports as a share of GDP, LDCs are also major recipients of food aid. Between 2000 and 2006, there was a notable decline in food aid as a share of total aid to LDCs, but it then rose sharply in response to the onset of the global food crisis (chart 19A). Net food importers and net agricultural importers as a group have a higher share of food aid in total aid than the LDCs as a group. This is to be expected, as these are the most food-insecure LDCs (chart 19B).

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*In 2008, at least 16 LDCs received of international emergency food assistance.*

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The emerging implications of the economic crisis, combined with the recent food crisis, have added to the nearly one billion people who live with chronic poverty and hunger world-wide. In 2008, at least 16 LDCs were in receipt of international emergency food assistance (FAO, 2009). In Ethiopia, Nepal and Somalia, the emergency assistance was designated for purchasing food locally, which reduces shipping costs and stimulates local food production. LDCs will require further assistance to raise investment in staple food production for the most food-insecure countries. To facilitate access to finance to ensure food security, the creation of an international borrowing mechanism for food (food import financing facility) could ease the liquidity constraints on net food-importing developing countries and facilitate emergency imports of food.

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*The agricultural sector needs structural transformation if long-term food security is to improve. Public investments have a crucial role to play in this process. A key starting point is to raise farm productivity.*

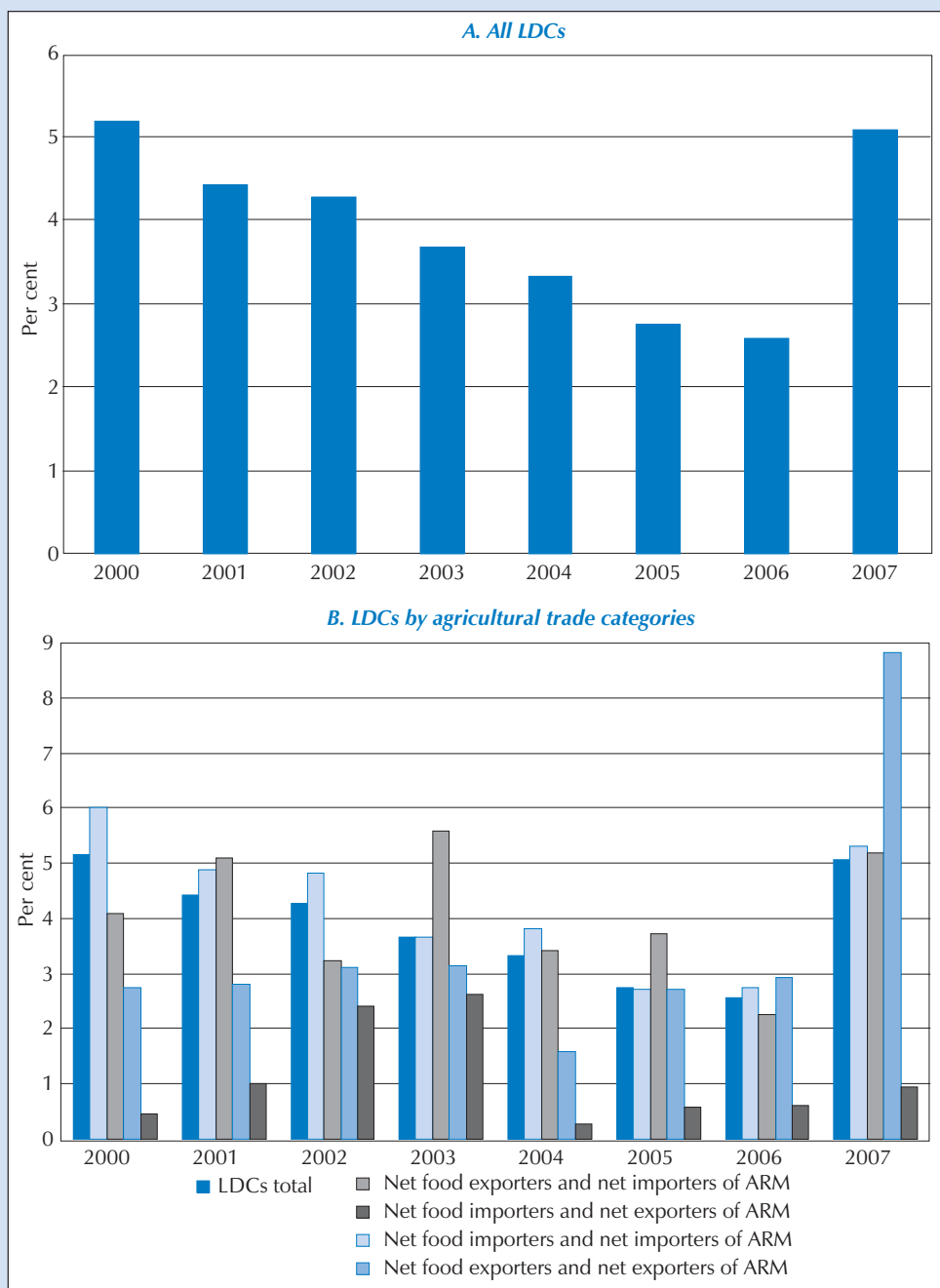
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Given the financial crisis, much more attention should be paid to developing LDC agriculture, in order to increase food security. This requires a comprehensive elimination of all trade-distorting subsidies and support measures in developed countries, complemented by aid for low-income net food-importing LDCs. An increase in ODA for agricultural development is urgently needed to support the development and implementation of agricultural policies, to build and strengthen institutions (e.g. agricultural development banks providing rural financing for food production), and to expand agricultural research and development (R&D) through support for local institutions to enhance their impact and reach.<sup>12</sup> LDCs also need assistance with information on food supplies and commodity markets, and through building better infrastructure, especially transport and logistics networks. This will help countries cope with the short- and medium-term adjustment costs associated with efforts to lower their food import bill. This type of aid should continue to be in the form of grants or concessional loans, provided that it is targeted at generating future streams of income from agriculture.

The agricultural sector needs structural transformation if the prospects for long-term food security are to improve. Public investments — especially in agriculture and infrastructure — have a crucial role to play in creating the basis for future food security. A key starting point is to raise farm productivity. LDC farmers need the benefits of fertilizer, irrigation and high-yield seeds, all of which were core ingredients of China's economic take-off. Investments are also required in roads and the energy sector: without these, the extent of the market for agricultural producers will remain limited. The rest of this chapter sets out how improved food security and structural transformation can be supported by the promotion of linkages between agriculture and the non-agricultural sectors.

Chart 19

Food aid as a share of total aid in LDCs, 2000–2007



Source: UNCTAD secretariat calculations, based on OECD/DAC, online (November 2008).

Note: See p. xii for the country group classification.

ARM - agricultural raw materials.



## C. Intersectoral linkages and the rural non-farm economy

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*The rural non-farm economy is of great importance to the LDC rural economy because of its production linkages and employment effects.*

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The study of economic development has long been dominated by what may be labelled the agriculture–industry conversion paradigm (Lewis, 1954; Schultz, 1964). This view is informed by the theoretical and empirical evidence that economic development is predicated on diversification of the national economy (Chenery, Robinson and Syrquin, 1986; Imbs and Wacziarg, 2003). On a sectoral level, the agriculture–industry conversion view suggests that development occurs if technical progress enables agriculture to become more efficient and to reallocate labour to industry, and, at a later stage, to services. This assumes that industry grows at a higher rate than the agricultural sector and is capable of absorbing excess agricultural labour. Customarily, “agriculture” used to be equated to rural areas, and “industry” and “services” to urban areas. One implication of this paradigm would be that rural development is best served by increasing farm incomes through efficiency gains. Indeed, the urban–rural wage gap was long referred to as the “farm problem”. A great deal of evidence exists to support the view that this would imply that economic growth, through diversification on the national level, is best served by specialization on the microeconomic and the regional (urban/rural) levels (Start, 2001; Balcombe et al., 2005).

Recently, the attention in rural development economics has shifted to the concept of the non-agricultural, or non-farm, rural economy. The rural non-farm (RNF) economy may be defined as all the non-agricultural activities that generate income for rural households (including remittances), either through work for wages or self-employment. In some contexts, rural non-farm activities are also important sources of local economic growth (e.g. mining and timber processing). It is of great importance to the LDC rural economy because of its production linkages and employment effects, and the income it provides to rural households represents a substantial and sometimes growing share of their total incomes.

A classification of the RNF economy should capture some or all of the following distinctions:

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*The income that the RNF economy provides to rural households represents a substantial and sometimes growing share of their total incomes.*

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- Activities closely linked to farming and the food chain, and those not part of that chain, since agricultural linkages are often important determinants of the RNF economy’s potential for employment, income and growth;
- Activities producing goods and services for the local market, and those producing for distant markets (tradables) — since the latter are able to create jobs and incomes independently of the rural economy; and
- Those activities that are sufficiently large, productive, and capitalized to generate incomes above the returns obtainable in farming, and those that offer only marginal returns — since this reflects the RNF economy’s capacity to generate local economic growth.

Equating rural areas with farming is — and probably always was — restrictive (Smith et al., 2001). Rural households in Africa derive up to between 40 and 45 per cent of their income from non-agricultural sources; in developing Asia the rate is about 30 per cent, and in Latin America 40 per cent (Barrett, Reardon and Webb, 2001: 2; Deininger and Olinte, 2001: 455). There is also evidence that this share has been increasing in recent decades in the same regions (Ferreira and Lanjouw, 2001: 30; Start, 2001; Haggblade, Hazell and Reardon, 2002: 6). Table 12 summarizes the findings from detailed studies on linkages from agriculture to the RNF economy in selected LDCs, as well as in developing regions. It shows that

Study	Activity reported: Size, extent (jobs, incomes) [Origins, Technology, Scale]	Making RNF activities work			Effects of RNF activity	Policy issues raised
		Supply side: Access, Resources required	Demand side: Market conditions	Transactions: supply chains and sub-sectors	Linkages: Production, fiscal, consumption, social	
<b>Bangladesh:</b> Mandal and Asaduzzaman (2000); Toufique and Turton (2003); Chatterjee et al. (2006); Davis et al. (2007).	37% of rural labour force in the RNF economy, more than half of rural household incomes from RNF sources. Activities include: fish and food processing, labouring, textiles manufacturing, light manufacturing (furniture, repair shops etc.), taxis and rickshaws. Landless turning to the RNF economy rather than farm labouring. Seasonal migration to urban centres is still growing to smooth annual rural income.	Dual structure: poor, lacking skills and education, crowd into poorly rewarded work; Better off with secondary education go into services. Credit a key limitation for rural population. Rural electrification and road building have helped.	The rural prosperous tend to import their consumption needs; the poor tend to spend any earnings locally.	No information.	Mandal sees the RNF as closely linked to upstream and downstream demands of farming. Toufique sees drive coming from elsewhere - remittances, urbanisation.	Importance of improving rural to urban infrastructure provision.
<b>Malawi:</b> Ellis, Kutengule and Nyasulu (2002); Sen and Chinkunda (2002); Orr and Orr (2002); Davis et al. (2007); McDonagh and Bahigwa (2002).	Malawi National Gemini MSME Baseline Survey, 2000, reports decline in rural employment in MSME from 932,000 in 1992 to 774,000 in 2000. But in previous decade very large increases in RNF reported for Mchinji and Salima. About half of incomes come from off the farm (or fishing); but wages and transfers main sources for poor; self-employment for rich. 2/3rds of MSMEs owned by females.	Access to assets allows trading up and acquisition of assets for other activities. Much RNF is micro, seasonal, and has to fit with maize cropping. Chronic lack of capital, inability to sustain risks.	Implicit that market is small, growing slowly. Market opportunities seen in niches for particular farm products - vegetables, tobacco, beans, dairy products.	Village heads and other local traditional leaders valued for helping social cohesion and resolving conflicts. Decentralised control of fishing beaches creates rental opportunities.	Most RNF activities involve processing and trading of produce from land, forests and water.	Major questions over how to remedy market failures. Debates over farm strategy and the degree of public support needed.
<b>Senegal:</b> Faye and Fall (2001); Faye et al. (2001).	Mainly account of change and adaptation in farming systems. Non-farm incomes have made up 50% of rural incomes since the 1960s. Non-agricultural income worth 35-40% income in all villages in 1999. Proportions much larger for poorer households at 67%. Includes migrant income: share of all non-farm income varied from 40% to 60% as wealth increases -although the household average in absolute terms is very similar. Of the local non-farm work, most is self-employment, in small trading, processing farm produce and selling cooked food (females), livestock trading (males), transport, building, and equipment repair.	Most non-farm work is self-employment, requires no formal education.	No information	Few supply chains to mention.	Most activities linked into farming and natural resources, being collection, processing, equipment repair - or is simple, local services. Remittance income to consumption and ceremonies	

Table 12 (contd.)

Study	Activity reported: Size, extent (jobs, incomes) [Origins, Technology, Scale]	Making RNF activities work			Effects of RNF activity	Policy issues raised
		Supply Side: Access, Resources required	Demand side: Market conditions	Transactions: supply chains and sub-sectors	Linkages: Production, fiscal, consumption, social	
<b>Uganda:</b> Ellis and Bahiigwa (2001); McDonagh and Bahiigwa (2002); Balihuta and Sen (2001); Smith et al. (2001); Canagarajah, Newman and Bhattamishra (2001); Deininger and Okidi (2001).	Crop and livestock income make up over 60% of incomes of most households in Mbale, but only 38% for the richest quartile. Poorer groups tend to have labouring income, rich tend to have self-employment. Similar trends for Mubende, although rich-poor differences less marked. National data suggest that during 1990s there were major falls in share of rural income from crops and above all from farm labouring; correspondingly off-farm self-employment rose. But households tended to have less diverse income portfolios. Remittances have also risen, especially for the poorest households. Women RNF firms in selling food and drinks.	Those with physical assets in land, livestock, fishing equipment find it easier to diversify. Access to credit - despite micro-credit schemes - and technical assistance are obstacles. Credit goes first to RNF. Improved rural infrastructure counts.	Economy recovering from chaos in new-found peace. Queries over decentralisation and the impact on local business conditions e.g. local taxation. Groups form around those with experience of work in private or public sector.	Decentralisation increases uncertainties of business, adds to actors involved in transactions. Traditional local leadership valued: local government much less so.	Growth in the rural economy in the 1990s based on the recovery of the farm economy. Many RNF activities added value to farm output. But equally, many depended on imports of fuel, cement, diverse goods.	The importance of creating an enabling environment with fair taxes and equitable collection.
<b>United Rep. of Tanzania:</b> Ellis and Mdoe (2002); Lyimo-Macha and Mdoe (2002); Jin and Deininger (2009).	Overall 50% of income comes from non-farm sources, but this varies from 32% for the poorest quartile to 57% for the richest quartile. Most of RNF income of poor comes from (farm) labouring; whereas most of non-farm earnings of rich comes from businesses. Most rich salaried work in the public sector. Non-farm business is thus a way out of poverty. Women were engaged in non-farm activities such as farm labouring, making and selling mats, local brewing, selling buns, food crop marketing, running shops and small restaurants.	Few details, but capital matters to set up businesses. Infrastructure and public services provision are critical to RNF enterprise growth.	Context of decentralisation, raising issues of preventing this becoming an opportunity for local level rent-seeking.	Local leadership appreciated for solving local disputes.	Not known	Importance of creating a local business environment that does not obstruct trade, investment and risk-taking.

Source: Adapted from Wiggins and Davis (2003).

the poorest households are engaged in wage labouring for others in the community, in farming and construction, or in self-employment in petty enterprises, such as:

- Manufacture of baskets, mats, carpets, clothes (tailoring) and pottery, processing of food and drink (including milling and brewing), tools (including blacksmithery), charcoal etc.; and
- Service provision in small-scale trading of cooked foods, farm produce, livestock, woodfuels, running small shops (including slaughtering and butchery), repairing vehicles and farm equipment, transporting goods locally, pumping or fetching water and hairdressing.

Almost all these activities are rewarded at rates similar to or below the average returns in farming (Haggblade, Hazell and Reardon, 2002; Wiggins and Davis, 2003). The other general point about these occupations is that they barely involve a supply chain (for example, labouring or trading cooked food). With few exceptions, the goods and services produced are consumed locally, with direct exchange of the output from producer to consumer. There is limited mention in the cases cited in table 12 of production of manufactures (or services) for urban markets, other than the processing of farm output or the trading and transport of livestock. The market for this work is almost entirely in the village, or at most, at a local rural market for sale to villagers from the neighbouring communities. Issues of transactions scarcely arise, and when they do, there are usually well-established institutions devised to deal with the issues (for example, forms of labour hire). In marked contrast to the activities undertaken by the poor are those practised by the better-off. These include larger-scale businesses and salaried employment. Larger businesses include:

- Trading with capital, stores, cafes, restaurants, and bars of substantial size;<sup>13</sup>
- Transport services, usually involving a motor vehicle, and repair workshops; and
- Manufacturing, involving some capital, and usually employing a few full-time workers beyond the immediate household in: carpentry, specialized processing of farm produce on a medium-to-large scale (e.g. coffee, grain milling).

Although there is little direct observation of money-lending and deposit-taking in the cited accounts, the existence of local, informal financial services is implicit when sources of capital and debt are described. In rural areas, salaried employment is overwhelmingly in public services (e.g. in administration and school teaching, and as nurses and health assistants). One point that arises within this set of activities is that many are similar to the earlier list, except that they are carried out on a larger scale, with more capital and equipment, which allows higher productivity and some economies of scale. In some cases, the activities may cross capital thresholds that confer a local natural monopoly on the business.<sup>14</sup>

The export of goods and services from village economies to the wider and urban economy is mainly confined to primary produce — crops, livestock, fish and forest products — and to labour services. Migration is not strictly part of the RNF economy, but accounts of widespread migration appear in roughly half of these studies, and for some villages, and some households within these villages, remittances are an inescapably important part of the local economy (Wiggins and Davis, 2003).

Demand makes RNF activity possible, and greatly influences the returns obtained. So what of demand? For many of the products and services of the RNF economy, demand arises locally, as has already been noted. This makes the growth of the RNF economy largely dependent on the incomes generated by those sectors that constitute the “economic base” — that is, those that produce tradable goods and services. Typically, the base is made up of sales of agricultural and other primary goods, and payments for labour services in the form of remittances. It follows that the RNF economy is more active when and where the local farm economy is prosperous. These areas tend either to have good natural resources or to be well connected to urban markets, or both. Closeness to urban markets may create opportunities for RNF activities. This applies particularly in peri-urban areas, where possibilities exist for commuting and for the provision of leisure, amenity and residential services to those working and living in the cities.

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*As has already been noted, for many of the products and services of the rural non-farm economy, demand arises locally.*

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*Typically, the rural non-farm economy is more active when and where the local farm economy is prosperous.*

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Closeness to cities is not always an advantage. Some RNF manufactures, usually those produced within the household, are highly vulnerable to competition from factory-made substitutes sold in rural market centres and villages.

One point of debate concerns the nature of local rural demand for the outputs of the RNF economy. In some cases, it is stated that most of the spending on these outputs comes from the wealthier households. In other cases, these households may see local goods and services as relatively inferior, and may spend most of their income on products brought in from urban areas. One RNF activity that has location advantages that could attract the demand of urban consumers and resist urban competition is tourism. Local linkage effects are weak where tourism develops as an enclave, with urban firms organizing facilities and importing goods and services from the urban economy or from abroad. For example, in the case of trekking in the Himalayas, above Pokhara in Nepal, tourism has not been particularly successful at creating local jobs. It may be that the supply of sufficiently attractive locations for international tourists is limited, and for the time being, given the current global recession, domestic demand for leisure may be limited.<sup>15</sup> However, Cernat and Gourdon (2007) cite examples in Indonesia and Malaysia where tourism has been generating the main source of RNF income, noting that the role of the State is a critical factor in boosting potential RNF linkages.

The RNF economy is of great importance to the rural economy for its productive and employment effects: it offers services and products upstream and downstream from agriculture, which are critical to the dynamism of agriculture; and the income it provides to farm households represents a substantial and growing share of rural incomes, including those of the rural poor. These sectoral contributions will become increasingly significant for food security, poverty alleviation, and farm sector competitiveness and productivity.

## 1. PROMOTING INTERSECTORAL LINKAGES

Traditional theories of structural transformation provide a useful framework for understanding the development and promotion of farm to non-farm intersectoral linkages.<sup>16</sup> For example, Kaldor (1966) emphasized the importance of generating an increasing agricultural surplus, which requires that agricultural labour productivity growth exceed the growth of labour's own consumption requirements by an increasingly larger margin. Therefore, building productive capacity in LDC agriculture to generate a growing agricultural surplus is critical to agricultural and non-agricultural development. Understanding the key linkages between agriculture and the other non-agricultural activities in the economic system is crucial to the formulation of an agricultural development strategy aiming to contribute to broad-based economic growth and transformation, through increased value-added and employment linkages. Linkages from agriculture to the wider economy may be illustrated as follows:

- Production linkages, both "upstream" from the farm via its demand for inputs and services for agriculture, and "downstream" from the farm via its demand for the processing, storage, and transport of produce;
- Consumption links, as farmers spend their increased income on goods and services, thus enlarging the market for domestic industrial output;
- Gains to rural human capital, as increased food production allows better nutrition of rural workers and investment in education;
- The release of rural labour for industrial employment; and

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*Understanding the key linkages between agriculture and the other non-agricultural activities in the economic system is crucial to the formulation of an agricultural development strategy aiming to contribute to broad-based economic growth and transformation, through increased value-added and employment linkages.*

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- Earning foreign exchange and increasing the supply of domestic savings (Johnston and Mellor, 1961).

Advocates of regional growth linkage theory, such as Haggblade, Hazell and Brown (1989) and Delgado et al. (1998),<sup>17</sup> show how an agriculturally-driven non-farm sector can develop in relatively isolated rural areas, due to the protection that market imperfections in rural areas (i.e acute information asymmetries and a proliferation of only partially tradable products — usually perishables — and services) provide, together with low purchasing power for urban imports. Such linkages between agriculture and the local RNF economy take many forms. Typical consumption and production linkages are outlined in table 13.

Consumption linkages are thought to be particularly significant, due to the propensity of small-scale producers to spend on rurally produced goods. In addition, there are a range of less direct linkages between sectors mediated via investments, infrastructure, skills and networks (Start, 2001). Indirect linkages occur across different sectors, however conventional consumption and production multipliers are particularly relevant to agriculture. These linkages are often lower in modern, non-traditional non-agricultural “growth engines” such as mining, as the skills and inputs for extraction and processing are not available within the local economy or are externally sourced (Davis, 2004; Start, 2001).

In the context of promoting intersectoral linkages, the difference between LDCs that produce cash crops and LDCs that produce food crops is important. The adoption of cash crops rather than food crops modifies the depth of linkages between agriculture and the rest of the economy. Thus, while rising productivity in food crops typically entails a greater food surplus, and therefore reduces the upward pressure on real wages, a growing surplus in cash crops may be highly beneficial for the rest of the economy, but only in so far as food can be imported at non-increasing prices (termed the “wage–good constraint”). However, for most agrarian-based LDCs, in practice this means that the resources for increased imports must come from the agriculture sector — which does not preclude establishing strong intersectoral linkages with industries engaged in food-crop or cash-crop transformation.

Table 14 presents evidence of strong agricultural growth multiplier effects in the non-farm economy. This shows that a \$1 increase in African rural income translates into a \$1.30–\$1.50 increase in income for other sectors through production and consumption linkages from agriculture to non-agricultural employment and growth in the RNF economy. Delgado et al. (1998) and Block and Timmer (1994) show that in developing countries, the growth multipliers from agriculture exceed those from non-agriculture. Most of these studies show that some 70 to 80 per cent of the total effect derives from consumption linkages. Rural services and commerce

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*In the context of promoting intersectoral linkages, the difference between LDCs that produce cash crops and LDCs that produce food crops is important. The adoption of cash crops rather than food crops modifies the depth of linkages between agriculture and the rest of the economy.*

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*Growth multiplier effects from agricultural in LDCs are often weaker than in ODCs, because of the low use of purchased inputs, more poorly developed rural towns, limited agro-industry and higher transport costs.*

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**Table 13**

**Agricultural growth-linked RNF activities, by sector**

Linkage to agriculture	Secondary sector (Construction and manufacturing)	Tertiary sector (Trading and services)
Production: forward	Processing and packaging industries. Construction of storage and marketing facilities	Transportation and trade
Production: backward	Agricultural tools and equipment	Agricultural and veterinary services; input supply
Consumption	Household items; home improvements	Domestic services; Transportation; sale of consumer goods

Source: Start (2001).



Table 14

**Agricultural sector multipliers:  
From increases in farm output to RNF sectors**

Location and period	Estimated multiplier
Sierra Leone, 1974–1975	1.35
Burkina Faso, 1984–1985	1.31 – 4.62
Niger, 1989–1990	1.31 – 4.62
Senegal, 1989–1990	1.31 – 4.62
Zambia, 1985–1986	1.31 – 4.62
Asia	1.6 – 1.9
Africa	1.3 – 1.5
Latin America	1.4 – 1.6
Source: Haggblade, Hazell and Reardon, 2002; Haggblade, Hazell and Brown, 1989; Delgado et al., 1998.	
Note: For the concept of the agricultural sector multiplier, see the main text.	

*The diversification of agriculture and the transfer of excess labour to other sectors are central to raising long-term growth. Agricultural growth is a vital step in reaching this target.*

account for the majority of rural non-farm linkages. Multipliers in LDCs are often weaker than in ODCs, because of the low use of purchased inputs, more poorly developed rural towns, limited agro-industry and higher transport costs. Also, in many LDCs, discrimination against small, rural, non-farm firms reduces the size of these multipliers (Hazell and Haggblade, 1993; Hazell, 1998). Park and Johnson (1995) note that during the early stages of development in Taiwan Province of China, small and medium-sized enterprises (SMEs) responded positively to rural demand particularly when it was related to rural consumption (e.g. textiles, light manufactures, furniture, beverages and food).

*In rural areas, agricultural growth and development is often constrained by limited physical access to markets and processing. These factors are also critical to the development of broader intersectoral linkages.*

The diversification of agriculture and the transfer of excess labour to other sectors are central to raising long-term growth. Agricultural growth is a vital step in reaching this juncture, but very few empirical studies have considered linkages in LDCs systematically, if at all. In some studies, RNF earnings and remittances are key sources of finance for investment in farming, or at least for underwriting risks in new agricultural ventures (Haggblade, Hazell and Reardon, 2002; Hazell, 1998). A key element on which little has been reported is the extent to which RNF activity involves either hiring labour and tightening rural labour markets, or further rounds of consumption spending in the local economy. Bah et al. (2006), in their case studies on rural–urban linkages in Mali, Nigeria and the United Republic of Tanzania, note that only two urban centres — Aba, in south-eastern Nigeria, and Himo, in the north of the United Republic of Tanzania — seem to play a role in the economic development of their region. Both appear to confirm the “virtuous circle” model of regional development, as they serve as markets for goods produced in rural areas, and as destinations for migrants and consumers engaged in non-agricultural employment (Quan, Davis and Proctor, 2006).

Factor markets (land, labour and capital) are often missing or inefficient due to market failure, based on distortions and asymmetric information. There are also — among other things — major structural constraints, including inadequate investment in public goods (e.g. infrastructure, roads, power and education), especially in remote rural areas, as well as high barriers for the entry of the poor to various dynamic markets, and high transaction costs for access to existing markets. To address these constraints, new effective organizational forms have to be devised, in order to create access to inputs such as fertilizers, electricity, irrigation and new seeds, for as large a group of farmers as possible, and in order to productively absorb rural (surplus) labour (box 12). Similarly, greater efficiency could be realized by land reform or tenancy rights reform, in conjunction with large-scale rural public works programmes (creating productive assets), which would also help the diffusion of major agricultural innovations to smallholdings and would make small farms viable farms. This will not happen automatically — the State has to initiate the changes.

**Box 12. Institutional and organizational dimensions of farm to non-farm linkages**

Several institutions and organizations help facilitate the development of intersectoral linkages. They establish linkages and cooperation, and contribute to growth. For example, sharecropping institutions enable those who decide not to farm to obtain income from their land and allow others to use it productively.

Contract farming is an important mechanism fostering linkages. There are problems with contract enforcement, which undermines institutional confidence among farmers, who need greater access both to information on their rights and to professional services, in order to defend their interests. Forming producer groups of contract farming participants can also help to shift bargaining power from firms to producers.

Cooperative farming can also be a powerful force for greater efficiency in resource use, because highly complementary inputs can now be used on a pool of productive assets.

Machinery rental is another important local farm-linked market, as it enables access to tractors and farm equipment. Without this, many producers could not utilize these capital goods, because they do not have the financial resources to purchase them. Policies that can facilitate the development of this market would assist both owners of machinery and lessees.

Integrating organizations are important, because they create new linkages between farmers, businesses and public institutions. These organizations have the potential to continue to grow and function as intermediaries, by linking technical assistance to financial and commercial services. The State can facilitate the expansion of these services.

Rural producer organizations, farmers groups and cooperatives etc. are important because they facilitate economic activity by establishing linkages, disseminate productivity-enhancing technologies, and provide for economies of scale. For example, in Malawi, NASFAM — a rural producer organization — has worked to distribute fertilizers and negotiate agricultural insurance schemes for members. It also helps members to negotiate contracts with input and processing firms, and facilitates contractual relationships. Although these organizations have the potential to play this role, they have tended to be weak and underdeveloped. Strengthening these organizations is ultimately the task of the producers themselves, but the process could be facilitated by the State.

The State plays a central role in fostering farm to non-farm linkages, because it sets the rules of the game that govern market institutions and actors. In many LDCs, the State is ineffective in this arena. Institutional reform is therefore a central requirement of public policy towards the agricultural sector.

Source: Onumah et al. (2007); Bijman, Ton and Meijerink (2007).

In rural areas, agricultural growth and development is often constrained by limited physical access to markets and processing. These factors are also critical to the development of broader intersectoral linkages, as illustrated by the case of Bangladesh (box 13), and are discussed further in the following sections.

The Bangladeshi case study (box 13) emphasizes that LDC economies need to improve agricultural productivity and diversify their economies to create non-agricultural employment opportunities and generate intersectoral linkages. This will require a new development model focused on building productive capacities, enhancing rural–urban intersectoral linkages, and shifting from commodity-priced growth to “catch up” growth. This implies a change from static to dynamic comparative advantage, and the active application of science and technology to all economic activities (UNCTAD, 2006; 2007b; 2008b). However, if there is no mechanism to ensure that the increases in agricultural surpluses and rural incomes through enhanced intersectoral linkages — as illustrated in box 13 — are used for the purposes of productive investment in agriculture and/or industry, they will not promote broad-based development. The market mechanism may not do this effectively, as (rural) savers may find it more profitable to invest in functionally unproductive assets (gold, land etc.), particularly when the distribution of land and other assets is already unequal. Alternatively, farmers may spend their higher incomes on (imported luxury) consumption. Therefore, the State has to step in and provide the mechanism to channel the agricultural surplus into productive investment. This can be done through measures such as a suitable price for agricultural produce, a price policy for principal inputs, and a policy of direct taxation on agriculture which does not destroy farmers’ incentives to produce, as well as fiscal and monetary policies that are conducive to private investment.

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*If there is no mechanism to ensure that the increases in agricultural surpluses and rural incomes through enhanced intersectoral linkages are used for the purposes of productive investment in agriculture and/or industry, they will not promote broad-based development.*

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### Box 13. Bangladesh: a case of improving rural non-farm linkages

The major impulses for change in the rural economy of Bangladesh are the transformation within agriculture, the increased linkages between rural and urban areas (improved transportation and communications), electrification, growing market linkages and access (demand/supply), the development of skills, the availability of financial services, and remittances from urban workers and — not least — from international emigrants. Bangladesh has seen a steady transformation of agricultural production during the last twenty years. The major reasons for this have been the use of high-yielding varieties of rice and other cereals<sup>18</sup> — which includes the increased use of chemical fertilizers and pesticides — and a rapid increase in irrigation through both deep- and shallow-tube wells. Most of the supply system is today privatized.<sup>19</sup> The total effect is that new technology and market systems are spread across the country, and double cropping (sometimes triple) has become typical in many areas of Bangladesh.

From a household perspective, increased production (several crop seasons) has meant that seasonal vulnerability and dependency on one major crop have been reduced. Furthermore, some of the negative effects from the continuous and steady decline in average farm size have, to some degree, been offset by the average production gains for rural households. Increased production has also increased the demand for local labour, which has resulted in real wage increases for the landless poor and seasonal migration within the country. At the national level, the outcome is that Bangladesh has, in recent years, become self-sufficient in food grains. However, the value added of crop types and processing is very low.

A potential source of productive employment and, consequently, poverty reduction is the growing RNF economy. This includes rural manufacturing, agribusiness, livestock, fisheries, cottage industries, trade and marketing services, rural construction, transport, infrastructure and various other services. In Bangladesh, the RNF economy constitutes around 36 per cent of the total economy (GDP) and provides over 40 per cent of rural employment. However, the non-farm economy is basically divided into a high-productive dynamic sector, catering mainly for urban demand, and a low-productive, mainly traditional, sector, which is in the hands of the rural poor. The latter is essential to many households' livelihoods and it constitutes a safety net option for the poorest, as an income of the last resort. The "dynamic rural economy" is dominated by more specialized businesses, run by entrepreneurs with better skills. These businesses tend to be referred to as small and medium-sized enterprises (SMEs), which are larger in scope and scale than traditional household (or micro) enterprises.

Sources: Chatterjee et al. (2006); Toufique and Turton (2003).

The resources thus obtained could be used for an expanded programme of public investment in productive capital and social overhead capital to transform agriculture and diversify the industrial production base. In agriculture, public investment is likely to crowd in private investment, thus creating a self-sustaining economic expansion (Belloc and Vertova, 2006). In this regard, this chapter focuses largely on the role of both public and private investment and finance in promoting intersectoral linkages and agricultural development in LDCs.

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*The State has to channel the agricultural surplus into an expanded programme of public investment in productive capital and social overhead capital to transform agriculture and diversify the industrial production base.*

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Improving LDC livelihoods and the quality of life for their growing populations will require substantial state investments in education to create a more skilled labour force, the development of productive capacities to employ the growing labour force, and improved infrastructure and housing to accommodate the service and amenity needs of the new firms and households (UNCTAD, 2006). If large proportions of the population remain outside the mainstream of development, they will have no alternative but to farm marginal lands, with consequent pressures on fragile ecosystems.

## 2. INVESTMENT IN AGRICULTURE AND INFRASTRUCTURE SUPPORTING FARM TO NON-FARM LINKAGES

Structural adjustment programmes that encouraged fiscal austerity and trade liberalization, and abandoned marketing boards and commodity stabilization funds, contributed to a decline of public and private investment in LDC agriculture (Staatz and Dembélé, 2008).<sup>20</sup> LDCs (especially those in Africa) lost considerable ground, where per capita research expenditure (in terms of both total population and agricultural workers) declined. Introducing policies and practices to endogenize innovation and increase the stock of knowledge is as important as adequate research funding, and there are some good LDC examples

of this, such as New Rice for Africa (NERICA) (Ngongi, 2008). However, UNCTAD (2007b) notes that in most cases of technological absorption and learning in LDCs, imitation or some kind of “reverse engineering” will be essential, based on a variety of skills and activities that would support a purposive search for relevant information, and its development through effective interactions within and among firms and other institutions familiar with knowledge acquired from abroad. In that respect, strong protection of intellectual property rights is likely to hinder rather than to facilitate technology transfer and indigenous learning activities (Kim and Nelson, 2000).

The recent food crisis has prompted LDC Governments to consider seriously their food security in the context of technological change and rural transformation. Agricultural research — for example, on rice — must be restructured, so that farmers are at the centre of the system, rather than at the periphery merely piloting modern varieties for agribusiness.<sup>21</sup> Some farmers’ organizations and non-governmental organizations (NGOs) have the potential to develop grassroots movements for food sovereignty that challenge the NERICA and agribusiness models in LDCs.

The agricultural production activities that create the most employment and sustainable livelihoods in LDCs are often based on traditional or indigenous knowledge systems (Akullo et al., 2008). Traditional knowledge systems tend to employ more environmentally benign cultivation techniques — such as the use of endemic varieties, which are typically more adaptive to local climatic conditions; improved crop rotation systems; and terracing — which in the long run may help to reduce land degradation. These have great potential as a reservoir of creativity, but they are largely de-linked from the modern knowledge systems (UNCTAD, 2007b). At the global level, the Consultative Group on International Agricultural Research remains the fulcrum around which most international public R&D for the agricultural sector in LDCs (and ODCs) is organized and financed. Public extension in LDCs is shifting away from a traditional mode of hierarchical (usually State) organizations tasked with transferring technology to farmers, to a more decentralized model encouraging greater accountability and diversified service provision. Among LDCs, Malawi (box 14), Benin and Uganda have developed innovative models of demand-led extension.

LDCs also need to promote technological capabilities in terms of enterprise-specific learning, which may be the basis for a successful process of industrialization. A key priority for LDCs (especially those in Africa) is to rehabilitate the R&D apparatus to the levels prevalent in East Asia, particularly in the area of export crops, which in recent years has attracted only low levels of R&D investment (Greenhalgh et al., 2006). LDC Governments could broker cost-effective arrangements between, for example, private biotechnology firms and national research bodies, to address these problems. The R&D priorities of

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#### **Box 14. Lessons from the application of smallholder farm technology packages in Malawi**

In the late 1990s, the Malawian Government tried to tackle extensive, chronic food insecurity by increasing agricultural productivity. The Starter Packs Programme (SPP) was an initiative that provided free packs of seeds, legumes and fertilizer to farmers. Every smallholder household (nearly 85 per cent of Malawi’s population) received free packs of seed, fertilizer and legumes. Distributing food-crop seeds and fertilizers had been tried before, but this time the SPP aimed for universal coverage, distributing 2.8 million packs. The SPP made a clear contribution to increased food availability and access to food. The inclusion of legumes in the pack contributed to increased soil fertility and diversified sources of food. The approach aimed to build household self-sufficiency and strengthen the domestic capacity to produce food, instead of using resources to buy imported food. But this approach went against the views of many donors on food security policy. A universal SPP can alleviate one key symptom of poverty — food insecurity — but it does not have a direct, lasting impact on poverty reduction. To be successful, a universal SPP needs to be part of a larger national food security strategy.

Sources: Harrigan (2008); Madola (2006).

LDCs, while focusing on high-potential crops, should also include livestock as part of any long-term technology strategy, and should be smallholder-friendly. This means that R&D technological packages, where appropriate, should be divisible (e.g. seed-fertilizer and credit combinations) to enhance smallholder uptake and effectiveness (box 14).

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*Public investment is needed in the generation and diffusion of research and technology and to strengthen indigenous capacities to develop and adapt the technologies needed to compete effectively in domestic, regional and global markets.*

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For LDCs, technology remains a key constraint on agricultural production, domestic food security, export growth and competitiveness. Public investment is needed in the generation and diffusion of research and technology, in order to encourage broad-based adoption of available technologies and to strengthen indigenous capacities to develop and/or adapt and diffuse the kinds of technologies needed to compete effectively in domestic, regional and global markets. This will require strengthening of LDC research capabilities. In some LDCs, given the generally small national budgets for R&D in the agricultural sector, the establishment and/or strengthening of regional centres of excellence for agricultural research would help build critical research capacity, and also the financial resource mass required to achieve economies of scale.

However, it should be noted that Green Revolution growth in Asia has generally been conditioned by the availability of a managed water supply — mostly irrigation. Thus, new agricultural technologies will be ineffective without appropriate irrigation, and these facilities are very often: (a) provided by the State; (b) dependent on electricity, which depends on public investment; and (c) dependent on credit, which, again, may be available only as priority (State-mandated) credit. Therefore, while it is useful to invest in R&D to develop new varieties etc., a critical constraint on agricultural productive capacity may be the availability of irrigation — which requires alternative public investments and interventions. Green Revolution growth in India has largely been dependent on irrigation, and the macroeconomic benefits to public investment in expanding irrigation and electricity are often far larger than the benefits of public spending on fertilizer use or price support (Storm, 1994).

*(a) Public sector investment in agricultural infrastructure*

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*New agricultural technologies will be ineffective without appropriate irrigation. These facilities are often: (a) provided by the State; (b) dependent on electricity, which hinges on public investment; and (c) dependent on credit, which may be available only as priority (State-mandated) credit.*

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Investment in economic infrastructure shapes the development of the RNF economy by influencing the scope for developing certain economic activities, the operational costs faced by enterprises, and the conditions for accessing outside markets. As has previously been noted, the recent food and financial crises have exacerbated food insecurity, unemployment and problems of inadequate infrastructure in many LDCs. If agriculture in the LDCs is to grow, it is essential to enlarge productive capacities, and this will require the State to play a key role, in partnership with the private sector and NGOs. Public sector investment in agriculture tends to crowd in private investment (enhancing the multiplier effect on productive capacity). New effective organizational forms have to be devised to mobilize rural investment resources, including public works programmes, farmers' organizations, cooperatives, etc., in order to build up productive capacity.

Government spending on rural infrastructure (e.g. roads, irrigation, power, and information and communications technology (ICT)) and on promoting institutional change aimed at raising investment is critical to addressing the challenges that the sector faces. The institutional issue that LDC Governments face is how to raise the finance required to make the necessary investments, especially in infrastructure. In many LDCs, the mass mobilization of labour through intensive public works schemes (e.g. the rehabilitation of infrastructure through food-for-work schemes) — together with targeted food, income and health interventions — has been



developed to improve food availability, economic growth and sources of income (Eichengreen, 2002).

The current world economic crisis has resulted in a decline in external sources of finance and may also result in a decline in ODA. Therefore LDCs will need to encourage public investment through, for example, public works schemes to help create productive assets and to generate private savings and investment. Typically, these schemes generate public goods (e.g. infrastructure), and although publicly financed, they may not necessarily be implemented by the public sector. Thus, while the structural transformation and growth of LDC agriculture is important for food security through its potential employment and income multiplier effects, the State response to food security problems must include the development of domestic productive capacities. From the experience of large rural employment-generation schemes in India (e.g. the National Rural Employment Guarantee scheme) and in Southeast Asia (e.g. International Labour Organization's (ILO) Advisory Support, Information Services and Training (ASIST AP) programme), it is clear that their potential for use is considerable in the presence of poor infrastructure and given the desire to tackle critical resource degradation, especially where population growth is high and the absorptive capacity of secondary or tertiary sector industries is relatively low. In the context of a global economic recession, rising unemployment and low labour productivity in LDC agriculture, these large rural employment-generation schemes could play an even greater role in counteracting the negative impacts of food insecurity and declining incomes. Bangladesh has implemented similar programmes, although they have been limited by inadequate levels of donor finance (Chatterjee et al., 2006; Toufique and Turton, 2003). In many LDCs, the changing capital/labour price ratio, which has increased in recent years, should encourage more labour-intensive investment in both the public and private sectors. However, these schemes are not without problems: the assets created are often of poor quality and maintenance is often inadequate, gender disparities in pay are often pronounced, and the schemes are not always well targeted.

The quality and availability of transport infrastructure (and services) is especially important. Local physical infrastructure, including the density of the road and telephone networks and household services, is an important aspect of the RNF economy, and is important for fostering both growth and intersectoral linkages (Lanjouw and Feder, 2001; UNCTAD, 2006).

Rural roads that allow reliable and regular motor vehicle access serve both the farm and non-farm economies. Rural electrification is particularly important for manufacturing activities (including agro-processing). For example, studies by Söderbom and Teal (2002) of food processing firms in Nigeria found that because of high losses of product associated with power cuts, most companies had to install their own generators, which raised their costs by at least 20 per cent compared to what they would have been with a reliable power supply from the grid. At the higher costs, many firms could not compete against imports without tariff protection. Most energy sector investments in LDCs (especially in Africa) are very low and are geared to exports (e.g. oil). In rural areas there is a heavy dependency on traditional biomass (e.g. wood and dung) and human energy. There is very little use of and/or access to modern forms of energy in rural areas (Davidson and Sokona, 2001). Rural areas are thus characterized by decentralized and dispersed energy requirements and a lack of basic energy infrastructure (UNCTAD, 2006).

In most LDCs there is a lack of strategic vision linking agricultural water development to poverty reduction and growth. Even though most poverty reduction strategies include some focus on agricultural growth, agricultural water development has generally not been seen as a vehicle for achieving this (World

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*The ineffective integration of rural and urban economies that exists in many LDCs impedes the positive feedback between the agricultural and non-agricultural sectors.*

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Bank, 2008b). Investment in agricultural water can contribute to agricultural growth, improve food security through higher rates of agricultural productivity, and reduce poverty directly by: (a) permitting intensification and diversification, and hence increased farm outputs and incomes; (b) increasing agricultural wage employment; (c) reducing local food prices and hence improving real net incomes; and (d) improving the health and productivity of workers. It can also reduce poverty indirectly, via increased rural and urban employment as a result of the multiplier effect on growth in rural and urban non-farm economies.

A key component in lowering marketing costs for farmers is to reduce the cost of transportation. An efficient and competitive transportation sector is important, because it lowers marketing costs for both agricultural and non-agricultural products that are domestically or internationally traded. The high impact on GDP growth of productivity growth in agriculture is due to intersectoral linkages and sustained demand increases for agricultural products. Furthermore, improvements in the transportation sector have a positive impact not only on the country where they take place, but also on neighbouring countries (Diao, Dorosh and Rahman, 2007: 54–56; Diao and Yanoma, 2003: 32–34). Studies from China show that investment in rural roads generates a return of national income of 600 per cent, as compared with 155 per cent for urban roads (Von Braun, 2008).

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*The single most commonly reported obstacle to investment and entrepreneurship in the non-farm rural economy is inadequate access to capital.*

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The ineffective integration of rural and urban economies that exists in many LDCs impedes the positive feedback between the agricultural and non-agricultural sectors described above. It is a key feature of low growth, or growth with a weak impact on rural poverty. Such integration can only be achieved with sound and supportive policies for the rural sector, and adequate infrastructure in rural areas. Growing LDC urbanization — coupled with deagrarianization and deindustrialization — will only exacerbate the food crisis, which cannot be resolved through emergency measures alone, but will require long-term economic development.

### 3. FINANCE TO SUPPORT FARM TO NON-FARM LINKAGES

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*The expansion of access to finance is of critical importance in LDCs, as it raises agricultural investment. The role of the State in creating smallholder access to formal credit is critical.*

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The single most commonly reported obstacle to investment and entrepreneurship in the non-farm rural economy is inadequate access to capital (Reardon et al., 1998; Haggblade, Hazell and Reardon, 2002). It is not that would-be rural investors lack access altogether, but for the most part, the best that is available is small loans for short periods. Given the lack of credit, the main source of funds is often the savings and assets of the (extended) household. In this regard, evidence from Uganda and the United Republic of Tanzania shows that households with assets can find ways to convert one asset or another to investment capital (an example of this would be cattle) (Ellis, 2001). Initiatives by NGOs and LDC Governments to promote micro-finance have improved access in some cases, but coverage is still slight (Haggblade, Hazell and Reardon, 2002; Ellis, 2001). Moreover, micro-finance groups may exclude the poor as uncreditworthy and too risky to form part of their groups. Micro-finance agencies, seeking institutional sustainability, are tempted to move upmarket and abandon provision to the poor, the marginalized, and the remote. The importance of savings services is now self-evident, but it is far from clear that promotion of savings alone will enable the majority of smallholder farmers to intensify their agricultural production.

The expansion of access to finance (both seasonal and longer-term) is of critical importance in LDCs, as it raises agricultural investment. However, there are few successful models of large-scale credit provision to smallholder farmers where output markets are highly competitive. Again, the role of the State in creating smallholder access to formal credit is critical. In India, for example, this is done by

means of a system of priority credit, within which commercial banks are obliged to provide a sizeable part of their resources as loans to farmers and small-scale rural firms. In fact, it is only by the provision of cheap and adequate (priority) credit and a package of agricultural extension services to small farm holdings that technological progress in farming can be made scale-neutral. Scale-neutral technological progress is essential to equitable growth, because no sustainable improvement in the distribution of incomes is possible without reducing the effective “scarcity of land” (Naastepad, 2001).

LDCs could also make greater use of existing institutional infrastructure, including banks. State banks, post offices, agricultural development banks (box 15) and commercial banks may have extensive rural branch networks that could increase access to financial services. There are several options for encouraging such entities, such as: (a) restructuring the management and corporate governance structure of a failing State bank (e.g. the Agricultural Development Bank of Nepal); (b) creating specialized rural/micro-finance units that operate independently through bank branches and systems (e.g. Banco do Nordeste in Brazil); and (c) partnership arrangements between micro-finance institutions and such entities (Pearce, Goodland and Mulder, 2004). These models are relatively new, and need further government support to improve and extend their use.

Innovative financial institutions — including micro-finance institutions, banks and cooperatives — have shown that it is possible to provide viable financial services to smallholder agriculture and RNF enterprises in rural areas. They have done this by adapting financial products, making creative use of delivery mechanisms to reduce costs, and adopting new technologies. Further innovation is needed to extend the benefits of financial services to wider LDC rural areas. LDC Governments and donors could support such innovation by conducting research to identify promising new approaches, and by funding, for example, mechanisms along the lines of the Africa Enterprise Challenge Fund, and country-level financial sector programmes. Support is also needed to roll out and replicate proven innovations (Pearce et al., 2004). For example, there are a number of initiatives aimed at making formal risk-management instruments accessible to LDC smallholders (box 16).

There are also other initiatives, which although not directly involved in improving the management of farm risks and increasing access to finance, aim to enhance service delivery to smallholder farmers and/or improve production and marketing. The International Fund for Agricultural Development (IFAD, 2003), notes that credit provided by agrimarketing companies (suppliers, processors and

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#### **Box 15. What role for agricultural development banks?**

In many LDCs, the lack of a specialized agricultural development bank that deals exclusively with agribusiness is one of the major hindrances to the development of agriculture. Agricultural development banks could provide alternative arrangements to the lending practised by mainstream commercial banks and other financial institutions. This could also encourage farmers to organize themselves into groups in order to get access to credit (Onumah et al., 2007). As part of structural adjustment policy reforms implemented during the 1980s, many LDC agricultural development banks closed. However, experience shows that reform is possible for failing agricultural development banks (Seibel, 2001). Among the prominent cases are Bank Rakyat Indonesia, the Bank for Agriculture and Agricultural Cooperatives (Thailand) and the Agricultural Development Bank of Nepal, which has been transforming its small farmer credit programme into financially self-reliant local financial intermediaries owned and managed by the poor. In sub-Saharan Africa, many agricultural development banks have gone into liquidation; but there have been some cases of reform, among them Banque Nationale de Développement Agricole, of Mali. If the political will for reform exists, LDC agricultural development banks have the potential to contribute to the sustainable provision of rural financial services. The successfully reformed institutions cited, have increased their saver and borrower outreach and the quality of their services to all segments of the rural population (Pearce et al., 2004; Seibel, 2001).

### Box 16. Initiatives to promote risk management and access to finance for LDC farmers

1. The World Bank is piloting weather-indexed insurance covering yield losses from bad weather. Index-based insurance products involve compensation payments based on indexes measured by third parties (e.g. government organizations such as the meteorological services department) and not on actual measures of farm yields.
2. Since 2000, the International Task Force on Commodity Risk Management in developing countries has been piloting the use by farmers in LDCs of market-based instruments (such as futures, options and swaps) offered by advanced commodity exchanges to hedge price risks.
3. Since the 1990s, the Natural Resources Institute has piloted various financial solutions to smallholder farmer risk management in several LDCs, such as a regulated warehouse receipts system.
4. Calamity funds or similar programmes are commonly used in Europe to compensate farmers for losses that occur due to systemic risks. India has a similar programme, but it mainly provides support for yield losses arising from weather-related events such as floods.
5. The European Union, the World Bank, UNCTAD and the Common Fund for Commodities are supporting the development of commodity exchanges in ODCs.

traders) is an important source of funding for both large-scale and smallholder producers in LDCs. This includes interlocking arrangements, such as contract farming and outgrower schemes (IFAD, 2003). In contract farming, the processing or marketing company provides inputs on credit, tied to a product purchase agreement. The initial repayment for the inputs is by means of produce supplied by the farmer at a predetermined price, with the rest being sold in the market or as specified in the contract. Outgrower schemes are a more integrated form of contract farming whereby the agribusiness has greater control. The farmers generally offer their land and labour in return for a package of inputs, extension services and an assured market. Crucially, interlocking arrangements reduce the risk of default to the credit provider, as farmers receive a range of non-credit inputs, advice, and in many cases, markets for their produce, thus reducing price and production risk (Pearce et al., 2004).

While acknowledging that credit delivery by suppliers and traders is no substitute for formal financial services, this service has been a lifeline for some LDCs. There is significant potential for financial institutions to build on the client (farmer) knowledge held by agribusiness companies and traders, and on the risk-reduction effects produced when farmers receive a range of services and inputs from agribusiness credit suppliers (Pearce et al., 2004).

The policy and operating environment surrounding financial institutions in rural areas also needs improvement. Rural households generally have no formal mechanisms to insure against risk, so lenders can be subject to acute credit risk in such areas. In addition, borrowers are often unable to offer suitable collateral, and even if they can, weak contract enforcement makes it difficult to enforce loan covenants when borrowers default. Better mechanisms to manage agriculture-related risk are needed. Improved client and asset registries and stronger judicial capacity to register and enforce claims on collateral are needed too.

Insurance and warehouse receipt schemes appear to offer good potential. For example, micro-insurance allows borrowers to access finance for agriculture by reducing the risk of default arising from adverse weather. Warehouse receipt systems (when accessible to smallholder farmers) provide a way of turning agricultural produce into collateral. Warehouse receipt schemes reduce smallholder farmer transaction costs by independent enforcement of commodity standards and allowing trade by description to occur with minimum risk of counterparty non-performance. Under the warehouse receipt scheme, a reputable third party (the warehouse operator) guarantees delivery of the commodities deposited by a named holder of a warehouse receipt, specifying the quality and quantity of the

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commodity deposited/stored, as well as the delivery location. Where the system is regulated, if parties so wish, receipting can be subject to compliance with specified commodity standards. The guarantee of delivery is usually backed by insurance and performance bonds. In Zambia, recent pilot schemes explored the feasibility of financial products that combine input credit with weather-indexed insurance and produce marketing using warehouse receipts systems (Onumah et al., 2007). At the same time, donors need to work with governments and private sector players to integrate interventions that reduce rural credit risk with mainstream rural financial development programmes and policies.

Agribusinesses have an important role in providing credit for inputs and for financing commodity trade in rural areas, and links with financial institutions offer a promising way forward in extending agricultural finance. Efforts to promote competitive and reliable fund transfer services, and to adopt technology that lowers the cost and improves the efficiency of financial services delivery to the rural population, have been constrained by a lack of infrastructure and supportive legal frameworks. The rural poor would benefit directly from regulatory systems that raise confidence in the role of micro-finance institutions and other non-bank financial institutions in rural savings mobilization. They would also benefit if micro-finance institutions and banks acted as channels for rural payments and for the transfer of remittances. Efforts to promote partnerships between the private sector and governments (in the North and the South), and to remove barriers to the flow of remittances, also have potential for improving access to finance for the rural poor.

#### 4. ENCOURAGING MARKET ACCESS LINKAGES

The structural transformation of agriculture requires a broader view of the sector, which encompasses an integrated approach to investing in the improvement of productivity and efficiency at all stages of the commodity chains, from input markets, to farm-level production, and all the way to the final consumer. Strengthening the linkages of the various stages is key to achieving an optimal contribution from the agriculture and food system to broad-based economic growth and structural transformation. At the regional level, there is a need to exploit the diversity of resource endowments on the basis of the principles of comparative and competitive advantage among regional LDC groupings (e.g. in Africa and Asia). Regional economic integration and cooperation should therefore be guided in the first instance by efficiency and comparative advantage rules. This could be facilitated by using agro-ecological zoning as a framework for identifying agricultural production potential and for planning infrastructure development across national boundaries.

The food and agricultural market in the LDCs (especially in Africa) is characterized by extreme fragmentation along subregional, national and even subnational boundaries, resulting in segmented markets too small to ensure the profitability of sizeable private investments in the different stages of a modern commodity chain. Paradoxically, while being largely closed to each other, the fragmented national and subregional markets of the African LDCs are increasingly open to imports from outside the region (Dorward et al., 2004). As a result, the gap between national/subregional domestic production and increasing regional demand tends to be filled by imports from non-LDC sources.

A practical way to achieve significant economies of vertical coordination and scale in LDC agriculture might be to work at the subregional/regional level around a limited number of strategic food and agricultural commodity chains (UNECA and African Union, 2009). Indeed, the creation of an optimal economic

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*Efforts to promote partnerships between the private sector and governments (in the North and the South), and to remove barriers to the flow of remittances, have potential for improving access to finance for the rural poor.*

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*The creation of an optimal economic space for agricultural transformation requires a broadening and strengthening of the integration of regional food and agricultural chains.*

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*For strategic food and/or agricultural commodity chains, market integration should move beyond the national and subregional levels and to encompass a larger regional market.*

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*Developing vertically coordinated regional chains for agricultural commodities would require public–private partnerships to create an environment conducive both to profitability and to security of private investment.*

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*Governments should also focus investment priorities on improving the performance of traditional food marketing, by linking these with new agribusiness systems and the development of new effective organizational forms to mobilize rural investment resources and build up productive capacities.*

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space for agricultural transformation requires a broadening and strengthening of the integration of regional food and agricultural chains. For selected strategic commodities, a common regional market (for example, in Africa, which might be based on existing regional economic communities) could offer sufficient economic space to allow private or public investments to achieve the economies of scale that would reduce costs and improve profitability. In other words, for strategic food and/or agricultural commodity chains, there is a need for market integration to move beyond the national and subregional levels and to encompass a larger regional market. For LDCs, such strategic commodities would be those that both carry an important weight in a given LDC food basket and have an important weight in the trade balance of the region, either through their contribution to foreign exchange earnings or because of large imports to meet the gap between regional production and demand. These strategic commodities may also constitute a source of production potential that is unexploited due to internal supply-side constraints or to external impediments imposed by regional trading partners. For example, in a sub-Saharan African context, commodities such as rice, maize, wheat, sugar, meat and dairy products, cotton, coffee and cocoa would all meet these criteria of unexploited production, but with the potential to respond to increasing regional demand.

Developing vertically coordinated regional chains (of production, processing and marketing) for such commodities would require public–private partnerships to create an environment conducive both to profitability and to security of private investment. More explicitly, the creation of such an environment could proceed from the opening of free subregional or regional investment zones in those areas where the greatest unexploited production potential for selected strategic agricultural commodities lies, so as to stimulate the mobilization of private investment into agriculture on a regional scale.

In such zones, the creation of an institutional and legal framework for the development and management of land and water resources, and the provision of the necessary public infrastructure and services, would increase the incentives and security for private investment and for the establishment of transnational agribusiness companies. This would be conducive to the mobilization of pooled investment through regional agricultural companies (joint ventures), with a view to developing — in a vertically coordinated manner — the different stages of the strategic food commodity chains. Such a strategy could be further strengthened by the development of local capital markets. Nonetheless, in the medium term, the performance of traditional food systems will remain a greater determinant of LDC farmer welfare and domestic food security than the growth of supermarket chains. Therefore, Governments should also focus investment priorities on improving the performance of traditional food marketing, by linking these with new agribusiness systems and the development of new effective organizational forms to mobilize rural investment resources and build up productive capacities.

Integrating the commodity chain and encouraging productive relationships between farmers and private processors will also require the strengthening of rural producer organizations (e.g. farmers' groups, crop associations and cooperatives). Such organizations are particularly important for facilitating changes in policy, which require broad, popular support (Onumah et al., 2007; Bijman, Ton and Meijerink, 2007).

UNCTAD (2007b) maintains that efforts should also be made to develop production clusters based on natural resources, by adding value to natural resources and exploring the possibilities for import substitution with local production of some inputs and equipment, and by the development of engineering capabilities for domestic production (Ramos, 1998: 124–125).

In recent years, farmers' organizations have been promoted (by NGOs, donors and the private sector) to take over some former State functions in linking farmers to markets, providing extension services and so on. The future prosperity of LDC smallholder farmers depends on whether their organizations can meet these challenges, especially when they operate in difficult environments with poor infrastructure and weak or absent market-supporting institutions. However, the pressures leading to change in the markets are also changing the form and functions of farmers' organizations. A range of new marketing arrangements — most of which link primary (grassroots) producer groups to specific uptakers or identified niche markets — have developed in LDCs in recent years (Onumah et al., 2007). Most of these tend to be mutually beneficial to the participants in the chain. However, the specificity of many of these linkages tends to limit participation by farmers; the implicit self-selection means large sections of the farming population are effectively excluded from such arrangements.

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## D. Conclusions and ways forward

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Agricultural governance at the national level does not develop in isolation — it is influenced by different global actors, issues and institutions, often with action at the global level being essential to the successful realization of national agendas. Alternatively, the opposite may apply — the global sphere can hinder local development through multinational rules that limit policy space. Most notably, global public goods (such as the environment), global food and financial crises, and transboundary issues (such as pandemic animal and plant diseases) require regional and/or global solutions. They also require development cooperation to carry these solutions out, as LDCs cannot do this alone. Consequently, the LDC agricultural governance agenda must include activities that can be most effectively addressed at the global level: (a) establishing fair rules for international trade; (b) agreeing on product standards and intellectual property rights; (c) providing new technologies for the benefit of the poor; (d) avoiding negative externalities such as livestock diseases; (e) conserving the world's biodiversity; and (f) mitigating and adapting to climate change. Several high-profile initiatives have been undertaken by international organizations in recent years to support agricultural development in LDCs. The following are a few examples:

- The United Nations Millennium Project report *Halving Hunger: It Can Be Done* (Sanchez et al., 2005) laid out a plan for reaching the Millennium Development Goals, and called for a major increase in ODA and an increase in rural productivity through a renewed Green Revolution to raise food output;
- *World Development Report 2008: Agriculture and Rural Development* (World Bank, 2008b) places great emphasis on the role and the potential of smallholder farmers in low-income countries; and
- The Strategic Framework of the International Fund for Agricultural Development (IFAD) (2007–2010) articulates how IFAD can act to reduce rural poverty. There is explicit recognition of the need to tackle poverty in rural areas and to focus on agriculture as the basis of improving the economic livelihoods of poor rural people.

This renewed attention to agriculture has not been restricted to international development organizations. As has already been noted, the Comprehensive Africa Agriculture Development Programme, led by NEPAD, has agreed targets of 10 per cent of government budgets should be allocated to agriculture.<sup>22</sup> These targets include a 6 per cent per annum growth rate for domestic agriculture. In order to

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*Integrating the commodity chain and encouraging productive relationships between farmers and private processors will also require strengthening rural producer organizations (e.g. farmers' groups, crop associations and cooperatives).*

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*Given the financial crisis, LDCs must develop their productive capacities, diversify towards a fuller range of more sophisticated agricultural products, and integrate into the global economy at a higher level of value addition in global market chains.*

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*A sustained increase in agricultural productivity is a precondition for development and the reduction of poverty in many LDCs. What is less straightforward is how to establish that necessary precondition.*

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*The lack of government investment in productive capacity and weak State institutions are among the most important reasons for low productivity growth in agriculture and chronic food insecurity in many LDCs.*

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*In general, investment in agricultural R&D, rural infrastructure, and education have the largest impact on productivity and growth.*

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escape the current trap of poverty and underdevelopment, LDC Governments and their development partners will need to redefine the terms of development partnerships (UNCTAD, 2008b). Given the financial crisis, LDCs must develop their productive capacities, diversify towards a fuller range of more sophisticated agricultural products, and integrate into the global economy at a higher level of value addition in global market chains.

There is now a consensus that a sustained increase in agricultural productivity is a precondition for development and the reduction of poverty in many LDCs. What is less straightforward is how to establish that necessary precondition. The argument developed in this chapter is that the lack of government investment in productive capacity and weak State institutions are among the most important reasons for low productivity growth in agriculture and chronic food insecurity in many LDCs.

The evidence shows that LDCs have reduced their budgetary support for agriculture, both in terms of its share in the national budget and as a percentage of agricultural GDP. To promote higher rates of output and productivity growth in agriculture, LDCs have to reverse these trends. Setting the right priorities for productive spending is also important: in general, investment in agricultural R&D, rural infrastructure, and education have the largest impact on productivity and growth. Government subsidies on output prices, and for inputs such as fertilizer, machinery and seeds, among others, may help smallholder farmers to access technology and markets, but they need to be well targeted, and phased out according to clear timetables. The challenges that LDC agriculture faces are stark: climate change, global economic recession, chronic poverty, dilapidated productive infrastructure and massive rural to urban migration. In LDCs in sub-Saharan Africa, over 50 per cent of rural farm households live on less than 1 hectares of land and are extremely poor (box 10). Over 50 per cent of rural farm households are net purchasers of staple food (Jayne, Mather and Mghenyi, 2006) and most of these people, without access to basic health care and education, lack the necessary human capital to contribute productively to society. The State in LDCs will have to play a major role in addressing these challenges. In LDCs, there are at least three dominant policy narratives regarding the role of the State in agriculture, which are as follows:

- (a) A free-market “old style” and “Washington consensus” narrative, which places emphasis on complete liberalization, structural adjustment reforms, and reliance on the private sector. In this narrative, there is a very limited role for ministries of agriculture;
- (b) A coordinated market narrative, which advocates targeted and sequenced State intervention that is justified in order to kick-start markets, address market failures, and assist in the coordination and provision of services; and
- (c) An embedded-market narrative, which emphasizes the role of NGOs and farmer organizations in providing services as a complement to market or State institutions. The role of the State here is to support the development of these institutions.

There remains some debate among economists regarding future policy emphasis on the role of the State in LDC agriculture, in the light of the weaknesses of the “Washington Consensus”. There are broadly two schools of thought: the first maintains that the failure of structural adjustment programmes is due to implementation failures (e.g. in input market reform), rather than the inappropriateness of the reform package proposed (Jayne, Mather and Mghenyi, 2006). This concurs with narrative (a) outlined above. On the other hand, it could be argued that the proposed structural adjustment programmes for many LDCs

were inappropriate, and that government failures to implement liberalization and privatization reforms were justified, because pervasive market failures would not have incentivized an often small private sector to enter the market for service provision. Where these failures are deep, the role of State intervention becomes both important and necessary for the provision of public goods, R&D, investment and market coordination. This concurs with narrative (b) outlined above. Under this approach, the State should, under specific conditions, become involved in seasonal finance, infrastructure provision, input supply and subsidies (to cover transaction costs), land reform, and extension services, to promote the growth of the sector. These interventions would be phased out, to let in private sector actors over time. These are key elements of the role of the LDC State in creating progressive (growth-stimulating) institutional change. Nonetheless, it remains broadly the case that narrative (c) is becoming the dominant paradigm regarding the role of the State in agriculture. One of the main reasons for this concerns remaining doubts on the part of international financial institutions and donors about the capacity of LDC Governments to deliver services efficiently. However, it is not clear that this is the optimal rural development path for LDCs.

Institutional and governance reforms are necessary in order to ensure that policymaking adequately addresses the lack of support for productive investment in agriculture and the lack of State capacity in implementing programmes. Such reforms include creating an appropriate institutional and policy infrastructure that supports local feedback, learning and adopting alongside global cooperation and knowledge transfers. Moreover, given the multisectoral nature of agricultural development, ministries of agriculture need new mechanisms and skills for regulatory activities and for cross-sectoral coordination and cooperation with a range of stakeholders, including other ministries, the private sector, civil society, and farmer organizations, in the formulation of integrated strategies.

For the LDCs, the global food crisis is of major proportions, and it must not be seen as a short-term phenomenon. It has not been caused simply by the rise in oil prices or the expansion of biofuel production, as is sometimes suggested. Rather, it is a consequence of decades of agricultural neglect. This relates to trade, to investment, to technology, to demographic patterns, and to commodity and agricultural policies. Failures have occurred at the level of national development policy, but there have also been important shortcomings at the international and multilateral levels. Unless the underlying structural factors behind the global food crisis are adequately and comprehensively addressed now — by focusing policy attention on the more complex and interlinked series of issues — the crisis will recur, most probably with increased intensity. Among the strategies that need to be undertaken, the following are particularly important:

- Proactive government policies to boost agricultural production in LDCs are needed to ensure food security. Renewed public sector support services and public investment are essential;
- Agrarian development and related reform programmes are essential in order to raise investment and productivity in food production. Such programmes should focus on smallholder, poor farmers, since they are the most vulnerable group in rural areas; on investing in rural infrastructure; and on providing access to credit. South Asia and sub-Saharan Africa are most in need of such programmes, which should also include improving access to affordable, modern farm inputs, and also to land, through land redistribution;
- The development of partnership arrangements between the State and the private sector, in order to perform some of the functions which in the past were associated with marketing boards and cooperative arrangements; and

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*Institutional and governance reforms are necessary to address the lack of support for productive investment in agriculture and the lack of State capacity in implementing programmes.*

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*As LDC national budgets for R&D in agriculture are small, the establishment and/or strengthening of regional centres of excellence of agricultural research would help build critical research and financial resources to achieve economies of scale. These could be created along the lines of agro-ecological zones or strategic food commodities.*

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*The scope for tariff policies to foster sectoral development is somewhat constrained.*

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- As LDC national budgets for R&D in agriculture are small, the establishment and/or strengthening of regional centres of excellence of agricultural research would help build critical research and financial resources to achieve economies of scale. These could be created along the lines of agro-ecological zones or strategic food commodities. Such centres would give special attention not only to farm-level technologies, but also to post-harvest technologies (i.e. storage, processing and transport) and appropriate biotechnologies for food and cash crops.

Regarding trade policy, the tariff regime is an important tool for raising government revenue and fostering agricultural development and industrialization. Tariffs in LDCs, however, have been declining as a result of multilateral, regional and bilateral agreements, structural adjustment programmes, and through autonomous reform efforts (UNCTAD, 2004). The scope for tariff policies to foster sectoral development is thus somewhat constrained. In view of the negative effects of the food and financial crises, trade policies and associated export taxes could be rationalized and reviewed to ensure availability of imported food staples at affordable prices and to promote agricultural production. For example, tariffs on agricultural inputs (seeds, fertilizers and transport equipment such as tractors) could be periodically lowered.

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*Policymakers should focus on helping participants in the rural non-farm economy to respond to new opportunities by lowering barriers to entry.*

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Financial speculation in commodities has contributed to the recent spike in global food prices. Thus, there is a need to align financial policies and commodity markets with the principles of an efficient marketing system, fair and orderly price discovery, and good market surveillance, in order to reduce the risk of destabilizing speculation in commodity markets (UNCTAD, 2009a).

A related challenge is the tendency to produce cash crops for export, and to minimize the production of food crops for the domestic market and especially for local urban centres. Governments in developed and developing countries will have to resolve the tension between the need to stock and supply food at acceptable prices for domestic consumers and the desire of food producers to take advantage of higher food prices.

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*Local authorities and civil society need to develop their capacities in the planning, design and implementation of a local development policy.*

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Although much of the activity in the RNF economy is stimulated by growth in the primary sector, the secondary and tertiary sectors (e.g. local service provision and retail enterprise) are becoming increasingly important. This suggests that policymakers should focus on helping participants in the RNF economy to respond to new opportunities by lowering barriers to entry. The regulatory environment also has an important role to play in promoting intersectoral linkages through the RNF economy, as does taxation policy (the two will need to be carefully designed to prevent exit from the formal to the informal sector). Policies for those RNF activities that have the potential to drive growth in the economy may differ from those that are pulled along by growth in other sectors. When devising appropriate policy responses for the RNF economy, it is important to consider whether the subsector in question is a driver of growth.

It is also important to strike the right balance of power and responsibility between national and local Government. If strong powers to tax and regulate local businesses go unchecked in rural areas, there is an increased likelihood of predatory taxation and regulation, and other forms of rent-seeking behaviour. In some LDCs, a long tradition of centralized governance by the State has weakened regional and local authorities. A renewed emphasis, where appropriate, on regional decentralization to establish or strengthen local institutions is required. Local authorities and civil society need to develop their capacities in the planning, design and implementation of a local development policy. A further step might be to design investment programmes and projects addressing non-farm activities,

perhaps beginning with agriculture-related activities (natural resource processing and services for farmers).

As the RNF economy in LDCs covers a lot of ground, the above is inevitably somewhat general. Few, if any, expected points are omitted. But a policymaker might wish for more guidance in prioritizing among the many useful things that might be done. How should one prioritize? What is needed is to be able to classify sets of policies by some criterion, such as phase of development, or geographical characteristics of the RNF economy: remote areas, middle countryside, peri-urban areas.

The typology in table 15 is expressed as phases, although the three phases could be characterized as remote, middle and peri-urban areas with relatively few adjustments. It provides a stylized illustration of RNF long-term priorities. Table 16 provides a summary of potential RNF economy interventions, highlighting key principles, strategies, activities and rationales for Governments and/or donors to promote the development of the sector and inter-linkages:

*For prioritization, sets of policies need to be classified according to criteria such as a country's phase of development or geographical location.*

**Table 15**  
**A stylized illustration of long-term priorities for the RNF economy in LDCs**

Phase and context	The agricultural and food chain	RNF economy	Policy implications
I. Isolated rural economy, little development	Production to cover local subsistence. Processing takes place within the village.	Highly diverse, since it needs to produce for most of the village. Main products: construction materials, utensils, tools, furniture, clothing. Services: repairs, construction, transport, trading. Education; health care. Migration may be an important source of funds.	Investments in basic physical infrastructure, especially roads. Education and primary health care, including vaccination campaigns. Improved drinking water and sanitation. Extension services for farmers.
II. Rural economy becomes more closely connected with urban economy	Production rises, with an increasing fraction of farm output destined for the market. More specialisation. Some processing may now shift to cities. Inputs — fertiliser, chemicals, tools and machinery — are bought in from urban industry. Some food products are brought in from other regions.	Imports from urban industry replace some local (artisan) manufacturing — e.g. textiles, plastic goods and ironmongery. Increased local purchasing power stimulates some parts of the RNF economy, above all retailing, construction, transport and entertainment. Increasing government spending on formal education, health services, physical infrastructure and utilities.	Supply-side policies: technology extension. Remedying market failures, above all in financial markets. Possible input supply and marketing. Formal institutions: property rights, weights and measures Expanded and improved physical infrastructure — including telecommunications and electrification, processing facilities and social investments.
III. Rural economy well integrated into national economy	As above, only more so. Farming may find itself facing higher land costs in competition with housing and industry in peri-urban zones. Access to water may be contested in such areas: pollution may become a charge on farming.	RNF economy becomes larger, driven by increased local and government spending, but becomes more specialized as goods and services are brought into the village or else villagers travel to urban centres to seek goods and services. RNF economy thus focuses on non-tradables: retailing, transport, education and health, construction. Emergence of new opportunities in leisure and tourism. In peri-urban areas, provision of urban services in housing. In some cases, decentralized manufacturing sets up in rural areas - seeking lower labour and land costs. Operates on sub-contract to urban firms. Government spending may become a significant fraction of rural incomes, if policy is to provide comparable services in rural areas to those in urban areas.	Maintenance of physical infrastructure and supply of social investments. Facilitating private investment and information flows and generally trying to reduce transaction costs. Elaborated technology and R&D policies. Development of R&D capacities to raise productivity and competitiveness levels. Land use planning and regulation in peri-urban zones.

Source: Adapted from Davis (2004).

**Table 16**  
**A guide to potential policy interventions in the rural economy**

Key principles	Strategy	Activities	Rationale	Comments
1. Prioritize activities targeting attractive markets	<ul style="list-style-type: none"> <li>Identify remunerative markets.</li> </ul>	Formal and informal market appraisals	<ul style="list-style-type: none"> <li>Capitalizing on activities with good growth prospects to achieve impact and contribute to local economic development</li> </ul>	Most higher potential activities will cater for non-local markets
2. Support producers to meet market requirements	<ul style="list-style-type: none"> <li>Improve production, marketing and managerial skills.</li> <li>Promote access to credit.</li> <li>Ensure access to intermediate inputs and technology.</li> </ul>	<ul style="list-style-type: none"> <li>Providing on-the-job and formal training and/or linking producers to training providers</li> <li>Promoting exposure visits</li> <li>Developing business advisory services and/or linking producers to providers of business advisory service</li> <li>Delivering credit and/or linking producers to credit suppliers</li> <li>Developing savings and loan groups and credit co-operatives</li> <li>Supporting input production and/or linking producers to input suppliers</li> <li>Promoting effective subcontracting systems</li> </ul>	<ul style="list-style-type: none"> <li>Producing what the market wants — whether locally or regionally — at competitive prices</li> <li>Targeting markets where product demand is sustainable beyond village level</li> </ul>	
3. Improve market access	<ul style="list-style-type: none"> <li>Develop market linkages.</li> <li>Stimulate demand.</li> <li>Improve the transport infrastructure.</li> <li>Develop producer organizations.</li> </ul>	<ul style="list-style-type: none"> <li>Organizing visits to markets and trade fairs</li> <li>Organizing visits to production sites by buyers</li> <li>Facilitating contacts between producers and buyers</li> <li>Providing information on buyers</li> <li>Advising producers on product labelling and certification and advertising and selling strategies</li> <li>Engaging in dialogue with relevant public stakeholders to develop critical public infrastructure and market promotion efforts</li> <li>Assisting formation and development of producer groups</li> </ul>	<ul style="list-style-type: none"> <li>Enabling producers to access non-local markets through a reduction in transaction costs, the development of customer loyalty, and/or an increase in scale</li> <li>Stimulating effective demand through a Green New Deal, innovative products and services such as e-commerce and the promotion of learning and technical change</li> </ul>	Linkage promotion is most effective when producers reach some minimal scale. Infrastructure development is often beyond the scope of RNF economy projects, and normally requires government action.
4. Whenever relevant and feasible, promote the development of common interest producer associations and co-operatives		<ul style="list-style-type: none"> <li>Providing training and advice on group leadership and management, marketing strategies, etc.</li> <li>Providing business advisory services</li> <li>Promoting market linkages</li> </ul>	Reducing service delivery costs, fostering scale economies, and improving the bargaining position and lobbying capacity of small-scale producers	The success of past experiences in group formation and development has been mixed.
5. Develop flexible and innovative institution coalitions	<ul style="list-style-type: none"> <li>Sensitize and mobilize a wide range of relevant players and supportive institutions.</li> <li>Support capacity-building within relevant public and private organizations.</li> <li>Engage with producer groups and NGOs.</li> </ul>	<ul style="list-style-type: none"> <li>Forming multi-stakeholder local consultative forums</li> <li>Developing dialogue with local, regional and national governments, etc.</li> </ul>	Attracting funding for projects and programmes, building on the strengths of different institutions and service providers, attracting government investment in critical public goods, promoting key policy reforms, ensuring the continuity of service provision after project lifetime, etc.	Need for a selective and strategic approach to institutional partnerships to reduce the complexity of co-ordinating project execution and stakeholder dialogue.
6. Adopt a subsector approach	Promote strategic food and commodity value-chains within a regional framework.	<ul style="list-style-type: none"> <li>Market appraisal</li> <li>Supply chain analysis</li> <li>Institutional analysis</li> <li>Identification of leveraged interventions</li> </ul>	Intervening taking into account the whole supply chain and the sub-sector environment (e.g. market players, support institutions, policies, constraints, opportunities, etc)	This also encourages the development of intra-regional trade linkages.
7. Develop sustainability strategies from the start	<ul style="list-style-type: none"> <li>Support financially viable economic activities.</li> <li>Strengthen the capacity of project participants.</li> <li>Promote effective linkages to service providers and buyers.</li> <li>Lobby for supportive public investment and policies.</li> <li>Develop appropriate time frame for implementation.</li> <li>Use subsidies strategically, emphasizing innovation and services with a public good component.</li> </ul>	The State can help develop sustainable community infrastructure programs (providing finance) by utilising voluntary labour from the local beneficiaries. Common-place in South America (especially in the Andean countries e.g. MINGA schemes).	Ensuring that critical support services and promoted economic activities continue beyond the project lifetime.	Lack of sustainability is often the weakest element of RNF economy project interventions.

Source: Adapted from Davis (2004).



1. Prioritize activities that are targeted at local and regional markets;
2. Support producers to meet market requirements;
3. Improve access to product and factor markets for the rural population;
4. Whenever relevant and feasible, encourage the development of common-interest producer associations and cooperatives;
5. Develop flexible and innovative cross-sectoral institutional arrangements;
6. Recognize the diversity of agricultural production and adopt a subsector approach to the policy intervention, investment or development programme; and
7. Develop sustainability strategies from the start of any investment or development programme.

Clearly, the key priorities highlighted in tables 15 and 16 focus on the provision of economic infrastructure in rural areas (such as roads, electricity and water resources) and greater levels of investment in productive capacities for the agricultural sector.

Although the economic and food crises have separate origins, they have interrelated and mutually reinforcing impacts, especially for the most vulnerable countries. The links between the crises persist, in that for most LDCs, the food crisis has added to macroeconomic imbalances, large fiscal deficits, and general inflation. Similarly, the financial crisis and the concomitant global economic recession have decreased demand for agricultural commodities, resulting in lower food and input prices. Also, investment in the agricultural sector has become difficult, with greater capital scarcity and potentially declining levels of ODA. Rates of malnutrition and poverty have risen, reversing positive trends in some LDCs towards the achievement of the MDG for hunger (UNCTAD, 2008b).

The post-financial crisis food security agenda for LDCs should not only aim to address the short-term humanitarian consequences of the food crisis, but also to reverse the decline of investment and productivity in the agricultural sector, which, in turn, has undermined the agricultural sector's contribution to overall economic growth. It should also generate the additional investment needed to foster growth in the RNF sector. Key structural constraints in the agricultural sector which contributed to the food crisis in the LDCs will need to be addressed. The response should include:

- Improving agricultural productivity and access to extension services;
- Improving access to financial resources (e.g. micro-finance, subsidized credit, etc.);
- Sustainably developing natural resources;
- Developing financial innovations directly targeted at producers, whilst raising investment in rural infrastructure;
- Establishing food procurement mechanisms, at national and regional levels, to arrange the purchase and trade of food in large quantities in a timely fashion;
- Widening market and extension services access for rural producers;
- Ensuring that emergency supplies of food and food aid take place in a manner that does not undermine local food production by causing market disincentives;

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*Although the economic and food crises have separate origins, they have interrelated and mutually reinforcing impacts, especially for the most vulnerable countries.*

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*The post-financial crisis food security agenda for LDCs should not only aim to address the short-term humanitarian consequences of the food crisis, but also to reverse the decline of investment and productivity in the agricultural sector.*

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*Effective government investment policies will play an important role in improving food security and agricultural growth in LDCs.*

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- Developing regional markets for strategic food and agricultural commodities (including products critical to regional food security);
- Enhancing LDC knowledge-generation and dissemination capacities;
- Creating employment and training opportunities in rural areas through public works schemes;
- Improving food security for the poorest groups by means of safety nets and the expansion of child nutrition programmes and social protection programmes; and
- Supporting LDC adaptation to sanitary and phytosanitary standards.

Effective government investment policies will play an important role in improving food security and agricultural growth in LDCs.

## Notes

- 1 “Food security” refers to a situation where all people, at all times, have physical, social and economic access to sufficient, safe and nutritious food that meets their dietary needs and food preferences for an active and healthy life (FAO, 2003).
- 2 Any analysis of this period is difficult, as there have been large fluctuations in the prices of food, agricultural inputs and energy prices (particularly oil).
- 3 The chapter has not provided strong statistical evidence on the growth of “agricultural surplus” in LDCs, due to a lack of reliable data
- 4 For example, Burundi, Ethiopia, Sudan, United Republic of Tanzania and Zambia all had negative per capita annual growth rates in staple food production of 1.0 to 1.7 per cent from 1995 to 2004 (World Bank, 2008b).
- 5 Critics of the Asian Green Revolution have also noted that it was not sufficiently sustainable because it depended on petrochemical, fertilizer and pesticide imports (UNCTAD, 2009b).
- 6 CAADP, which is endorsed by African Heads of State, provides a strategic framework for boosting growth in agricultural production on the continent by 6 per cent per annum, thereby enabling income growth and wealth creation sufficient to cut poverty in half by 2015.
- 7 The partial productivity measure compares a single type of input (e.g. land, labour or capital) to total output. Total factor productivity, on the other hand, shows the relationship between an output and total inputs. In both cases, productivity is raised when growth in output is greater than growth in inputs.
- 8 The overall number of undernourished people in the world is forecast to rise to one billion in 2009. See FAO (2009) *The State of Food Insecurity in the World 2009* (forthcoming). Food and Agriculture Organization of the United Nations, Rome.
- 9 On the global financial crisis and speculation in commodity markets, see UNCTAD (2009a).
- 10 The CME Group market is a merger of the former Chicago Mercantile Exchange and the Chicago Board of Trade and is the world’s largest and most diverse derivatives exchange.
- 11 The measurement of hunger utilizing the undernourishment indicator may need to be refined. The indicator is limited because it measures food production, modified by distribution data. Empirically this is different from a conception of food security, which incorporates availability, access and the ability to utilize available food. In an LDC context a refined measure would incorporate “underweight” indicators and other data which better reflect access to food.
- 12 The United Nations Millennium Development Goal (MDG) Africa Steering Group’s Thematic Group on Food Security and Agriculture estimates that to achieve MDG 1c (a reduction by half of the proportion of people who suffer from hunger) in sub-Saharan Africa alone will require increased investments for agriculture of approximately \$ 8 billion per annum (Africa Steering Group, 2008).
- 13 Distinguished from petty versions by having dedicated premises and inventories.
- 14 This point should not to be exaggerated. Village monopolists who exploit their position are likely to face competition from businesses based in rural market centres (as in the case of taxi and bus operators), and possibly, social opprobrium in small communities.
- 15 For most LDCs, the market for tourism is largely made up of foreign, long-haul tourists. The domestic market is small, and in some cases it is made all the smaller by the preference of the local affluent populace for taking any vacations in cities rather than in rural areas.
- 16 For example, Chenery, Robinson and Syrquin (1986) and Kaldor (1966).
- 17 National growth linkage models, a precursor to regional models, explained national industrialization also in terms of national intersectoral resource transfers, particularly from agriculture to industry. Inspiration for these models came from the (rather untypical) case of Taiwan Province of China (e.g. Lee, 1971).
- 18 From international research centres and delivered by BADC (Bangladesh Agricultural Development Corporation) and, increasingly the private sector.
- 19 Irrigated “boro” rice has become more important than traditional “amon” as the primary crop.
- 20 The share of agriculture in ODA for all developing countries declined from 18 per cent in 1980 to 4 per cent in 2007 (Organization for Economic Cooperation and Development – Development Assistance Committee database, accessed in November 2008).
- 21 Modern biotechnologies provide a potential means of improving agricultural productivity and food security. Although considerable potential exists in traditional approaches to selection and improvement, LDCs need to retain and enhance their capacity to adopt and safely manage modern technologies (e.g. genetically modified organisms (GMOs)) if selected.
- 22 Since the introduction of this target in the African Union Maputo Declaration of 2003, fewer than 10 countries have achieved it (IFPRI, 2008b).

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# Tailoring Industrial Policy to LDCs

Chapter

4

## A. Introduction

Least developed countries (LDCs) are currently looking for a combination of effective macroeconomic policy measures and international financial support to limit the damage they face from the economic crisis. However, they must also look to ways of reducing their vulnerability to future shocks. In this respect, industrial policy, as broadly defined in this Report, will have to play a critical role. In particular, building a more diversified economic structure remains the surest way of reducing vulnerability to shocks and ensuring more rapid recovery once a shock has hit. Moreover, the simultaneous effort to raise investment levels, build new backward and forward linkages across the economy, and upgrade technological capacity — which is at the heart of the industrial policy challenge — is intimately connected to promoting a more strategic integration into the world economy that can ensure more reliable sources of foreign exchange and avoid the economic dangers of the lopsided reliance on private capital flows that has been exposed by the current crisis. However, shrinking policy space can jeopardize efforts at autonomous policymaking and impede an effective policy response.

This chapter provides a general framework for a developmental industrial policy (DIP), an industrial policy that can be tailored to the needs and conditions of individual LDCs. The chapter consists of seven sections. The present section presents an overview of the key opportunities and constraints for LDC economies today, including the challenge of overcoming the impact of the global economic crisis, and describes the main structural trends in the LDCs. Section B outlines the functions of the State in DIP and argues that effective policy is fundamental to economic growth; it also reviews the various concepts of industrial policy and introduces DIP as a contribution to the policy discourse, by linking industrial policy to the creation of productive capacities. Section C reviews the role of foreign direct investment (FDI) as an alternative to industrial policy in LDCs. Section D sets out enabling conditions for knowledge-based structural change and discusses public sector support for commercial innovation. Section E reviews the comparative merits of diverse models of industrial policy in successful, small open economies, from an historical perspective, which includes East Asia, Ireland and most Nordic countries (Denmark, Finland and Sweden). Section F evaluates recent experience with industrial policy in LDCs, principally Senegal and Uganda, followed by the Conclusion.

*The Least Developed Countries Report 2008* argued that, despite their recent strong performance, high growth rates were unlikely to be sustained in LDCs given their excessive dependence on commodity and low-tech manufactures exports, and their vulnerability to volatile, external markets. Most LDCs did not benefit greatly from this pattern of growth and they still suffer from very low levels of per capita income and poorly developed productive capacities. Given the weakness or absence of the requisite framework of incentives, rules and regulations needed for markets to function efficiently, it is likely to take some time before the LDC economies are able not only to grow, but also develop in a sustainable way.

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*Despite record rates of GDP growth over the last five years, most LDCs remain far off track to meet the MDGs.*

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By and large, the promised benefits of the liberalization, privatization and deregulation policies of the last three decades have not occurred as expected. The gains from a globalized economy have proved to be unequally shared across nations, and growth episodes have not been sustainable in the world's poorest countries. This can be seen in their uneven, volatile or even stagnant economic performance, as a rising share of primary commodities in their exports has actually increased their vulnerability to external shocks, notably so in African LDCs (UNCTAD, 2008). Despite record rates of gross domestic product (GDP) growth over the last five years (coinciding with the commodity boom), with the exception of a few areas (primary school enrolment and access to water), most LDCs remain far off track to meet the Millennium Development Goals (MDGs) and other development objectives, especially those relating to reducing hunger and poverty, and improving human welfare. Over two thirds of all people in LDCs remain in a state of destitution, living on less than \$2 a day. The absolute number of poor is growing. Food insecurity and malnutrition are on the increase,<sup>1</sup> thus compromising long-term human capital formation. Migration (brain drain) is on the increase, further weakening human capital.

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*It seems unlikely that the LDCs will achieve accelerated growth by relying solely on market forces.*

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Given this record, it seems unlikely that the LDCs will achieve accelerated growth by relying solely on market forces. In most cases, the Governments will have to take a clear leading role in laying the bases for sustainable growth and structural transformation, and to do so will, in many cases, require alternative development strategies to those they are currently following. The current economic crisis resulting in a major downturn of the global economy creates both the necessity and the opportunity for a change of direction. While State intervention per se is no guarantee of success, improvements in LDCs' economic performance are unlikely to occur without an inclusive growth-oriented macroeconomic policy (chapter 2 of this Report). Such macro interventions should be dovetailed with meso- and micro-policies fostering structural change, knowledge diffusion and social inclusion. Only a coordinated effort at different policy levels can establish the foundations for political and social stability, and reduce the external vulnerability of LDCs, thereby preventing future crises. Historically, no late-developing economy has succeeded without industrial policy by relying on the market alone.

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*There is now a good deal of agreement on the need for the State to play a larger role in shaping the economy and a rebalancing of forces between the State and the market.*

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The analytical framework adopted here follows UNCTAD's structuralist tradition, arguing that development requires economic transformation or the "ability of an economy to constantly generate new dynamic activities" (Ocampo, 2005). Mobilizing domestic resources to strengthen capital formation and diversify into new lines of activity is seriously constrained in LDCs. However, capital accumulation is not enough. Learning is also critical, and learning takes time and resources. In the current crisis, the LDCs urgently need short-term humanitarian aid, but this will not be sufficient to alleviate the precariousness of their development prospects in the long run.

## 1. THE CRISIS AS A NECESSITY AND AN OPPORTUNITY FOR CHANGE

There is now a good deal of agreement, across the international development community, on the need for the State to play a larger role in shaping the economy and a rebalancing of forces between the State and the market, not only because of the market failures behind the current crisis, but also because three decades of neoliberalism have delivered limited success. There is argument as to what precisely the role of Government should be, but there is broad agreement that investment, structural change and diversification of output and exports are among the central determinants of growth in any economy. In a situation of generalized poverty, the most effective mechanism of reducing it is not only sustained economic growth, but inclusive growth (UNCTAD, 2008). Recent research demonstrates that growth

accelerations, based on structural change or diversification of manufacturing industry, have exerted the most enduring impact on developing countries thus far (Taylor and Rada, 2007). Increasingly, evidence suggests that “mastery over an expanding range of products” is central to the development process (Rodrik, 2006; Wade, 2006; UNCTAD, 2006b).

In order to achieve such objectives, this chapter argues that it is a *necessary condition for States* to engage in *developmental industrial policy (DIP)*, defined as *any strategic intervention by the State that catalyses structural change and stimulates economic restructuring towards more dynamic, higher value added activities*. To mount such policies implies addressing institutional weaknesses, such as bureaucratic inertia and clientelism, institutionalizing and deepening developmentalism, freeing the bureaucracy from the rigid economic orthodoxy based on the Washington Consensus paradigm, but, most of all, creating a broad base of popular support for the economic and social change that development entails.

## 2. CHANGING DESTINY VARIABLES: FROM INITIAL CONDITIONS TO DYNAMIC COMPETITIVENESS

There are competing theories about the relative importance of different explanatory variables in economic growth, such as: (a) policy, natural resource endowments, and many others suggested by Wood and Mayer (2001); and (b) technological capabilities and absorptive capacity (Lall, 1992; UNIDO, 2005). A particular focus of debate is on the appropriate weight given to the policy variable over other growth fundamentals — such as savings, investment, institutions and human capital — and the so-called destiny variables, such as climate (Bloom and Sachs, 1998), geography (Bloom and Sachs, 1998; Wood and Jordan, 2000), linguistic and ethnic fragmentation, demography, external shocks and other critical variables. The economic literature, however, points to the absence of any simple, causal relationships between policy and economic performance and the precise weight of individual variables in overall growth performance remains unresolved. Some authors fault policy for most of the things that have gone wrong in Africa. While some claim that dependence on natural resources hinders growth and industrialization (Collier, 2002; 2007), others argue that institutions are the decisive factor in economic performance and challenge the geography hypothesis (Acemoglu, Johnson and Robinson, 2001). With some exceptions, however, most analysts tend to be rather pessimistic about future growth prospects in Africa (for example, Collier, 2007).

Nevertheless, countries such as Mauritius, Botswana and Uganda have shown that late development in Africa is possible and that the continent is not condemned by nature or by inherited institutions (Rodrik, 1999; 2007). Africa’s poor industrial performance is most often blamed on the legacies of colonialism, inefficient government intervention, corruption or poor governance (World Bank, 1981; Sachs and Warner, 1995; Collier and Gunning, 1995), or on policies such as import substitution industrialization (ISI), statist command-and-control policy regimes, overvalued exchange rates, restrictive trade policies, lack of openness, poor investment climate and poor public service delivery and infrastructure (World Bank, 1981). Despite the unresolved debate about “good” policies versus “bad” policies, there is a broad consensus in the literature that either way, policy matters. Undeniably, policy can still mitigate or lessen the effects of natural shocks such as climate change, and accelerate growth and economic change. This is not to deny that there are limits to policy, as there are limits to the explanatory power of any other variable.

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*Developmental industrial policy is any strategic intervention by the State that catalyses structural change and stimulates economic restructuring towards more dynamic, higher value added activities.*

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*Despite the unresolved debate about “good” policies versus “bad” policies, there is a broad consensus in the literature that either way, policy matters.*

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### 3. SPECIALIZATION AND MANUFACTURING IN LDCs

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*The manufacturing sector offers the greatest scope for positive externalities and increasing returns, creating the largest multipliers for overall economic progress.*

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*The manufacturing component barely increased, from 10 per cent to 12 per cent of GDP, in almost 40 years for all LDCs.*

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*Asian LDCs experienced a more rapid growth in manufacturing, mining and construction since 1970, all of which contributed to an overall industrial expansion.*

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*Industrialization failed in sub-Saharan Africa, setting the stage for renewed developmental industrial policy.*

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The central role of industrialization, spearheaded by the manufacturing sector, in the development process has been widely observed since the early days of development economics, especially in the works of Lewis, Nurske, Gerschenkron, Rosenstein-Rodan, Kaldor and Hirschman. Such recognition is based on the fact that the manufacturing sector offers the greatest scope for positive externalities and increasing returns, creating the largest multipliers for overall economic progress. Recent evidence shows that “growth accelerations are associated with structural changes in the direction of *manufacturing*” (Rodrik, 2006: 6). The highest growth rates were registered by countries that have moved into medium- and high-technology exports. Between 1980 and 2000, the manufacturing value added (MVA) in sub-Saharan Africa grew by 1.7 per cent per annum, while in East Asia, the MVA grew by 9.1 per cent per annum (Shapiro, 2007: 157). For this reason, this Report focuses on industrialization via manufacturing, which does not deny the importance of services, which also registered high rates of growth in some LDCs, especially in island LDCs. However, given that the growth has been registered largely in the petty trade, low productivity services in most LDCs in the informal sector (for which no reliable data are available), and given the heterogeneity of services, it is beyond the scope of the chapter to include the service sector in its analysis.<sup>2</sup> Moreover, measuring productivity in services in the informal sector is rare.

Long-term changes in the industrial structures of LDCs since 1970 suggest different trajectories of industrialization for Asia and Africa (table 17), including the role of the State in promoting industrialization. The growing importance of the industrial sector in the structural composition of output of the LDC group overall is indicated by the rise of its share in total production from an average of 20 per cent in 1970–1979 to 28 per cent in 2007 (considering data in real terms). Data indicate that the manufacturing component barely increased, from 10 per cent to 12 per cent, in almost 40 years for all LDCs. The aggregate figures reflect the expansion of mining and utilities over the past four decades, rather than any real growth of the manufacturing sector. Since manufacturing plays a central role in transferring knowledge and creating multipliers, its relative demise is an issue of major concern for LDCs, especially in African LDCs.

In Africa, tepid industrial growth masks the stagnation in the GDP share of manufacturing component, largely associated with the increased share of the mining sector. Africa’s manufacturing share in GDP was virtually unchanged (in real terms) between the 1970s ISI period and the later decades, following the adoption of free market policies. For African LDCs, data show the decisive importance of the mining sector, which has been the real — and perhaps only — engine of industrial expansion. The share of mining and utilities in GDP doubled to 13 per cent of GDP between the 1970s and 2006–2007. In contrast, Asian LDCs experienced a more rapid growth in manufacturing, mining and construction since 1970, all of which contributed to an overall industrial expansion. The importance of manufacturing in Asia (the sectoral GDP share grew by 5 per cent in real terms from 1970 to 2007) is increasing and more significant than in Africa (where it rose less than 1 per cent point over almost 40 years). The contribution of manufacturing to GDP is relatively small in the island LDCs, with a minor exception for construction.

In Africa, the trends indicate slow rate of growth in most countries, and even a decline in sub-Saharan Africa,<sup>3</sup> whilst Asian LDC trends indicate an increase in contribution of manufacturing to GDP. From 1970 to 1979, the manufacturing share contribution to GDP was 11 per cent, growing to 16 per cent in 2007. The overall picture shows that industrialization failed in sub-Saharan Africa, setting the stage for renewed developmental industrial policy (table 17).

**Table 17**  
**Trends in industrial sector composition in LDCs, 1970–2007**  
*(Percentage contribution to GDP)*

		Period average					2005	2006	2007	
		1970–1979	1980–1989	1990–1994	1995–1999	2000–2005				
All LDCs	GDP at current prices	Industry	22.10	20.52	21.08	22.26	26.02	31.97	33.39	32.49
		Manufacturing	11.49	11.35	10.17	10.19	10.24	10.03	9.94	10.08
		Mining and utilities	5.97	4.31	6.26	6.51	10.02	16.14	17.48	16.49
		Construction	4.64	4.86	4.65	5.56	5.76	5.80	5.98	5.93
	Real GDP at 1990 prices	Industry	19.69	20.39	20.38	22.34	24.99	27.08	27.63	28.08
		Manufacturing	10.11	10.92	10.08	10.58	11.42	12.13	12.26	12.40
		Mining and utilities	4.95	4.66	5.73	6.67	7.85	8.84	9.13	9.55
		Construction	4.63	4.80	4.57	5.09	5.72	6.11	6.24	6.13
LDCs: Africa and Haiti	GDP at current prices	Industry	24.68	21.79	21.97	21.78	26.12	34.36	35.88	34.80
		Manufacturing	11.27	10.86	8.99	8.13	7.98	7.85	7.70	7.82
		Mining and utilities	8.28	6.13	8.55	8.39	13.03	21.45	22.79	21.62
		Construction	5.13	4.80	4.43	5.27	5.12	5.06	5.39	5.37
	Real GDP at 1990 prices	Industry	21.57	22.13	21.05	22.32	25.31	28.05	28.53	28.94
		Manufacturing	9.84	10.55	9.29	9.09	9.83	10.67	10.58	10.59
		Mining and utilities	6.63	6.60	7.35	8.51	10.37	11.99	12.43	13.01
		Construction	5.11	4.98	4.41	4.72	5.11	5.39	5.52	5.35
LDCs: Asia	GDP at current prices	Industry	16.28	18.40	19.68	23.12	26.13	28.34	29.10	28.54
		Manufacturing	12.04	12.30	12.20	13.00	13.38	13.80	14.32	14.47
		Mining and utilities	0.79	1.15	2.47	4.14	6.12	7.48	7.68	7.08
		Construction	3.45	4.94	5.01	5.98	6.63	7.06	7.11	6.99
	Real GDP at 1990 prices	Industry	14.75	17.04	19.24	22.56	24.60	25.59	26.29	26.75
		Manufacturing	10.92	11.77	11.70	13.37	14.24	14.74	15.28	15.72
		Mining and utilities	0.49	0.85	2.66	3.43	3.60	3.51	3.50	3.52
		Construction	3.34	4.42	4.88	5.76	6.76	7.33	7.50	7.51
LDCs: Islands	GDP at current prices	Industry	18.88	14.11	14.05	14.00	15.05	15.51	14.82	15.20
		Manufacturing	7.29	6.70	7.24	7.05	6.74	6.50	6.02	6.09
		Mining and utilities	5.82	1.61	1.89	2.25	2.75	3.05	2.91	2.90
		Construction	5.77	5.80	4.92	4.71	5.55	5.96	5.89	6.21
	Real GDP at 1990 prices	Industry	18.39	13.42	12.97	13.51	16.14	16.06	15.08	15.66
		Manufacturing	6.34	6.15	6.41	6.07	6.74	6.27	5.69	5.66
		Mining and utilities	5.77	1.57	1.83	2.47	2.99	3.23	3.07	3.09
		Construction	6.28	5.70	4.74	4.98	6.41	6.56	6.32	6.91

Source: UNCTAD secretariat calculations, based on data from the GlobStat database.

LDC exports tend to be highly concentrated in a narrow range of products, as demonstrated by the export concentration index of LDCs, other developing countries (ODCs) and developed economies (chart 20). LDCs specializing in commodities exports exhibit the highest concentration ratios, while import concentration tend to be much lower for the same group of countries. Oil exporters tend to exhibit the largest export concentration, followed by agricultural, mineral and services, then by manufactures and finally by mixed exporters. These data indicate limited export diversification in LDCs and thus their vulnerability to external shocks.

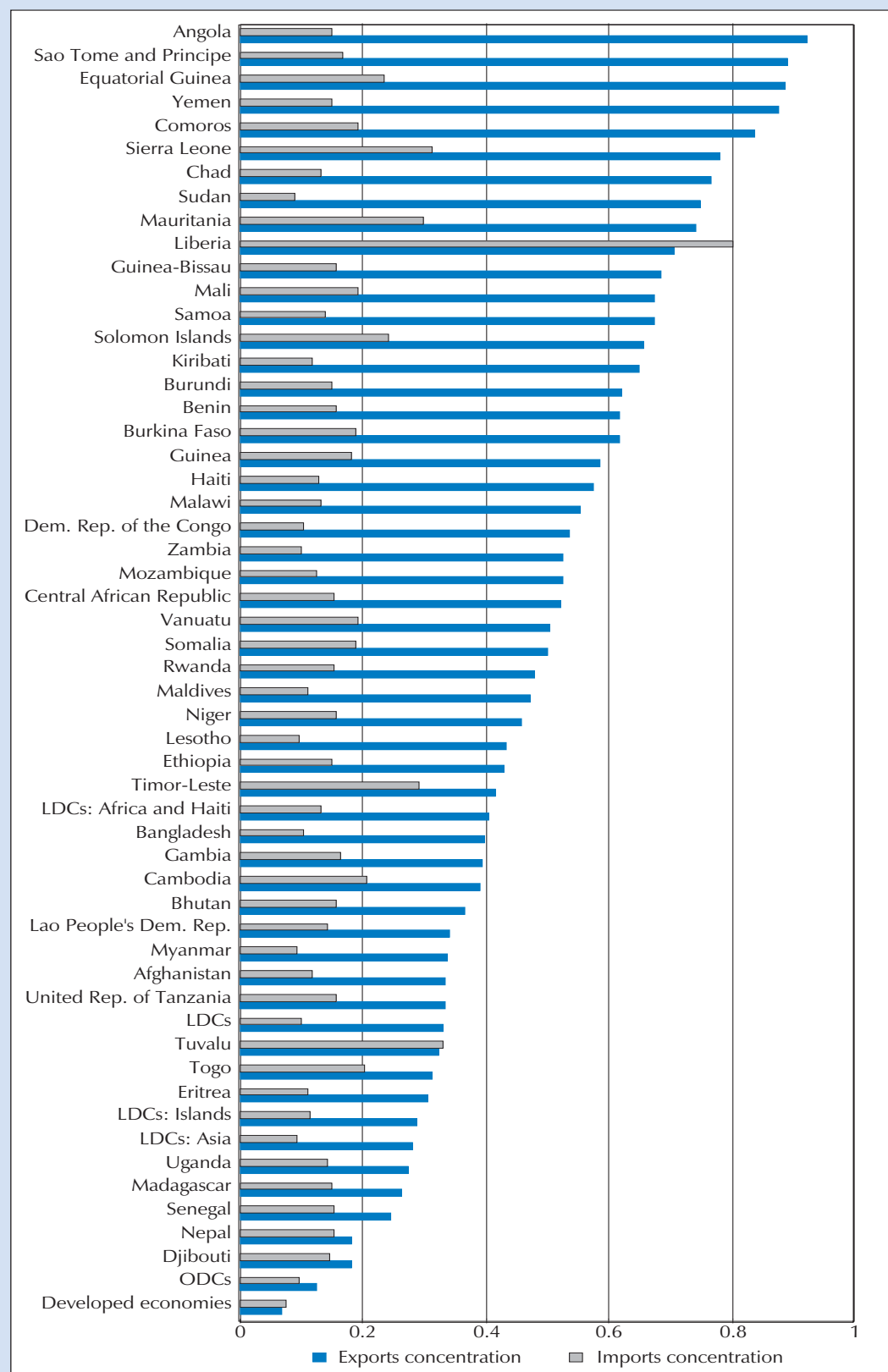
## B. Change of perspective in favour of industrial policy

Since the peak of the dominance of the neoliberal paradigm in the late 1990s, views have started to change about government interventionism, moving away from the general perception that it is undesirable and “crippling” to the smooth functioning of free markets. Economic literature generally distinguishes between market-friendly *functional measures* and market-supporting *selective interventionism*. While most orthodoxy accepts the need for functional



Chart 20

## Imports and exports concentration indices



Source: UNCTAD secretariat calculations, based on data from the GlobStat database.

Note: Herfindahl-Hirschmann index; averages 2000–2006.

interventionism to deal with market failures, it rarely accepts selective interventionism (targeting the most promising sectors or engines of growth), on the grounds that governments are corruptible, less competent and less capable of improving upon allocation by markets. Whether it is better for the government to support particular activities (selective) or a wide range of related activities (functional) will depend on the specific economic context. In order to promote industrial upgrading and diversification, the State instead can select or target high-end products or processes (rather than all of the firms' activities), aimed at activities that drive the upgrading process forward (Wade, 2006). This type of proposal appears to be a plausible compromise with potential benefits to LDCs, given the scarcity of resources available for investment in productive capacities. For example, inadequate government support for the textile industry in Cambodia and pharmaceuticals in Bangladesh has been noted as a constraint to the development of these key sectors (UNCTAD, 2006a; 2007).

Few LDC governments can afford functional interventionism and have little choice but to opt in favour of selective interventionism, targeting the most promising sectors as engines of growth. Often in the past, such policies have been associated with rent-seeking activities (indefinitely subsidizing uncompetitive activities) (Castel-Branco, 2002). This is a serious risk that needs to be addressed at the institutional level. No industrial policy is infallible. Governments are not omniscient. They have imperfect information, they are not always rational, and they are subject to capture by special interests. The same criticisms, however, apply equally to the market. The key question is which is the greater, market or government failure, and the costs and benefits associated with each.<sup>4</sup> The theoretical underpinnings of the free market optimality are, however, far less relevant in the LDC context, owing to the structural characteristics of their economies. Rather, long-term development challenges facing LDCs require a more integrated approach which can simultaneously address threats and vulnerabilities, such as food insecurity, chronic balance-of-payments deficits and unsustainable debt burdens, as well as accelerating structural change, developing productive capacities and raising productivity (UNCTAD, 2006a; 2007; 2008). A traditional ISI-based industrial policy relied heavily on protection (tariffs and quotas), direct subsidies and regulatory instruments, while the new DIP relies primarily on incentives (e.g. fiscal) and indirect subsidies (e.g. to investment geared towards performance) with sunset clauses (Rodrik, 2002; Wade, 2006). An insight from Wade is worth noting: the "new industrial policy" tools (incentives) impose costs on the public budget, whereas the old industrial policy tools mostly impose costs on the consumers. Hence, the former are likely to be of shorter duration than the latter (Wade, 2006: 46).

Manufacturing performance in Africa during the ISI stage has been discredited, although this view is not supported by evidence. While ISI did not build up the domestic capital goods sector in Africa, its performance was nevertheless not surpassed in the next period of market-led development policy. According to UNIDO (2007: 2):

"Between 1963–1970, the average annual growth of GDP in Africa was about 4.7 per cent compared to about 2 per cent in the 1950s. The manufacturing sector grew at a rate of 8.3 per cent. The contribution of industry to the GDP rose from about 14.5 per cent in 1960 to approximately 20 per cent in 1970, and to about 25.8 per cent in 1977. The share of value added of manufacturing in industry at constant factor cost (1970) was approximately 13 per cent. The percentage share of individual countries, Uganda included, was between 6 to 20 per cent. According to the Economic Commission for Africa (ECA), of the 39 countries for which data was available, in the 1960s and 1970s, the share of manufacturing to GDP

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*In order to promote industrial upgrading and diversification, the State can target high-end products or processes aimed at activities that drive the upgrading process forward.*

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*The key question is which is the greater, market or government failure, and the costs and benefits associated with each.*

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*The theoretical underpinnings of the free market optimality are far less relevant in the LDC context, owing to the structural characteristics of their economies.*

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*While ISI did not build up the domestic capital goods sector in Africa, its performance was not surpassed in the next period of market-led industrial policy.*

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*LDCs need to strengthen their domestic productive capacities in order to produce more sophisticated products through a strategic collaboration between the State and the private sector.*

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*Unless growth is accompanied by continuous increase in productivity and a stable or rising employment–population ratio, growth is not likely to be sustainable.*

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*Structural change is a condition for dynamic and sustainable growth.*

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*The current global crisis reveals how crucial structural change and economic diversification can be in reducing LDC vulnerability to external shocks.*

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was less than 5 per cent in 15 countries in the 1960s. However, by 1974, seven countries had a share of less than 5 per cent. Twenty-three countries had a manufacturing contribution of 5 to 15 per cent to GDP in the 1960s, but by 1974, there were about 28 countries in this category. In the case of Uganda, the recorded rates were 12 per cent and 15 per cent respectively. Some countries recorded 15 to 20 per cent manufacturing contribution to GDP. The main reason for the growth was increased production in response to growing real demand in the countries. The increased prosperity in the industrial sector was accompanied by increased population growth rate and low agricultural productivity.”

Uganda was successful during the ISI phase (1970s–1980s), for example, in producing light consumer goods. Apart from being seriously hampered by domestic political tensions, in the long run, the initiative failed because it neglected to support the production of intermediate and capital goods, limited local purchasing power, small domestic market and relative brevity of the ISI experience.<sup>5</sup>

The importance of government policies in explaining a country’s economic performance relative to other variables remains debated in academic and policy circles. This Report takes the view that policy is a fundamental influence on growth and industrialization. Overcoming the challenges facing LDCs requires a fresh perspective on the role of the State in triggering and sustaining a cumulative process of catch-up growth by focusing on the development of their productive capacities. LDCs need to strengthen their domestic productive capacities in order to produce more sophisticated products through a strategic collaboration between the State and the private sector that will encourage their structural transformation from agrarian to post-agrarian economies. As elaborated in *The Least Developed Countries Report 2008*, what a country exports is as important as *how much* it exports. Unless growth is accompanied by continuous increase in productivity and a stable or rising employment–population ratio, growth is not likely to be sustainable. Structural change is therefore a quintessential condition for dynamic and sustainable growth, characterized by higher productivity and increasing returns to scale. More importantly, the current global crisis reveals how crucial structural change and economic diversification can be in reducing LDC vulnerability to external shocks.

Ample evidence and increasing recognition suggest that certain preconditions enable the market to promote sustained and inclusive growth. This Report shows that, at the sectoral level, industrial policy — buttressed by trade and sectoral policies (such as agricultural policy) — needs to be aimed at economic transformation through promoting dynamic competitiveness and diversification into sectors or activities with increasing returns or structural change. Successful historical experiences strongly suggest that there are preconditions (e.g. infrastructure, education and other public goods) or conditions attached: (a) existence of a developmental State; (b) social contract; and (c) an autonomous bureaucracy. Without these, industrial policy is less likely to be as successful, but not impossible.

## 1. PERSPECTIVES ON MARKET AND STATE SHORTCOMINGS

The prevailing view is that, even if the market is the principal framework for managing economic activities, non-market, public institutions are required to deal with the failures that threaten economically and socially desirable objectives.

Critics of such intervention claim that “bad governance”, lack of information, the assumed incompetence of policymakers to deal with economic problems, the

lags involved in policymaking and the threat of its capture by narrow income groups invariably lead to economic mismanagement, instability and suboptimal economic results, which are far greater than those involved in market failure. Much of this criticism is ideological and far too sweeping, but some of it is valid and needs to be taken on board as renewed efforts at industrial policy are undertaken in developing countries, particularly the least developed. The important question is how to design a set of policies that would stimulate the transformation of LDC economies from being dominated by activities with decreasing or constant returns to those with increasing returns. It has been pointed out that the arguments in favour of the State motivating and coordinating investment in a developing economy have not changed for over 50 years. Essentially, due to the presence of externalities, complementarities and scale economies, a big investment push is needed to catalyse the growth process (Shapiro, 2007). Moreover, as subsequently developed by UNCTAD economists, government action to encourage rents is also required to ensure that firms have sufficient access to finance to keep the investment process going at a pace faster than would be dictated by market forces alone (UNCTAD, 1994; 1996).

Even prior to the current global financial and economic crisis, the impact of unregulated markets in developing countries had come under severe criticism, and industrial policy was again emerging as a leading issue in the debates over development. The magnitude and the impact of the global downturn has justifiably reinforced the critique of market fundamentalism.

Policies inspired by the neoliberal model of the market and the concomitant downgrading of the economic role of the State have not helped to stimulate sustainable growth, particularly in LDCs. Integration into the global economy has not, by itself, delivered on its promises and appears to have contributed to growth divergence between countries (UNCTAD, 2003; Ocampo, Jomo and Vos, 2007). The income gap between the developed and developing world has widened since the 1980s, and perhaps more telling, divergence across developing countries has been marked (Ocampo, Jomo and Vos, 2007: 3). This is particularly clear in the case of African LDCs, but it also holds for many countries in Latin America, where a process of “premature deindustrialization” has occurred (UNCTAD, 2003). Rising average labour productivity, based on technological change, was always present in the growing regions, while either absent or marginal in the stagnant regions. Moreover, whilst the Asian Tigers raised the technological content of their exports, there was technological downgrading in many LDCs, especially in Africa. Consequently, there appears to be a need for shifting towards a more balanced pattern of growth, steering away from market-led external integration as a strategic objective per se, but rather pursuing virtuous growth circles including both external and internal integration as its pillars (Wade, 2006). The manufacturing sector remains the most dynamic of all in explaining growth dynamics.

## 2. CHANGING PARAMETERS OF INDUSTRIAL POLICY

It is time to bring industrial policy back to the fore in economic management. Defining industrial policy is complex. Concepts include (a) public actions to promote enterprise competitiveness; (b) economic interventionism in pursuit of productivity increases; (c) policies for enterprise development; (d) strategic interventions by Government aimed at transforming the given or inherited comparative advantage of their resource endowments; and (e) strategic intervention in support of domestic competitiveness and boosting domestic industry (Reinert, 2007). The crucial point is that industrial policy cannot be equated with a particular set of policy instruments, but may evolve over time. Governments should seek to promote structural change towards more dynamic and diversified activities and should have

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*The important question is how to design a set of policies that would stimulate the transformation of LDC economies from being dominated by activities with decreasing or constant returns to those with increasing returns.*

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*Beyond a few core elements, there is no single homogeneous model of State–market relations into which the appropriate industrial policy can be inserted.*

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*Given the premium on flexibility and “adaptive efficiency”, restricting the policy space available to developing countries is more than likely to be counterproductive.*

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*The market-led approach to development policy, adopted by most African countries in the 1980s and 1990s as part of structural adjustment programmes, has paid almost no attention to industrial development and structural transformation.*

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*Asian LDCs embarked on selective trade liberalization processes, pursuing integration into the world economy more as an instrumental opportunity than as a strategic objective in itself.*

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sufficient policy space to intervene in any way necessary with a view to achieving that goal. A policy framework tailored to the specific needs and exigencies of each country is the essence of DIP, and consequently different types of industrial policies arise in practice. The sectors targeted by industrial policy may vary. Whilst in Senegal during the ISI phase, for example, intervention targeted the agricultural sector, in Uganda, attention focused on the light manufacturing sector.

Beyond a few core elements, there is no single homogeneous model of State–market relations into which the appropriate industrial policy can be inserted. Each country must experiment and find the configuration of institutions and conventions that will work best in its national conditions and meet the expectations of its population. Particularly where large structural changes are involved and there is a significant level of risk and uncertainty about the sources of progress, careful experimentation with institutions and policies is needed to discover what will be effective in a particular national context where history, culture and initial economic conditions all have an important influence on the possibilities for growth and development. Given the premium on flexibility and “adaptive efficiency”, and given also the absence of universal laws of economic growth, restricting the policy space available to developing countries is more than likely to be counterproductive.

The market-led approach to development policy, adopted by most African countries in the 1980s and 1990s as part of structural adjustment programmes, has paid almost no attention to industrial development and structural transformation. Employment creation outside agriculture has come almost invariably from service sectors, while many LDCs have actually experienced deindustrialization and not surprisingly, technological learning has remained restricted to a few leading firms, if any (Rodrik, 2006).

In contrast with this experience, some LDCs — mostly Asian — opted for more gradual and selective reforms. The experience of late industrializers in Asia demonstrates a reliance on trade-related industrial policy tools such as incentives, local content, national treatment, export subsidies and tariffs (Singh, 1996). Selective protectionism primarily implied high tariffs, quotas, import licensing, rationing for exports, local content, subsidies and credit allocation. Many of these traditional policy tools are no longer considered acceptable or can only be used to a limited extent under the World Trade Organization (WTO) (table 18) and under regional and bilateral trade and investment agreements. Rather than abandoning them altogether, these countries pragmatically revisited their industrial policies and complemented them with more market-friendly and incentive-based mechanisms including, above all, a strong export orientation. This more selective approach to industrial development pays greater attention to underlying incentive structures and political economy issues but, at the same time, acknowledges that the various economic activities present different opportunities for learning and technological catch-up. Gradual reformers have thus put a more tangible emphasis on supporting structural change and industrialization processes. Correspondingly, Asian LDCs embarked on selective trade liberalization processes, pursuing integration into the world economy more as an instrumental opportunity than as a strategic objective in itself. Thus, export orientation that fosters learning-by-doing and technological upgrading has typically complemented a certain degree of domestic protection. Likewise, FDI and export processing zones have been conceived and managed as strategic tools to favour the emergence of dynamic comparative advantages, enhancing technological transfer and learning (Amsden, 1989; 2001).

Mauritius and Botswana are among the African developing countries that have succeeded by embracing these policy actions. Among the key common features



<b>Table 18</b> <b>Key industrial policies tools and measures used by successful industrializers and policy space currently available under multilateral rules</b>		
Tools of industrial policy	Key policy measures	Multilateral agreements and disciplines potentially affecting use of measures
Import tariffs	<ul style="list-style-type: none"> <li>Tariffs used to:               <ul style="list-style-type: none"> <li>protect domestic industry output from import competition (infant-industry protection)</li> <li>facilitate import of capital goods and inputs for domestic industry</li> </ul> </li> <li>Tariff dispersion</li> </ul>	<ul style="list-style-type: none"> <li>Use of tariffs and change thereof depend on schedules that each country has filed in WTO under GATT. Generally tariffs bindings of LDCs are well above applied rates</li> <li>LDCs currently being requested to expand the coverage of tariff bindings</li> </ul>
Non-tariff barriers (NTBs)	<ul style="list-style-type: none"> <li>Import licensing</li> <li>Import quotas</li> <li>Import and export prohibitions</li> <li>Exchange rate controls</li> <li>Anti-dumping and safeguard measures</li> </ul>	<ul style="list-style-type: none"> <li>Import licensing allowed subject to specific rules (Agreement on Import Licensing Procedures)</li> <li>Import quotas normally prohibited (GATT)</li> <li>Import and export prohibitions normally forbidden (GATT)</li> <li>No disciplines on exchange rate controls</li> <li>Anti-dumping and safeguard measures allowed, but subject to disciplines that require institutional sophistication (Agreement on Implementation of Article VI (Anti-dumping) and Agreement on Safeguards)</li> </ul>
Export promotion	<ul style="list-style-type: none"> <li>Export subsidies</li> <li>Marketing of domestic industry and firms</li> <li>Import duty drawback</li> <li>Export finance/insurance/guarantee</li> <li>Export quality management</li> <li>Export processing zones</li> <li>Export promotion organizations</li> <li>Export targets for industries/firms</li> </ul>	<ul style="list-style-type: none"> <li>Export subsidies authorized according to SDT measure</li> <li>Most export promotion tools allowed</li> <li>Export targets forbidden by TRIMs</li> <li>Import substitution subsidies prohibited (TRIMs)</li> </ul>
Export duties/prohibition		Export prohibitions normally forbidden
Aid to enterprises	<ul style="list-style-type: none"> <li>Industry targeting through administrative measures (e.g. restricting access to domestic market), part of strategic and export industries</li> <li>Subsidies               <ul style="list-style-type: none"> <li>production subsidies (e.g. to inputs)</li> <li>credit subsidies</li> <li>tax subsidies (holidays, exemptions, export subsidies)</li> </ul> </li> <li>Credit allocation to priority sectors/firms</li> <li>Market reserve/licensing</li> <li>Adjustment assistance</li> <li>Manpower training</li> </ul>	<ul style="list-style-type: none"> <li>Industry/firm targeting generally incompatible with WTO rules (e.g. SCM, national treatment and MFN provisions of GATT, GATS, TRIMs)</li> <li>Horizontal measures (including subsidies) allowed, if not conditional on local content</li> <li>Local content requirement forbidden by TRIMs</li> <li>"Specific" subsidies can be challenged under SCM</li> <li>Support to firms cannot be explicitly linked to export performance</li> <li>No restriction on human resource development</li> </ul>
Technological change and innovation	<ul style="list-style-type: none"> <li>Lax enforcement of intellectual property rights (if any)</li> <li>Facilitating reverse engineering and imitation</li> <li>Assistance to R&amp;D (subsidies/direct public participation)</li> <li>Technology-related requirements on domestic firms</li> </ul>	<ul style="list-style-type: none"> <li>LDCs exempt from TRIPS disciplines until 2013 (SDT measure), but some have committed to abide earlier under bilateral FTAs</li> <li>TRIPS requires domestic IPR institutions and protection</li> <li>TRIPS restricts reverse engineering, imitation and mandatory licensing</li> <li>TRIPS foresees transfer of technology to LDCs, but contents and implementation of requirement remains vague</li> </ul>
Investment incentives and guidelines	<ul style="list-style-type: none"> <li>FDI policy               <ul style="list-style-type: none"> <li>performance requirements (e.g. trade performance, transfer of technology, local content, joint-venture with domestic partner, employment of nationals, R&amp;D activity)</li> <li>selective right of establishment</li> </ul> </li> <li>Investment regulation (incl. sectoral restrictions and guidance)</li> <li>Regional assistance</li> </ul>	<ul style="list-style-type: none"> <li>TRIMs explicitly forbids some performance requirements (local content, export performance, trade balancing); others can be challenged alleging national treatment;</li> <li>Regulation of FDI in service sectors (right of establishment etc.) depends on GATS commitments, which vary from limited to very comprehensive among LDCs</li> <li>Subsidies to R&amp;D and to regional development can be challenged under SCM</li> </ul>
<p>Source: UNCTAD secretariat compilation.</p> <p>Notes: GATS - General Agreement on Trade in Services            GATT - General Agreement on Tariffs and Trade            IPR - intellectual property right            MFN - most favoured nation            R&amp;D - research and development            SCM - Agreement on Subsidies and Countervailing Measures            SDT - special and differential treatment            TRIMs - Agreement on Trade-related Investment Measures            TRIPS - Agreement on Trade-related Aspects of Intellectual Property Rights</p>		



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*Unlike the African countries, the Asian countries produced a number of intermediate and capital goods from the very initial stages of their industrialization process and pursued vigorous export-oriented industrial policies.*

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*The functions of the State include not only instigating the process of change, but also ensuring its viability through managing distributional conflicts.*

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*Export expansion is dependent on the creation of additional production capacity in industry and on productivity growth.*

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*A sustainable growth process requires mutually reinforcing dynamic interaction between savings, investment and exports.*

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of these countries are: (a) the importance of a “Weberian bureaucratic class” that keeps vested interest relatively under control and operates at reasonable levels of efficiency; (b) a sustainable macroeconomic record; (c) a gradual and strategic approach to liberalization; (d) a close coordination among private and public actors; and (e) a deliberate effort to promote structural change, whilst ensuring that the resulting social transformations are politically feasible (Bhowon, Boodhoo and Chellapermal, 2004).

Some Asian countries also adopted import substitution policies and export-oriented strategies with great success, such as Republic of Korea, Taiwan Province of China and Malaysia. “However, unlike the African countries, the Asian countries produced a number of intermediate and capital goods from the very initial stages of their industrialization process and pursued vigorous export-oriented industrial policies with strong state support and a wide range of incentives. Asian governments created the enabling environment for a realistic and sustainable industrial development” (UNIDO, 2007: 3).

An effective industrial policy regime requires the existence of the State, in its broadest sense, not just the Government as the executive branch, but the state, on the one hand, as a complex of institutions and practices which embody not just economic incentives, but a nation’s basic values regarding justice, the rule of law etc. and, on the other, as the embodiment of a common vision, a sense of shared purpose and aspirations. Industrial policy, if successful, is an expression of the social contract, a partnership between different segments of society willing to share both the risks and benefits of change in an equitable manner. Accelerated growth tends to be turbulent and socially destabilizing. The multiple functions of the State include not only instigating the process of change, but also ensuring its viability through managing distributional conflicts.

Policy development should be an interactive process, rather than top-down. In developed market economies (DMEs), the private sector was able to ally with the State and become an agent of change, but in LDCs, the State must lead, since the private sector is too weak to carry out the transformative role.<sup>6</sup>

### 3. DEVELOPMENTAL INDUSTRIAL POLICIES AND THE PROFIT–INVESTMENT–EXPORT NEXUS

The development model underpinning this analysis is the “profit–investment–export nexus” model (UNCTAD *Trade and Development Report* series, 1996–2008; Akyüz and Gore, 1996). The “profit–investment–export nexus” paradigm analyses a process of industrialization that is categorized by continuously rising exports, domestic savings and investment, both in absolute terms and, for the most part, as a proportion of GDP. In this process, investment initially exceeds domestic savings by a large margin, with the difference being financed by net inflows of capital, but over time, the external gap narrows as exports and savings grow faster than investment (Akyüz, Chang and Kozul-Wright, 1999). Export expansion is consequently dependent on the creation of additional production capacity in industry and on productivity growth (which itself is dependent on investment), and a sustainable growth process requires mutually reinforcing dynamic interaction between savings, investment and exports. This model starts in the early stages of industrialization and accompanies the entire development process through the creation of new export opportunities in low-skill manufacturers. It calls for an infant-industry programme to be designed and implemented at each stage of the early industrialization process that is fuelled by investment in the productive resources.

The function of developmental industrial policy in LDCs transcends “targeting sectors” or “picking winners”, to provide fundamental support and direction for satisfying the needs of broad sections of the society and setting the terms of public–private partnerships (investment coordination). The case of Mauritius, one of the most successful cases of industrialization in Africa, illustrates the effectiveness of complementing selective industrial policies with a broader stimulus for entrepreneurship and small and medium-sized enterprises (SMEs), thus setting the stage for inclusive growth and for greater employment creation (Rodrik, 1999).

The standard conceptions of industrial policy are far too narrow when applied to LDCs attempting to embark on programmes of major economic transformation. In departing from the mainstream perspective, there are several dynamic objectives the new developmental industrial policy should strive for:

- Creating a dynamic domestic comparative advantage, in an increasingly complex and sophisticated range of products and services;
- Upgrading human capital and promoting learning by providing incentives at the firm / shop floor level to stimulate learning-by-doing;
- Upgrading productive capacities, in the sense of innovating to increase value added. The concept of upgrading — “making better products, making them more efficiently, or moving into more skilled activities” (Giuliani, Pietrobelli and Rabellotti, 2004) — is critical in this context;
- Building industrial policy capability, decreasing social marginalization and reducing poverty through incomes and “labour market” policies, fiscal policy, entrepreneurship and technological development policies, as described in *The Least Developed Countries Report 2007*;
- Creating conditions for full employment and inclusive growth, through compatible pro-growth macroeconomic policies (chapter 2 of this Report) and sectoral meso-policies that highlight intersectoral linkages;
- Creating conditions for the transformation from agrarian to post-agrarian societies;
- Improving the supply of all public inputs with a view to raising labour productivity;
- Facilitating diversification of natural resource activities; and
- Building capacities at meso/sectoral- and micro-levels, by actively promoting learning and knowledge diffusion among firms, as well as among workers.<sup>7</sup>

Especially in times of liquidity crisis, mobilizing resources to finance public interventions and DIP represents one of the main challenges for LDCs. A promising strategy for resource mobilization is the option of transferring the surplus produced in other sectors of the economy to strengthen the “profit–investment–export nexus”. This may take different forms, depending on the specificities of each economy: from the upward renegotiations of mineral royalties, to the establishment of mandatory pension contributions and the promotion of postal savings. A second option to finance public intervention is broadening the tax base, with special attention to widespread informal activities; nonetheless, tax revenues are not likely to be a major source of funding in the near future, given the longstanding fragility of taxation systems in most LDCs. Moreover, monetization of government deficits and public debt financing may be additional ingredients of “development-friendly macroeconomic policies”, but more as supportive strategies in countries with moderate inflation and sustainable macroeconomic outlook, rather than as pillars of resource mobilization per se (chapter 2 of this Report). In the immediate future, the bulk of resources mobilized in LDCs is most likely to come from foreign

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*The new developmental industrial policy should strive for creating a dynamic comparative advantage, upgrading human capital...*

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*... upgrading productive capacities and creating conditions for the transformation from agrarian to post-agrarian societies.*

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*Mobilizing resources to finance public interventions and DIP represents one of the main challenges for LDCs.*

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savings, that is, mainly from official development assistance (ODA) and debt relief or lending. That is why it is essential that ODA commitments are at least matched by actual disbursements, and preferably scaled up (UNCTAD, 2008).

Despite the inherent difficulties involved in any of these choices, they should not lead to development pessimism. Given the strong complementarities among different forms of capital accumulation, public investment can exercise a “crowding-in effect”, enhancing the appeal of overall capital accumulation and ultimately leading to large supply responses. Policymakers should exploit synergies between public and private investment. If appropriately designed, government efforts can create the momentum for a developmental partnership between private and public actors, reaping the benefits of a cumulative effect from the expansion of productive capacities.

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*In the immediate future, the bulk of resources mobilized in LDCs is most likely to come from foreign savings, mainly ODA.*

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*Given the heterogeneous nature of LDCs, institutional diversity is unavoidable.*

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*Owing to externalities, missing institutions, economies of scale and market failures, markets alone cannot be relied upon to coordinate the processes of capital accumulation, structural change and technological upgrading in a way consistent with sustainable growth and development.*

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#### 4. INDUSTRIAL POLICY AGENCIES AND INSTITUTIONS PROMOTING GROWTH

Hirschmann argued that development is a search process which involves “calling forth and enlisting for development purposes, resources and abilities that are hidden, scattered or badly utilized” (Hirschman, 1992: 13). Rather than being a spontaneous process, it is a continuous process of discovery involving both cumulative improvements to existing activities and radical departures into new markets and along unfamiliar technological trajectories. In such a world, productive assets are as much acquired as they are given. The forces of competition are joined by increasing returns, uncertainty, cumulative causation and path dependence to shape the context for policymakers and private entrepreneurs alike. This perspective is influenced by Joseph Schumpeter’s “plausible capitalism”, where the challenge to established firms and industries through new products and technologies rests on the actions of entrepreneurs as agents of “creative destruction”. However, if entrepreneurship is truly purposive activity in an uncertain world, institutions to support it must provide a more broadly enabling environment than suggested by Schumpeter himself. Whilst including an appropriate incentive system to encourage risk-taking and create new economic activities — “the creative role of markets” (Kaldor, 1972) — this environment must also provide the preconditions by and through which change can be understood and implemented, and purposeful activity thereby made possible. To this end, institutions must function to reduce uncertainty, regulate conflict and establish the linkages to ensure the flow of knowledge and capabilities between economic units.

No ideal institutional configuration can be characterized as universally “successful”, and given the heterogeneous nature of LDCs, institutional diversity is unavoidable. Once the distraction of the ideal model is abandoned, one is faced with a myriad of context-specific challenges. The underlying assumption argued by this Report is that — owing to externalities, missing institutions, economies of scale, and other types of market failure — markets alone cannot be relied upon to coordinate the processes of capital accumulation, structural change and technological upgrading in a way consistent with sustainable growth and development. The policy response to the current global crisis shows how government intervention is necessary even in DMEs; the need to address chronic coordination failures by the State is greater than ever, especially in LDCs. An issue of great concern is the lack of fiscal policymaking options through which LDCs can carry out industrial policies. This constraint suggests the need for a “big push” from external sources.

In the past, LDCs’ experiences with industrial policy were mixed (UNCTAD, 2006b). Failures were exposed during the debt crisis and provided the opportunity

for a big shift in thinking about development strategy. Active industrial policies were a major casualty of this shift, but one should not deny or ignore the instances in which industrial policy was successfully used — not only in East Asia, but also Ireland and most Nordic countries (Denmark, Finland and Sweden).

## 5. KEY FEATURES OF A DEVELOPMENTAL INDUSTRIAL POLICY

### (a) *Institutions: dynamics between policies and institutions*

Unmistakably, changing the policy environment alone is insufficient to solicit the type of behaviour that would encourage growth and poverty reduction, as policies do not operate in an institutionally disembodied environment. Institutions are socially constructed rules of the game that reduce uncertainty by establishing a stable structure of interactions and linkages. Institutions, however, differ widely from organizations, and it is the recurrent interactions between the former and the latter that ultimately shape the direction of institutional change (North, 1990).<sup>8</sup> Industrial policy is embodied in these institutions and incentives.

The present Report argues that the institutional framework brought about by the Washington Consensus in the last decades has confined industrial policies to a very marginal role, taking for granted that structural change would occur spontaneously once economic fundamentals are in place (Rodrik, 2006). Most market-based institutions — such as those of the financial sector and business organizations — as well as the State and the institutions of the civil society, tend to be weak and underdeveloped throughout the LDCs. There is now general agreement that the market mechanism alone cannot function efficiently without a complementary public sector. The private sector alone cannot bear the burden of development, so it is clear that the private sector and the State have to complement each other.

To avoid repeating the mistakes of the past, this Report does not assume a prescriptive “one-size-fits-all” attitude towards industrial policy. Rather, it stresses the need for building industrial policy capability through greater policy space, namely, a broader range of industrial policy tools available for each government to deploy, in light of its specific developmental needs. In this respect, this Report builds on the findings of previous research (UNCTAD, 2006b; 2007; Chang, 2002), arguing that some WTO agreements — including the Agreement on Trade-related Aspects of Intellectual Property Rights (TRIPS) and the Agreement on Trade-related Investment Measures (TRIMs) — and regional and bilateral trade and investment agreements circumscribe the use of industrial policy tools used in traditional industrial policy, such as credit and export subsidies, government procurement, credit allocation, price management and local content clauses (table 18). These tools were justified on the basis of infant-industry protection.

### (b) *Institutions and incentives for coordinating change*

A lively debate continues over the role of institutions in economic growth and development. The main argument of those who favour policy intervention is that it is the interaction of policies and institutions that make up the incentive structures which instigate, accelerate or delay economic change. The State, through industrial policy, can shape the structure of social and economic interactions through the provision of incentives. Incentives and institutions represent the main coordinating devices for economic and social activities. Incentives — interpreted as rules that govern the exchange of goods and services as well as the creation of new markets — coordinate activities of economic and productive agents. The question of

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*The institutional framework brought about by the Washington Consensus has confined industrial policies to a very marginal role.*

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*The market mechanism alone cannot function efficiently without a complementary public sector.*

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*Productive capacities, which form the basis of a production-oriented paradigm need to be created, nurtured and developed by the new developmental State.*

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institutional readiness needs to be addressed firmly in the LDC context. Skepticism has been expressed as to the extent to which the prevailing institutional setup in many LDCs is capable of sustaining growth-accelerating processes (World Bank, UNIDO, Collier, etc.), while other critics have questioned whether national elites are ready and willing to support policies for change (Bora, Lloyd and Pangestu, 2000). But institutions are dynamic and can be modified and shaped by prices, incentives and regulations in order to coordinate investment.

Selected examples of LDC and ODC institutions that promote growth include: (a) ministries of development, industry and trade, e.g. the Ministry of Industry and Handicrafts of the Lao People's Democratic Republic, which works with business associations; (b) the Chamber of Commerce, Industries and Agriculture in the United Republic of Tanzania; (c) private development banks, such as Grameen Bank in Bangladesh; (d) public development banks, such as the Banco Nacional de Desenvolvimento Econômico e Social (BNDES) in Brazil; (e) specialized government agencies, such as the Bangladeshi Rural Development Board (BRDB); and (f) university-sponsored initiatives, such as the Federal University of Santa Catarina's Centre for Ceramics Technology in Brazil.

#### *(c) Investment*

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*Public investment is a key factor in raising the levels of productivity in agriculture in order to generate a net agricultural surplus as a key source of accumulation.*

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Productive capacities, which form the basis of a production-oriented paradigm, will not emerge spontaneously from markets alone, but need to be created, nurtured and developed by the new developmental State. *The Least Developed Countries Report 2006* identified the following elements as essential to productive capacities: capital accumulation (investment), technical change and structural change. Owing to a series of market failures and inefficiencies, investment is unlikely to occur at all or on a sufficient scale. These include: (a) imperfect or missing credit, information, equity and insurance markets; (b) coordination failures (lack of backward and forward linkages and complementary investments); and (c) weak positive externalities (Khan, 2008).

The role of the State is essential for creating the right set of incentives for investment, through regulating prices of both inputs and outputs via exchange rate policies, sectoral policies to promote technical change, and fiscal policies. Public investment, for example, is a key factor in raising the levels of productivity in agriculture in order to generate a net agricultural surplus as a key source of accumulation (chapter 3 of this Report).

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*Governments can play a fundamental role in accelerating growth and promoting structural change by engaging in "strategic coordination" with the private sector.*

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Historical evidence illustrates that Governments can play a fundamental role in accelerating growth and promoting structural change by engaging in "strategic coordination" with the private sector. In countries where coordination failures tend to prevail and resources are scarce, regular consultation with potential investors, exchange of information, and similar activities become valuable instruments to nurture and orient the accumulation process towards more dynamic sectors. Further, these kinds of "nudging industrial policies" (Wade, 2004) are typically highly cost-effective when vested interests are kept under control, and tend to feed back into a greater institutional efficiency and social dynamism, as in the case of Taiwan Province of China.

#### *(d) Incentives*

LDCs can employ a large menu of instruments for industrial development, including preferential treatment reflected in incentives or targeted supports, a plethora of fiscal and investment incentives, as well as trade policy tools (tariffs



and non-tariff barriers), subsidies, grants or loans. Most of these can be used to encourage capacity-building in the private sector and stimulate the process of economic transformation. Moreover, “new-style” industrial policy tools, such as fiscal and investment incentives, are less susceptible to rent-seeking and more self-limiting than tariffs or quotas (Wade, 2006). Additionally, Governments can facilitate this process by strengthening their domestic financial institutions, whether State-owned development banks such as the BNDES in Brazil, or privately-owned credit institutions such as Grameen Bank in Bangladesh.

#### (e) Innovation

While innovation is considered by many as the foundation of growth, the innovation process in LDCs follows a different pattern (Abramovitz, 1986; Lall, 1992; Srinivas and Sutz, 2008; Srinivas, 2009). As elaborated previously in *The Least Developed Countries Report 2007*, innovation in LDCs (adopting whatever is new to a firm) is not a perfected or a common occurrence.

Learning and innovation may arise from a variety of sources, such as research and development (R&D — which is codified knowledge), tacit learning-by-doing, investments in new machinery and equipment, technology suppliers, mobility of labour, etc. For many low-income economies, however, the opportunities for industrial learning have been limited because of the lack of incentives to engage in a collective learning process with others. But firms do not innovate alone (Kozul-Wright, 1995); in developed market economies, they are heavily supported by a dense array of institutional support institutions that buttress institutional learning on a continuous basis. Such institutions are largely missing in most LDCs, especially in sub-Saharan Africa (Oyelaran-Oyeyinka, 2006).

#### (f) Capabilities, capacities and policy space

The key to development lies in improving productive capacities and capabilities of both firms and farms, as well as the capability of the developmental State to carry out industrial policy. The State capability to carry out industrial policy will depend on its institutional and technical capacity (knowledge, skills and competent bureaucracy), as well as the constraints that impinge on that capacity. Policy space defines the parameters of the State capabilities to carry out national development strategies. This includes external constraints that are found in the international commitments made by LDCs through international trade and investment agreements, at the multilateral, regional and bilateral levels. Table 18 illustrates how multilateral commitments constrain the capability of LDCs to carry out effective industrial policies. The policies, institutional framework and State capabilities to design and implement policy will determine the effectiveness of industrial policy. But even if countries employ the same instruments and policies, the sequencing or combination of different instruments can produce very different outcomes. Industrial policy instruments will vary according to the conditions that prevail in a given economy at a particular time, and both the form and content of industrial policy should evolve in relation to the development of market institutions, as well as the capabilities of the State itself to manage economic change and transformation. For example, to build capabilities, public-private partnerships in knowledge creation were used successfully as tools in East Asia, establishing collaborative arrangements between firms, governments and banks that encouraged cooperation, risk-sharing and common purpose.

Over the last two centuries, historically unprecedented growth rates in the developed world, fuelled by the harnessing of science to productive activities,

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*The asymmetric creation and access to knowledge is one of the main reasons for widening of the gap.*

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*All developing countries, including LDCs, are being challenged by increased knowledge requirements for catch-up growth.*

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have underscored the importance of knowledge and innovation for growth, competitiveness and poverty reduction. This trend intensified in the late twentieth century, leading to the emergence of so-called knowledge based economies (KBEs). The Organisation for Economic Co-operation and Development (OECD) describes KBEs as those economies “which are based directly on the production, distribution and use of knowledge and information” (OECD, 1996: 7). In contrast, most developing countries are falling behind and only a few emerging economies are beginning to catch up. The asymmetric creation and access to knowledge is one of the main reasons for widening of the gap (UNCTAD, 2007).

The role of knowledge in growth assumes far greater importance in determining “comparative advantage” than traditional, static factors of production (Reinert, 2007). Their rise has been accompanied by an increasing reliance on codified knowledge that can be formalized and hence transferred as the basis for the organization and conduct of economic activities (Abramowitz and David, 1996; Amsden, 2001). By implication, all developing countries, including LDCs, are being challenged by increased knowledge requirements for catch-up growth (Bell and Pavitt, 1993; UNCTAD, 2007).

While knowledge is generated globally, it is embedded locally. The local technological institutions carry out the generation, creation and diffusion of knowledge available from the local and global domains. Local knowledge institutions have been normatively defined as “a set of agents that act as the repository of creative assets, and devolving in a milieu of dynamic interaction with other agents” (Oyelaran-Oyeyinka, 2004: 21). This is why local productive business enterprises are a critical component of domestic learning processes. African firms, for example, tend to be largely small enterprises that generally do not interact with either formal or non-formal agents or sources of knowledge, be they other firms or universities, public research institutions and other knowledge networks. Small firms, however, tend to under-invest in training while the widespread institutional failure in developing countries to attenuate the skills market failure is well known (Lall, 2000; Teubal, 2008). Knowledge accumulation remains a key challenge for LDC enterprises (Juma, 2007).

#### *(g) Building firm-level capabilities*

Developmental industrial policy emphasizes the promotion of technological learning to complement rather than replace the market. At the micro level, this will require building capable and competitive large firms able to generate externalities and spillovers with strong multiplier effects throughout the economy. From this perspective, industrial policy is inseparable from investment coordination. Developing such firm-level capabilities is essential to the catch-up growth model. Specific incentives to encourage learning at the shop floor should be implemented in the twenty-first century.

LDCs exhibit a number of structural constraints, including (a) poor logistics coordination; (b) heavy dependence on imports; (c) infrastructural weaknesses, including telecommunications; (d) poor transport facilities; (e) limited human resources, including education; and (f) high levels of indebtedness. Unless these constraints are addressed with industrial policy, LDCs will not be able to engage in learning and capital accumulation. Another potential source of learning is

FDI. However, for FDI to benefit the local enterprises, it needs to become an integral component of a developmental industrial policy, creating a systematic framework that goes beyond hands-off promotion to a hands-on approach that includes training and skills development, enabler technologies to support logistics coordination and efficiency-driven innovation (Rasiah, 2007).

### C. FDI: not a substitute for industrial policy

Policies privileging exports and foreign investment have been a common feature in many LDCs over the last few decades. These were part of the liberalization reforms associated with structural adjustment programmes (SAPs). Indeed, many LDCs gave preferences to export processing zones and fiscal incentives were granted to foreign capital over domestic producers and investors. The experience of LDCs, however, suggests that the contribution of FDI to industrial and technological upgrading has been very limited. Indeed, FDI in LDCs has been largely focused on extractive industries or, as in Asian LDCs, on simple processing and labour-intensive activities with few local linkages and spillovers (UNCTAD, 2007). As such, it can be argued that these policies to attract FDI have been relatively successful in Africa and Asian LDCs. But the expected benefits related to FDI such as employment generation and technological transfer did not materialize for various reasons, including lack of industrial policy.<sup>9</sup>

FDI inflows to LDCs have been a negligible proportion of total world FDI and a similarly low share of the FDI going to developing countries. Among LDCs, African countries have always received the largest inflow of FDI, particularly in the present decade (chart 21).

Likewise, FDI was directed predominantly to commodity exporters, mainly oil, but to a lesser extent to mineral and agricultural exporters. FDI inflows to manufactures and service exporters, despite generous incentive schemes, remain marginal (circa 1 per cent) (chart 22), declining in 2008 and in 2009 following the global economic crisis.

Evidence concerning FDI stocks confirms the previous analysis. African commodity-exporting LDCs host the bulk of FDI stocks, while those in Asian and island LDCs (mainly service and manufactures exporters) have slightly declined in the last 10 years.

Relative to GDP, FDI inflows are more significant for developing economies as a whole than for LDCs alone, although these inflows are more important for both of them than for the entire world economy. As a by-product of globalization and of the increasing importance of transnational corporations (TNCs), there has been a clear trend for rising FDI inflows for all the regions considered, although it is notably flatter for Asian LDCs than for all the other groups. In the last five to ten years, FDI inflows have gradually acquired a relatively significant role in African and island LDCs, where they represent more than 3 per cent of GDP. With the rise in commodity prices, FDI flows peaked around 2003–2004, but are expected to decline sharply with the onset of the global crisis (chart 23).

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*The experience of LDCs suggests that the contribution of FDI to industrial and technological upgrading has been very limited.*

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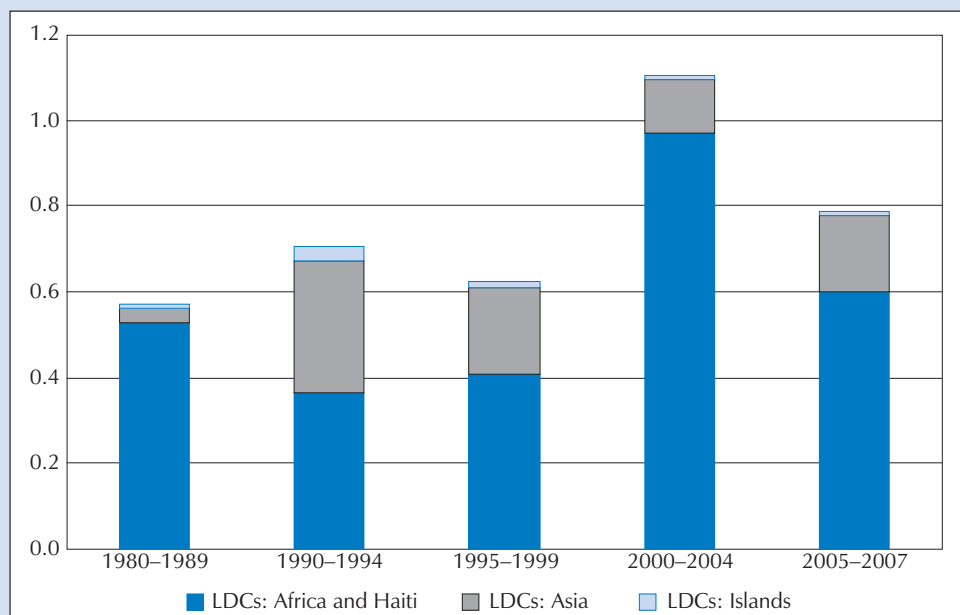
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*FDI was directed predominantly to commodity exporters, mainly oil, but to a lesser extent to mineral and agricultural exporters.*

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Chart 21

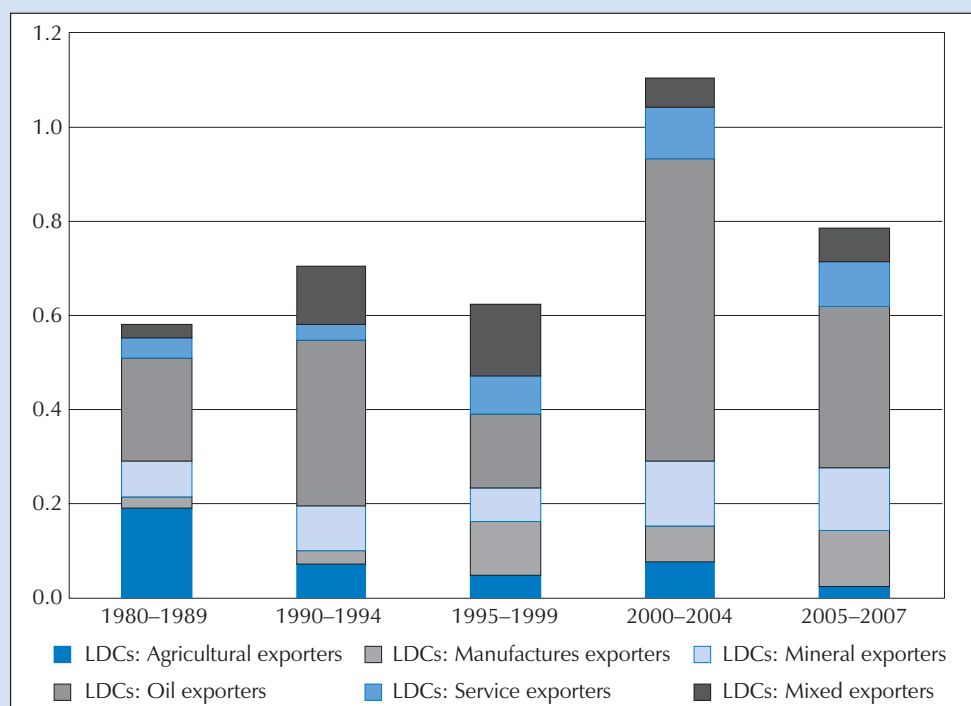
FDI inflow to LDCs, by region, 1980–2007  
(Per cent of world total FDI inflows, period average)



Source: UNCTAD secretariat calculations, based on data from the GlobStat database.

Chart 22

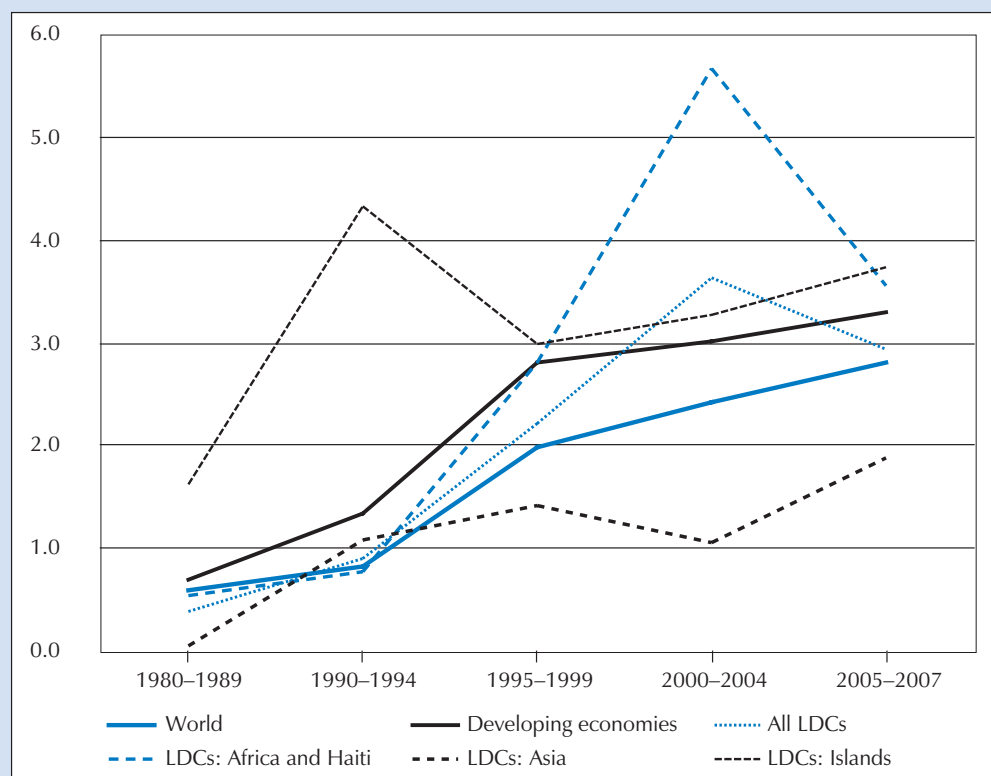
FDI inflow to LDCs by export specialization, 1980–2007  
(Per cent of world total FDI inflows, period average)



Source: UNCTAD secretariat calculations, based on data from the GlobStat database.

Chart 23

### FDI inflow as a percentage of GDP of the receiving countries (period average)



Source: UNCTAD secretariat calculations, based on data from the GlobStat database.

## D. Enabling conditions for knowledge-based structural change

### 1. TECHNOLOGY POLICY AND LEARNING

Technology policy in LDCs is much more than investment in R&D (see Srinivas, 2009). Developmental industrial policy needs to focus on: (a) facilitating and enabling access to new technologies; (b) human resource development; (c) general training; (d) the collection, analysis and diffusion of technical data; and (e) entrepreneurship. This approach advocates State intervention through a proactive technology policy towards the generation of productive and technological capabilities at the firm and farm level. A mixture of general and selective policy tools is available to Governments for promoting technological development. This approach distinguishes the different phases of development — namely, between infant and mature industries (UNCTAD, 2007). One of the priorities of industrial policy in LDCs is to create the conditions for learning, through the acquisition of technological and productive capacities.

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*There are strong feedback links between economic diversification, learning and capital accumulation. The task of much industrial policy is to strengthen those linkages.*

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*Market signals, if left to themselves, may even discourage the accumulation of technological capabilities.*

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*The developmental industrial policy should build firm-level capabilities by generating a cumulative process of growth of commercial innovation in the business sector.*

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*Demand for investment in LDCs is too low. Hence a rise in aggregate demand must take place to generate the investment levels necessary for growth to take place.*

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It is important to bear in mind the characteristics of knowledge before elaborating a policy framework for the LDCs. Technology is more than information: technological know-how is “sticky” — that is, it is embodied in specific people, organizations and local networks. Consequently, learning is not automatic. Learning accompanies the acquisition of production equipment, using it and adapting it to local conditions. It is important to differentiate between production capacity, which covers knowledge and the organizational routines needed to run, repair and improve existing equipment and products, and technological capabilities which involve the skills, knowledge and organizational routines needed to manage and generate technical change (Bell and Pavitt, 1993).

Various types of activity contribute to the accumulation of technological capabilities. These include formal modes of learning, as well as experiential learning-by-doing. In both cases, learning is a costly and time-consuming activity that does not occur automatically, but needs to be deliberately managed. Moreover, because learning is directly related to the production experience itself, the more complex the production process, the greater the possibilities for learning. Consequently, there are likely to be strong feedback links between economic diversification, learning and capital accumulation. The task of much industrial policy is to strengthen those linkages (Lall, 1992).

Market signals, if left to themselves, may even discourage the accumulation of technological capabilities (Cimoli, Dosi and Stiglitz, 2008). At the enterprise level, the State needs to invest in the accumulation of technological capabilities and to create the conditions to stimulate learning. At the national level, the State needs to find and ensure financing for technical change and innovation. Creating these conditions is a function of industrial policy.

The developmental industrial policy should build firm-level capabilities by generating a cumulative process of growth of commercial innovation in the business sector until it becomes internalized. Programme implementation should aim at rapidly generating a critical mass of firms undertaking commercial innovation. Sufficient financial resources must be available initially, with a budget that increases over time (Teubal, 2008). The specific objectives for commercial innovation are:

- Diffusion of the activities/functions underlying the innovation throughout the business sector;
- Creation of relevant capabilities, particularly in firms;
- Promotion of entrepreneurship; and
- Identification of areas with sustainable competitive advantage.

## 2. LEARNING AND TECHNOLOGICAL UPGRADING IN LDCs

In order to increase productive capacities, the role of demand cannot be overlooked. However, demand for investment in LDCs is too low (UNCTAD, 2006a). Since investment is demand-determined, and given the underutilization of labour and other resources, a rise in aggregate demand must take place to generate the investment levels necessary for growth to take place. This situation calls for a much deeper type of industrial policy in LDCs than is usually envisaged.

Mainstream economics interprets development as a process largely driven by the *accumulation* of physical and human capital. The present Report argues, however, that the process of development is driven by catching up through the general principle of *adaptive imitation* (Kozul-Wright and Rayment, 2007) through



learning from the more advanced countries how to produce competitive products and by emulating both their economic structures and their institutions. “Catch-up” growth refers to closing the gap between those countries which produce new knowledge (developed countries) and those that are learning to produce products and processes that are novel to their economic systems (Ocampo, Jomo and Khan, 2007; Cimoli, Dosi and Stiglitz, 2008). The potential advantage for latecomers, such as LDCs, is that new technologies and new technological knowledge are already available. Successful emulation of new production processes and products can lead to high rates of growth of output and productivity, which in time can strengthen domestic capabilities for generating further structural transformation (UNCTAD, 2007). This is not, however, an automatic process.

Catch-up growth involving emulation refers to the purposeful effort to adapt frontier technologies and production activities to a country’s “comparative advantage” (Reinert, 2007). This process will need to involve explicit public policies to support learning in firms as well as in the wider national system of innovation. However, the mere physical accumulation of technology is evidently not sufficient. The logic that interprets learning as automatic and knowledge as a linear process would conclude that it is enough to provide capital to poor countries for development to automatically follow. But capital per se cannot be the key to growth in countries that lack the absorptive capacity to use it profitably. If investments in human capital are made without corresponding changes in the productive structure to create demand for the skills acquired, the result may be knowledge flight (“brain drain”) through emigration (Ocampo, Jomo and Khan, 2007; UNCTAD, 2007).

This perspective shifts the role of industrial policy towards one that focuses on facilitating assimilation through *learning* (copying, imitating and eventually innovating), in addition to capital accumulation. This implies that the modern form of industrial policy is indispensable for articulating the links between science, technology and economic activities, through networking, collaboration and fine-tuning the learning components (learning by doing, adaptive R&D and labour training) into an integrated development strategy (Amsden, 2001). However, such interactions cannot be created by decree; they require institutions, resources and capabilities.

From the perspective of this Report, changes in economies’ productive structures are essential in order to generate growth in activities characterized by increasing returns, dynamic imperfect competition and rapid technological progress. Not all economic activities, however, are generators of accelerated growth: for example, commodities and agricultural activities tend to be characterized by decreasing returns to scale, low productivity and low rates of formal employment. Different economic activities transmit different learning patterns and knowledge spillovers. Activities that generate dynamic growth tend to be those with the ability to absorb the innovations and new knowledge that produce increasing returns to scale. Successful growth episodes not only entail rapid capital formation (investment), but also active policies for “transferring and mastering skills and, above all, creating a viable market” (Ocampo, Jomo and Khan, 2007: 199).

Learning does not occur automatically or without cost — policy and institutions matter. In the global context, science, technology and innovation are not luxuries for LDCs, but a precondition for their economic development (UNCTAD, 2007). Publicly available science, technology and innovation (STI) resources offer an opportunity to so-called “latecomer” firms in LDCs to accelerate their development process, provided: (a) they enhance their understanding of innovation as an interactive, multidirectional (searching), highly interactive process that integrates

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*Industrial policy focuses on facilitating assimilation through learning and on capital accumulation.*

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*Activities that generate dynamic growth tend to be those with the ability to absorb the innovations and new knowledge that produce increasing returns to scale.*

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or “articulates” science, technology and production; and (b) they design policies that can establish virtuous circles between technology and productivity growth. STI policies can enhance their absorptive capabilities provided they can begin to establish and enhance their national systems of innovation, which have been called the “engine of capitalist growth” (Nelson, 1993).

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*Despite continuous allegations of pervasive government failure by the dominant paradigm over the last three decades, a long history of successful industrial policy in advanced economies since the nineteenth century persists.*

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*LDCs can benefit from the knowledge of what works or does not, albeit in different circumstances.*

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*The successful late industrializers all faced severe capital and skills limitations.*

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*The Nordic countries and Ireland enacted industrial policies that explicitly incorporated social inclusion, involving labour, business and civil society.*

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## **E. Comparative accelerated growth experiences in successful industrializers**

Industrial policy success is not limited to East Asian newly industrialized countries (NICs), with their unprecedented and sustained growth experiences. It has been used in almost all countries to promote development (Shafeaeddin, 2006; Shapiro 2007; Kozul-Wright, 1995). Despite continuous allegations of pervasive government failure by the dominant paradigm over the last three decades, a long history of successful industrial policy in advanced economies since the nineteenth century persists. Examples include Japan, the first-tier East Asian NICs — Hong Kong (China), Singapore, Republic of Korea and Taiwan Province of China —, the Nordic countries (Denmark, Finland and Sweden) and Ireland. In all cases, the State played a key role in promoting economic growth. There are as many types of industrial policy as there are market models.

All late-developing countries share a surprising number of common features. While none of these individual experiences are directly reproducible, given differences in historical contexts, internal and external political characteristics and economic geography, LDCs can benefit from the knowledge of what works or does not, albeit in different circumstances.

The successful late industrializers all faced severe capital and skills limitations, to which the city-States of Hong Kong (China) and Singapore added extremely limited supply of land. Their respective industrial policies entailed accelerated capital accumulation initially through external sources, and increasingly through endogenous sources. The historical setting and longevity of the accelerated growth phase varied widely: the Nordic countries (Denmark, Finland and Sweden) began their industrialization efforts a century ago, while the other economies started their economic transformation after World War II.

Resource- and labour-rich, but capital-poor, with small and open economies, the Nordic economies achieved enormous structural and institutional change with minimal social upheaval. As one fifth of the Swedish population emigrated in the late nineteenth century, simultaneous capital inflows enabled wages to rise. Industrial policies encouraged innovation, diversification and deepening of skills, combined with spending to ensure social equality and inclusion from the start of their growth phase in the late nineteenth century. In the Nordic case, natural resource processing and high-tech manufacturing have been closely linked (from timber to IKEA).

The Nordic countries and Ireland enacted industrial policies that explicitly incorporated social inclusion, involving labour, business and civil society. The State led, but did not dominate, policy initiatives. In contrast, the NIC economies built their policies on the power of the bureaucratic-economic elites, discouraging or excluding other voices (Chang, 2006).

## 1. SOCIAL COMPACT/PARTNERSHIPS

The Nordic countries promoted a relatively comprehensive welfare State and a social climate that supported change during the accelerated growth phase. Over the years, they have created a strong social support network, based on high and progressive taxation rates, extensive and high-quality public services, including transportation, and comprehensive social insurance. The sharing of benefits (as manifested in low Gini coefficients) was essential to the model.

A fully articulated social compact had already been created during the early agricultural phase in late nineteenth century Sweden, which carried over to the industrialization phase. The social democratic model demonstrates how the State and other social partners can develop productive capacities in a natural resource-based economy undergoing structural transformation. The social compact delivered benefits through shared understanding about wage restraints, public goods, goals and coordination of local economic development, labour-firm compacts to boost international competitiveness, explicit investments in technology, and using innovations to deliver on domestically necessary innovations, even while exporting.

Similarly, social consensus stood behind the Celtic miracle in Ireland. Ireland's severe 1980s crisis created the resolve to draft policies that incorporated the ideas from government, industry, unions and farmers on a consensual basis. The National Economic and Social Council consciously crafted policies that codified social partnerships in the 1987–1990 agreement on moderating wage growth, formulating consensual agreements on wide-ranging economic and social policies, including tax reform, welfare, health expenditures and structural adjustment.

In a different manner, the collective drive is also visible in East Asia. Governments in the first-tier East Asian NICs directed a top-down industrialization policy with constructive government–business interactions, autonomous from interest groups. Collective consensus on policies was less prevalent, although some State–business collaboration did exist. When an industry lagged, the Government had more latitude to withdraw support and reallocate resources, imposing discipline without fear of conflict.

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*The social democratic model demonstrates how the State and other social partners can develop productive capacities in a natural resource-based economy undergoing structural transformation.*

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## 2. STRONG DEVELOPMENTAL STATES AND POLICY ALIGNMENT

Within the first-tier East Asian NICs, industrial policy was embedded within a developmental State (Johnson, 1982). The State did not resort to direct ownership in a generalized way; instead, the autonomous bureaucratic elites strongly directed and constrained the private sector. These conditions facilitated coherent, decisive, yet flexible policy (Evans, 1995; Haggard, 1989). Bureaucratic elites encouraged export-intensive manufacturing, without disregarding the domestic economies.

Through selective allocations of capital, enabling legislation and the creation of institutions, both Irish and Nordic Governments promoted industrial policy and enterprise development, but allowed SMEs and clusters of firms to lead initiatives related to entrepreneurship and innovation. It is well known that the Irish Industrial Development Agency dominated industrial policymaking and implementation from the 1960s, replaced in 1994 by Forbairt (Enterprise Ireland) and Forfás.

By aligning domestic demand and social spending with the requirements of their productive structures, the Nordic Governments were able to transform their industrial structures. Export strategies were not set against social demands, but instead the latter provided a base for the former. They invested in flourishing

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*The first-tier East Asian NICs directed a top-down industrialization policy with constructive government–business interactions, autonomous from interest groups.*

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sectors or regions through transfer of resources from those that were in relative decline, but selective measures were taken to create employment in the latter. Sweden exacted high taxes on profits, which reduced the pressure for inflationary wage agreements. By means of industrial policies, they became leaders in technological innovation, in part through technology transfer (Bigsten, 2001). The Nordic countries succeeded in combining efficient bureaucratic tradition, coupled with a strong corporatist network (Vartiainen, 1995).

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*In the Nordic countries and Ireland, labour participated extensively in a consensus-based formulation of industrial policy.*

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In the Nordic countries and Ireland, labour participated extensively in a consensus-based formulation of industrial policy. Labour representatives and industrialists shared a common understanding of dependence on the world economy, accepting structural change and wage restraint to rationalize industry and make it more competitive. High wage-led growth and social participation also assured good labour relations in Ireland.

In East Asia, the social contract effectively managed labour relations in a manner that would be more politically and internationally complex today. The high-wage promise delivered to East Asian labour forces limited potential demands for a “place at the table” (Chang, 2006).

### 3. THE ROLE OF EXTERNAL FINANCE

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*All of the successful late industrializers relied heavily on external sources of capital, including private capital inflows, FDI, ODA or fiscal transfers to initiate industrialization.*

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All of the successful late industrializers relied heavily on external sources of capital, including private capital inflows, FDI, ODA or fiscal transfers to initiate industrialization. At the outset, they were heavily indebted, but were mostly able to generate sufficient surplus and economic growth to repay the debts. East Asian savings policies and behaviours were uniquely used to finance growth.

The East Asian NICs depended heavily on external financing in the early stages of industrialization. Later, capital accumulation derived from other sources, such as family-owned businesses and conglomerates or the diaspora. Policies that encouraged savings insured continuous finance sources. Credit rationing was also prevalent. Once productive capacities were established, the NICs attracted a significant amount of FDI. In 1966, the Asia Development Bank began to provide assistance for food production and rural development, and later expanded to supply technical assistance and aid for education, health, infrastructure and industry.

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*East Asian economies coupled infant-industry protection and ISI with strong export promotion incentives.*

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Similarly, in Ireland, external financial resources were used in the early phase of the industrialization drive. Ireland launched a major programme to attract FDI. Instead of ODA, Ireland was the beneficiary of significant fiscal transfers following its integration with the European Union in 1973. The focus of financing industrial development subsequently shifted from grants to equity, from providing start-up capital to offering business services, and to deepening linkages with TNCs, while actively developing indigenous firms, domestic capabilities, clusters and sectors (O'Donnell, 1998).

### 4. TRADE TOOLS, MECHANISMS AND DEVELOPMENT INSTITUTIONS

East Asian economies, known for their strategic trade liberalization, freely used protectionist measures to ensure unimpeded growth of critical, export-oriented industry, while rationing foreign exchange to rectify the persistent balance of payments distortions (table 19). The Governments coupled infant-industry protection and ISI, with strong export promotion incentives (Chang, 2006; Yusuf and Peters, 1985; Wade, 2004). Tax incentives for exports, credit and

interest rate policy were used to promote infant industries. Export strategies were facilitated by management of foreign exchange rates that promoted exports of the manufacturing sector.

During the early phases of accelerated economic growth, all late developers deployed various forms of industrial policy to support and protect domestic firms. Institutions and practices established for commodity trading were readily applied to higher-value industrial products, under the strong leadership of public development institutions. In Ireland, robust enterprise support was provided by the Industrial Development Agency, later Forbairt (Enterprise Ireland) and Forfás. Forfás is Ireland's national policy advisory body for enterprise and science, an agency of the Department of Enterprise, Trade and Employment (table 20). These agencies promoted indigenous enterprise development, and linkage programmes with the diaspora to promote investment in the domestic economy. The Governments in East Asia offered its producers both production and export

*During the early phases of accelerated economic growth, all late developers deployed various forms of industrial policy to support and protect domestic firms.*

**Table 19**  
**Instruments of industrial and export promotion policies – Republic of Korea and Japan**

Export promotion and import restrictions
<ul style="list-style-type: none"> <li>• Import restrictions, both general and specific;</li> <li>• Favours particular sectors for export promotion, in some cases particular firms for that purpose;</li> <li>• Seeking compliance for subsidies given to exporters by means of export targets for specific firms (Republic of Korea);</li> <li>• Interest rate subsidies and the availability of credit and foreign exchange to favoured firms that meet export targets;</li> <li>• General export promotion through JETRO (Japan) and KOTRA (Republic of Korea);</li> <li>• Provision of infrastructure, including human capital, in support of exports;</li> <li>• Taxation relief on imported inputs and on R&amp;D expenditures; and</li> <li>• Allowing favoured conglomerates to import capital goods and foreign technology and to raise cheaper finance on international markets.</li> </ul>
Industrial policy measures
<ul style="list-style-type: none"> <li>• Lax enforcement of competition policy, including the extensive use of cartels;</li> <li>• Government creation and promotion of conglomerates (Republic of Korea);</li> <li>• Tax concessions to corporations to increase investment;</li> <li>• Promotion of a close, long-term relationship between finance and industry, which was critical to the implementation of the industrial policy;</li> <li>• Labour repression to ensure labour peace in a period of structural change (Republic of Korea);</li> <li>• Establishment of State industries to enhance industrial development (Republic of Korea); and</li> <li>• Extensive administrative guidance.</li> </ul>

Source: Singh (1996: 163–164).

**Table 20**  
**Industrial policy instruments – Ireland**

Instruments	Notes
Strategic economic integration into the European Union, and in particular with the United Kingdom	Since 1973
Good provision of public goods and development of specific infrastructures in support of surging economic sectors	Paid by the Government, but after 1973 also with EU transfers
Nurturing specialized human capital needed by dynamic economic sectors	Paid by the Government, but after 1973 also with EU transfers
Active support for R&D, innovation and learning activities	Forbairt
Generous fiscal incentives to attract FDI (especially in the finance and information and communication technology (ICT) sectors)	Especially vis-à-vis European fiscal discipline
Active promotion of SMEs and productive clusters	Forbairt
Government support to firms' marketing strategies to conquer foreign market outlets	
Extensive administrative guidance and assistance to firms	Forbairt
Performance requirements	
Strong social cohesion and wage-led growth	Social compact notion
Efficient and upgrading bureaucracy	

Source: UNCTAD secretariat elaboration.



subsidies, low interest rates, grants and inexpensive loans, as well as help with capabilities development.

Several Nordic countries balanced the growth of big business with the needs of smaller, decentralized production sites. State–corporation compacts were managed to ensure that domestic productive capacities were built. Industrial clusters were commonly used in Nordic countries, as well as Ireland, to benefit from external economies and specialized knowledge. Skill development and training were essential in the process. The State heavily subsidized education, training and infrastructure to ensure the success of domestic upgrading (table 21).

**Table 21**  
**Industrial Policy Instruments – Nordic countries (Denmark, Finland and Sweden), 1950s and 1960s**

Aid to national enterprises (infant-industry policy)
<ul style="list-style-type: none"> <li>• Proactive State policy to promote domestic enterprises especially in manufacturing sector (credit allocation to manufacturing investment);</li> <li>• Credit directed towards targeted industrial sectors – low interest rates to promote manufacturing.</li> <li>• <i>Investment</i>: Preferential treatment of manufacturing investment;</li> <li>• <i>Financing</i>: Subsidies were generous, both for investment and payroll purposes; tax and credit incentives received special government attention;</li> <li>• <i>Subsidies</i>: A variety of subsidies used to enhance productivity in all growth subsidies;</li> <li>• <i>Administration of Prices</i>: Control of prices of some staples;</li> <li>• <i>Government procurement</i>: Played an important role in industrial programme;</li> <li>• <i>Infrastructure</i>: Heavily subsidized;</li> </ul>
Agents of change
<ul style="list-style-type: none"> <li>• <i>Government, central bank, key industrialists</i>: (small number of agents of change) who collaborated with representative workers' associations;</li> <li>• <i>The State</i>: Led a conscious programme of industrialization;</li> <li>• <i>Social compact</i>: Collaborative relations between capital and labour;</li> <li>• <i>Training</i>: Government heavy investment in training;</li> <li>• <i>Innovation</i>: Heavy investment in research and development, training and knowledge creation.</li> </ul>

Source: UNCTAD secretariat elaboration.

## 5. LESSONS LEARNED

The experiences described above cannot be directly replicable, from which policy lessons can be drawn. Nonetheless, the following features are shared by all late developers:

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*Industrial clusters were commonly used in Nordic countries, as well as Ireland, to benefit from external economies and specialized knowledge. Skill development and training were essential in the process.*

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- (a) Initial contexts are not determinative, nor are endowments destiny. It is possible to overcome context with well-considered policies, effective public sector institutions and evolving capabilities that promote inclusive growth;
- (b) Developmental advocates, acting as an autonomous bureaucracy separate from self-interest, need to inspire and lead the growth process;
- (c) Social inclusion is vital, especially when enacting policy changes that affect certain groups negatively. The countries cited above are relatively small and homogeneous. The challenge for LDCs within a heterogeneous, sometimes contentious, political–social environment will be that much greater;
- (d) Social compacts are vital for building a dialogue based on trust. Shared understandings between the State and other social partners allow concessions when needed, and can promote investment, where investors can be assured of harmonious relations. Inclusive cooperation can help re-establish the credibility of State institutions through social dialogue;
- (e) Focus on structural change and diversification is essential in building competition and sustained growth. For that, productivity growth must be inherent in growth performance;



- (f) Institutional density, including standards and technical support, should be fostered through the establishment of institutions that support growth and that are variants of development agencies;
- (g) Small domestic markets limit the expansion of technologically more sophisticated production. Since non-tradable goods have similar effects on macroeconomic conditions, the State should direct spending and ODA assistance towards building the economies of scale, stimulating domestically oriented production and expanding limited domestic demand;
- (h) The “big push” drives can work to ignite the process of industrialization, but the Government needs to coordinate investment and crowd-in private sector investment with significant public sector activities.
- (i) Countries reliant on commodity-based value chains, with the concomitant emphasis on international standards, may inadvertently neglect production for the non-traded domestic market. The relative lack of attention to promoting domestic demand for primary goods or other products has not supported this avenue of capital accumulation;
- (j) Greater productivity growth and productive upgrading in agriculture have broad benefits, limiting rural-to-urban migration and building broader aggregate demand. Agricultural research and diffusion, improved infrastructure shared by farm and non-farm rural employment, irrigation schemes, and increasing the capacities of extension services can all be significant elements of an industrial policy;
- (k) An activist Government should encourage and support firm / farm level innovation and commercialization, even attempting to leapfrog older technologies, while encouraging firm-based learning and knowledge-sharing;
- (l) Apply agricultural production surplus to reinvestment in improved technologies and techniques, higher-value processing and technological upgrading. An opportunity may exist in green, environmentally-friendly solutions that developed countries seek;
- (m) Use trade rules and tools to support upgrading and diversification (strategic integration); and
- (n) Foster regional institutions and regional trade, rather than resorting to a “beggar-thy-neighbour” stance.

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*Small domestic markets limit the expansion of technologically more sophisticated production.*

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*The State should direct spending and ODA assistance towards building the economies of scale, stimulating domestically oriented production and expanding limited domestic demand.*

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*The “big push” drives can work to ignite the process of industrialization, but the Government needs to coordinate investment and crowd-in private sector investment.*

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## F. Application of industrial policy to LDCs

The role of the State in overcoming long-term structural constraints to productivity growth in Asia has been a much-discussed issue for some time (Singh, 1996; Rasiah, 2006; 2009). As in other regions, Asian LDCs, these countries face a number of structural constraints, including: (a) insufficient infrastructure; (b) high transaction costs; (c) lack of access to credit for productive investment; (d) lack of education; (e) skills shortage; (f) inferior health services; and (g) inequality in wealth, knowledge and learning. All of these hinder the development of productive resources and the industrialization project. The role of the State in these circumstances is to provide those public goods, thereby enabling the market to perform allocative and creative functions. This has not been yet the case in Asian LDCs, however, where the State has not really been cognizant of the need to direct and coordinate investment.

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*Asian LDCs have less opportunity than their predecessors in industrial policy formulation to select those industries they want to promote, because they lack both the necessary infrastructure and the required capital.*

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The Republic of Korea, Taiwan Province of China, Singapore and China experienced rapid growth of capacities and capabilities associated with the textile- and garment-related industries, which have served as a lead sector in all East Asian countries. While expansion occurred, it has not been accompanied by similar development of “firm-level capabilities, such as minor improvements in machinery and equipment, inventory control systems and training methods and, at the highest level, R&D effort” in Bangladesh, Cambodia, the Lao People’s Democratic Republic or Myanmar (Rasiah, 2007: 86). These Asian LDCs have less opportunity than their predecessors in industrial policy formulation to select those industries they want to promote, because they lack both the necessary infrastructure and the capital to build it.<sup>10</sup> Basic infrastructure provision — including roads, telecommunication networks, health and sanitation, power and water, and educational enrolment — have improved only slightly in these countries. Whilst possessing natural resources, Cambodia and the Lao People’s Democratic Republic lack the labour skill, capital and world-class logistics coordination to attract a higher value sector, such as electronics manufacturing. The landlocked Nepal and Bhutan lack the transport infrastructure to ship goods to overseas markets. Security issues, poor infrastructure and the lack of cross-border synergies have limited investment and growth in Bangladesh (Rasiah, 2007).<sup>11</sup>

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*Many sub-Saharan African countries experimented first with State-led models in the 1950s and 1960s, followed by market-led export models in the 1980s and 1990s.*

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Since their independence, many sub-Saharan African countries have been strongly encouraged to experiment, first with State-led models associated with central planning in the 1950s and 1960s, followed by market-led export models in the 1980s and 1990s. Sub-Saharan Africa’s evidence of manufacturing performance thus far suggests that neither of the two simplistic models exerted a significant impact on its growth trajectories. Indeed, their comparative performance indicates little, if any, improvement in industrialization and overall economic performance over the last 50 years (Soludo, Ogbu and Chang, 2004). This, however, reflects the pursuit of ineffective kinds of industrial policy, not that industrial policy is always doomed to fail, as the examples of Uganda and Senegal indicate in discussion below. Indeed, this Report would argue that a DIP type of industrial policy is likely to succeed, as it has in many other countries.

## 1. INDUSTRIAL POLICY CASE STUDY — UGANDA

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*Uganda’s experience with ISI was unsurpassed as from 1963 to 1970, the manufacturing sector grew at 8.3 per cent per annum.*

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The 1980s and 1990s witnessed a series of reforms marked by increased openness to imports and foreign capital, particularly FDI and a greater role for the market. These reforms were followed by a significant increase in FDI. Its share in gross capital formation rose from 0.1 per cent in 1990 to 21 per cent in 1999 (UNIDO, 2007). Despite widespread intellectual support for this agenda, backed up by loan conditionalities and surveillance by multilateral lending institutions, the promise of the new reforms has not been realized.

The experience with industrial policy in Uganda has been mixed. UNIDO has identified the following key structural constraints to industrialization in Uganda: (a) limited capacities and capabilities for policy analysis and inappropriate policies; (b) inadequate industrial support institutions; (c) inadequate knowledge for processing agricultural and mineral products; (d) lack of entrepreneurial and entrepreneurial skills; (e) lack of engineering industrials that produce capital goods; (f) limited scope for linkages; and (g) inadequate technological competencies and capabilities.

In terms of the performance of the manufacturing sector, Uganda’s experience with ISI was unsurpassed. Indeed, from 1963 to 1970, the manufacturing sector grew at 8.3 per cent per annum. In the 1970s and 1980s, the country experienced a long period of political instability and civil unrest. In the 1980s and 1990s, it

followed neoliberal proscriptions that denied any role for industrial policy. As in other African countries, such structural adjustment policies led to very disappointing results. Consequently, the State withdrew, but the private sector did not step in to fill the void. The local private sector still could not compete. Structural constraints were largely ignored, such as infrastructural bottlenecks, electricity, energy, transport, communications, water, skills and the like. Some growth took place in the non-traditional sectors, such as cut flowers, fresh vegetables and vanilla, but not in the traditional exports.

Recent findings on the impact of foreign ownership and technological intensities on the manufacturing sector in Uganda indicate that the potential benefits of FDI (learning, technological intensity and productivity) did not materialize to the extent expected in the domestic manufacturing sector (Rasiah, 2009).<sup>12</sup> The policy environment was not as effective as it might have been had the policy been more attuned to the needs of domestic enterprises, rather than the objectives of the foreign firms — for example, in garments and textiles. Now more cognizant of the need to build linkages with TNCs, Uganda has enacted new industrial policy initiatives, as illustrated in box 17.

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*In Uganda, policy was not as effective as it might have been had the policy been more attuned to the needs of domestic enterprises, rather than the objectives of the foreign firms.*

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#### Box 17. The business linkages programme by Enterprise Uganda

Enterprise Uganda is a one-stop enterprise development centre with a mission to develop a new generation of dynamic Ugandan entrepreneurs by providing support to SMEs to improve their productivity, growth and competitiveness.

One of the services provided by Enterprise Uganda is to structure commercial deals involving world-class corporations and local SMEs through innovative and well-structured business linkages premised on supplier chains.<sup>a</sup> Along these lines, Enterprise Uganda is implementing a two-year business linkages pilot programme in partnership with the Uganda Investment Authority and the United Nations Development Programme (UNDP). The programme's objective is to facilitate the creation of new linkages and to deepen and expand existing ones between international companies' affiliates and domestic SMEs.

The participating companies in the programme are Uganda Breweries Limited, Unilever (U) Ltd., MTN (U) Ltd. and Celtel (U) Ltd., which are subsidiaries of TNCs, and Kinyara Sugar Works, a domestic company. The nature of the services provided includes: (a) capacity upgrades of intermediary organizations in agribusiness (Uganda Breweries will assist the upgrade of Kapchorwa Commercial Farmers Association (KAFOCA) benefiting 2,000 barley farmers; (b) Kinyara Sugar Works strengthening Kinyara Sugarcane Growers Ltd., benefiting about 2,500 farmers; and (c) the development of retail sales networks (MTN and Celtel).

Experience so far demonstrates that, in spite of the limitations inherent in most SMEs, TNCs are ready to upgrade business relationships with SMEs to long-term relationships, provided SMEs are committed to correcting the shortcomings in their business systems, attitudes and skills. The two-year pilot project aims to facilitate over 20 business linkages in agribusiness, real estate development, retail merchandising, manufacturing and telecommunication.

Source: Ferriere (2006).

<sup>a</sup> Other services include providing diagnostic tools and solutions for businesses, business mentoring and on-site business counselling, and support for the creation of new business ventures and building competitiveness.

## 2. INDUSTRIAL POLICY CASE STUDY — SENEGAL

The industrial policy experience in Senegal is typical of other LDCs in sub-Saharan Africa. Two types of policies have been tried there: (a) a crude form of ISI, during the 1960s and 1970s; and (b) a World Bank-inspired "New Industrial Policy"<sup>13</sup> from the 1980s. The latter was part of the SAP liberalization package, carried out under the aegis of the World Bank, and consisted of full trade openness, export orientation and labour market reforms. Preferential treatment was given to export processing zones outside of Dakar, foreign capital flowed in and the State apparatus was largely dismantled.

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*The industrial policy experience in Senegal is typical of other LDCs in sub-Saharan Africa.*

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### (a) 1960s: ISI focus on agriculture

The ISI policy largely consisted of traditional import substitution measures for agriculture. Following independence, in the 1960s, the Government of Senegal

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*Senegal was the first to set up industrial free trade zones outside the capital with a view to attracting FDI.*

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intervened extensively in agriculture, but not long enough to have a lasting impact. The State emphasized the need for increasing and diversifying agricultural production, and it provided seeds, fertilizers and agricultural tools on favourable terms to local producers, including many smallholders. It also encouraged diversification of the food processing sector (Rochetau, 1982). But State support for agriculture aimed at increasing the value added of local resources ended in the late 1960s. The 1970s were a turning point for public investment when it favoured industrial manufacturing over agriculture. While the first phase was considered relatively successful in economic terms, it was too short-lived to leave a long-lasting impact.

*(b) 1970s: Switch to industry*

Following social unrest and increasing unemployment in 1968–1969, the Government reoriented its focus toward the manufacturing sector in the hope of increasing employment. Policy then became increasingly externally oriented, setting up numerous FDI incentives to attract foreign enterprises in expectation of imported development. First, the State supported the natural resource processing industries, such as fishing and groundnuts production. Senegal was the first to set up industrial free trade zones outside the capital, Dakar, with a view to attracting FDI. This was largely successful, but liberalization was not the equivalent of development. The politically popular policy of “Senegalization” of the business class became the official State policy, but because it was based on “clientelism”, rather than merit, its success was limited (Daffé and Diop, 2004).

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*The market-led policy reforms were primarily focused on the liberalization of trade and labour markets, on deregulation, privatization and improved governance.*

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*(c) 1980s: Market-led policy reforms*

The 1980s and the 1990s were years of economic crisis in Senegal. Government-led production of groundnuts expanded, and has remained the mainstay of Senegalese production. However, groundnut production declined, slowing GDP growth, and has rarely attained its earlier levels. Private foreign capital inflows, primarily French, surged into Senegal in the 1970s, and were accompanied by increased conspicuous consumption (Daffé and Diop, 2004). The country’s public finances deteriorated and debt became a chronic feature of the national economy, as foreign borrowing became the preferred source of financing of the domestic and external deficits (Boye, 1992). The World Bank admits that the new policy reforms had a recessionary impact on the local economy, which soon became dominated by foreign interests. The policy reforms were primarily focused on the liberalization of trade and labour markets, on deregulation, privatization and improved governance.

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*The reforms had an adverse impact on domestic efforts at industrialization and technological upgrading.*

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Following the policy reforms, domestic investment in Senegal never caught up with foreign investment, which greatly exceeded domestic investment in strategic sectors, such as phosphates. The deterioration of the public finances has continued until the present, and the economy has continued to stagnate. The reforms had an adverse impact on domestic efforts at industrialization and technological upgrading. The expected increases in employment and competitiveness, and the diversification of manufacturing exports, did not materialize. Indeed, between 1992 and 1995, the number of firms active in industry in the country was only 500. A large number of these were foreign owned or dominated by foreign interests. But the mid-1980s, FDI started to fall in the wake of economic decline. The current-account deficit rose to 11 per cent of GDP, while the share of the Senegalese exports to foreign markets fell by one fifth of what it was in the 1960s (Daffé and Diop, 2004). The trade-opening measures had a disastrous impact on the domestic industrial sector: production declined 13.5 per cent (1985–1989),

job losses were significant, and about 50 local enterprises closed as a result of competition from cheap imports (World Bank, 1994).

Of the 22 biggest industrial enterprises in Senegal, 13 became entirely controlled by foreign interests and only five by private Senegalese interests. According to the World Bank, the new policy reforms failed because of “weak determination on the part of the Government” (World Bank, 1994). The reforms reduced the role of the State to “the guarantor of free trade” and of a “stable macroeconomic environment”. Following the World Bank report, the national currency was devalued by 50 per cent in 1994, the standard austerity measures were applied and social discontent, emigration, and brain drain all increased.

There are many lessons to be learned from Senegal’s experience with this kind of industrial policy. Without a social contract and an appropriate and adequate institutional infrastructure to implement the reforms, and without adequate productive and trade capacities, the reforms had little chance of succeeding. The Government’s own administrative capacities were also woefully inadequate. According to Rodrik, Senegal was one of the first countries to experiment with the new industrial policy in the 1980s, but it proved unable to reverse the country’s decline, and stagnation emerged in the 1970s. The new industrial policy of the last 20 years casts doubt on the relevance of trade openness for LDCs whose export capabilities are highly concentrated in two or three main products. The lessons learned also indicate that it is necessary to overcome the obstacles related to quality standards, lack of professional skills and information, imperfect or missing markets and so on.

To be effective, trade openness needs to go hand-in-hand with the building of domestic capacities and the acquisition of technological skills. This process is not only long and costly, but also requires risk-sharing mechanisms to manage the process of “creative destruction”.

The experience of privatization in Senegal, as in many other sub-Saharan African countries, did not bring about the emergence of a domestic entrepreneurial class (Daffé and Diop, 2004). State policy was not autonomous, but coerced into being overly receptive to the recommendations of the World Bank and other donors. The NIP was not locally embedded, but imposed from the outside without any local adaptation. The Government was not in a position to act as an independent and autonomous entity, but was overly influenced by those who provided financial resources. This dependence only exacerbated the country’s vulnerability and Senegal joined the LDC group in 2001.

## G. Conclusions

John Maynard Keynes (1936) long ago noted that nothing influences economic policies more than the power of economic ideas. Africa has been subject to major swings in ideas about economic development more than any other continent, ranging from crude State-led models to market fundamentalism. It was implicitly assumed that policymakers had the independence and flexibility to choose whatever policy they considered appropriate. In fact, especially in LDCs, the donor agencies and the Bretton Wood institutions since the 1980s have played a major role in determining the policy choices of African countries. The provisions of trade liberalization agreements signed within the WTO have also restricted the potential use of relevant policy instruments, such as credit and export subsidies, performance requirements and local content clauses (Bora, Lloyd and Pangestu, 2000). Such

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*The new industrial policy of the last 20 years casts doubt on the relevance of trade openness for LDCs whose export capabilities are highly concentrated in two or three main products.*

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*To be effective, trade openness needs to go hand-in-hand with the building of domestic capacities and the acquisition of technological skills.*

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*As donor agencies and IFIs since the 1980s have played a major role in determining the policy choices of African countries, LDCs have gradually lost much of their policy space.*

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*In most LDCs, there is very little large-scale domestic industry; i.e. the manufacturing sector is largely composed of light manufacturing and other labour-intensive activities, organized in small enterprises, including in the informal sector, often employing 20 people or less.*

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*This chapter emphasizes instead the importance of appropriately-designed developmental industrial policies, in order to overcome the pervasive effect of market failures and ignite the process of industrialization and economic growth.*

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*LDCs require greater policy space than is currently the case, in order to increase the range of their policy options, to provide time and space for policy experimentation, and to adapt various development “models” to suit their own needs.*

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shifts in development thinking have confined industrial policies to a marginal role, implicitly assuming that growth and structural change would follow spontaneously once economic fundamentals were in place and distortive interventions removed. Bilateral agreements and RTAs have further restricted policy space to carry out sorely needed industrial policies. Reforms are required on many fronts, including at the multilateral level, to reform the system to accommodate the specific needs and challenges facing LDC economies.

Manufacturing performance in most LDCs has been weak by comparative standards. Indeed, previous UNCTAD work has shown that, even during periods of strong investment and growth, the manufacturing sector in many LDCs, particularly in sub-Saharan Africa, failed to take off. The market-led reforms since the debt crisis of the early 1980s have, to a large extent, failed to correct this deep-seated structural weakness. As a result, lopsided, stagnating or declining manufacturing performance has been part of uneven and unsustainable growth in many LDCs over the last three to four decades. In most LDCs, there is very little large-scale domestic industry; i.e. the manufacturing sector is largely composed of light manufacturing and other labour-intensive activities, organized in small enterprises, including in the informal sector, often employing 20 people or less. On average, light manufacturing, low-technology products accounted for over 90 per cent of all LDC manufactured exports in the 2005–2006 period (including food, drinks, garments and textiles), while medium- and high-technology manufactured exports remained below 2 per cent of total manufactured exports.

This chapter emphasizes instead the importance of appropriately-designed developmental industrial policies, in order to overcome the pervasive effect of market failures and ignite the process of industrialization and economic growth. To do so, the chapter advocates greater industrial policy capability, not just capacity, for a broader range of industrial policy tools that can be tailored to the specific needs of LDCs. Industrial policy capability includes policymaking space that is being compromised by the commitments emanating from international trade and investment agreements. Following a long-established UNCTAD view, it is strongly argued that LDCs require greater policy space than is currently the case, in order to increase the range of their policy options, to provide time and space for policy experimentation, and to adapt various development “models” to suit their own needs. Without such freedom to choose, alternative “models” of trade or industrial policies are no more likely to succeed than their predecessors.



## Notes

- 1 According to the FAO, in 2009 out of 31 countries in food crisis requiring external assistance, 21 are LDCs (FAO, 2009).
- 2 The analysis of services in LDCs is further complicated by the fact that the tertiary sector typically presents an intrinsic dualism, with a large pool of low-productivity informal activities (think of petty trade) side by side with localized pockets of highly productive ones, as in finance or engineering and other knowledge services.
- 3 Our analysis excludes South Africa.
- 4 The optimality of the free market allocation rests ultimately on axiomatic assumptions about the rational behaviour of atomistic agents, about information being fully and freely available to all, and about technology being “off the shelf” and readily available to all users equally. Only subject to these highly restrictive hypotheses is the decentralized allocation necessarily optimal from a welfare point of view, and consequently State intervention cannot but be distortive.
- 5 See discussions in UNIDO (2007).
- 6 The case of the Deliberation Councils in South Africa, for instance, points to an interesting example of collaboration and building trust between the private and public sectors (Rodrik, 2007).
- 7 In the last decade, numerous contributions have emphasized how pervasive and perverse can be the effect of market failures in hampering the accumulation of knowledge and human capital, thereby constraining the prospects for economic growth. These findings imply that appropriate government intervention, including by means of subsidy schemes, thus becomes desirable to achieve optimal economic outcomes (Cimoli, Dosi and Stiglitz, 2008).
- 8 For instance, the Bretton Woods agreements created a system of organizations (the International Bank for Reconstruction and Development and the International Monetary Fund) intended to ensure economic stability and prevent future crises.
- 9 Similarly, the UNCTAD (2005: 82) concludes that “not only is attracting FDI not the same thing as development, but it seems clear from the findings in this report that whether it contributes to development depends on macroeconomic and structural conditions in the host economy”.
- 10 Myrdal (1957) and Hirschman (1958) argued that governments should focus on selected sectors for promotion that create spread or linkage (crowding-in) effects, limiting the expansion of sectors that create backwash (crowding-out).
- 11 Following the lead sector argument, several factors might make garments or natural resource processing an excellent growth vehicle for the Asian LDCs in the contemporary global environment. First, garments face minimal competition from substitute goods, while also utilizing natural fibres, one of their primary commodities. Second, LDCs no longer enjoy the same preferential access for more technologically advanced manufactures, which has recently been conditioned on embracing neoliberal policies. Third, textiles and garments provided foreign exchange vital to the development of strategic industries in Japan, the Republic of Korea and Taiwan Province of China. FDI inflows have become more widely dispersed since the end of the Cold War, so new Asian LDCs must compete more aggressively than their predecessors for investment.
- 12 The ambiguous effect of discretionary incentives for FDI in Uganda can be illustrated by referring to the following two examples. In 2004, the government introduced a comprehensive package of incentives, including a 25-year holiday on income tax and a 17-year holiday on value added tax, to encourage an investor, BIDCO (from Kenya) to establish a \$120 million palm oil project. Other edible oil producers complained, alleging unfair treatment. The BIDCO project has been very slow in its implementation. Similarly, Tri-Star Apparel, an investor in garment manufacturing targeted at the United States market under the Africa Growth and Opportunity Act (AGOA), received \$15 million in government guaranteed loans, but closed with huge losses after five years and failed to repay the loans.
- 13 Or no industrial policy.

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