

# THE LEAST DEVELOPED COUNTRIES REPORT 2013

*Growth with employment  
for inclusive and sustainable development*

## OVERVIEW



UNITED NATIONS

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## Introduction

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Despite the sluggish global economic performance of recent years, the least developed countries (LDCs) in general have enjoyed moderate economic growth. Per capita income for the group as a whole has been expanding steadily, raising hopes that some of them may even be able to graduate from the category within the decade. However, there are worrying signs that this growth trend has not been inclusive and that its contribution to poverty reduction has been limited. The main explanation for the lack of inclusiveness is that growth in LDCs has not generated enough “quality” jobs — that is, jobs offering higher wages and better working conditions — especially for the young. Creating employment opportunities is critical because of the fundamental role that work plays in economic development and in people’s lives. Not only does it influence income, aggregate demand and investment decisions, it is also the best and most dignified pathway out of poverty.

Since the onset of the global financial and economic crisis in 2008, employment generation — and especially the phenomenon of jobless growth — has increasingly been recognized as a major policy concern worldwide. This is particularly true of the LDCs, where the challenges posed by demographic patterns, persistent poverty, accelerated urbanization and rising inequalities make the absence of remunerative employment a source of significant social and political tension. Not all LDCs are rich in mineral resources or other natural endowments. For most of these countries, their most valuable asset is their people, in particular the young. It is only by engaging their people in productive employment that LDCs can achieve lasting and constructive growth.

This *Report* examines the link between investment, growth and employment. More specifically, it considers how LDCs can promote growth that generates an adequate number of quality jobs and that enables them to reach what UNCTAD believes are their most urgent and pivotal goals, both now and in the post-2015 development agenda: poverty reduction, inclusive growth and sustainable development.

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## **Recent economic trends and outlook for the LDCs**

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With the global economy still struggling to return to a strong and sustained growth path, the external environment faced by the LDCs has been less propitious in the past five years than previously. The recent slowdown of world trade, which is now at a near-standstill, has weakened the demand for LDC imports, most notably in the case of developed countries but also in emerging economies. In addition to weaker demand for their exports, the LDCs have been confronted with a heightened volatility of commodity prices and capital flows.

As a result, economic growth in the LDCs has been weaker by a full two percentage points in the past five years (2009–2013) than during the previous boom period (2002–2008). It has also been below the target rate of 7-per-cent annual growth established in the Istanbul Programme of Action (IPoA) for the Least Developed Countries for the Decade 2011–2020.

Despite the slow global recovery, however, real gross domestic product (GDP) growth in the LDCs has picked up somewhat, from 4.5 per cent in 2011 to 5.3 per cent in 2012. International Monetary Fund (IMF) forecasts point to a similar growth rate in 2013, in the 5-to-6 per cent range. The real GDP growth rates for different groups of LDCs continued recent trends in 2012, with African LDCs lagging behind their Asian and island counterparts. The growth rates of African LDCs' real GDP per capita have also lagged, a result of their higher population growth rate.

The heterogeneous performance of LDC groups has been reflected not only in real GDP growth rates, but also in the growth rates of individual countries. There were 15 countries with growth rates exceeding 6 per cent, but also 10 countries with growth rates below 3 per cent. Given the high population growth rate, the latter countries had stagnant or negative growth in per capita terms. This has severe consequences for their poverty reduction, for their achievement of the Millennium Development Goals (MDGs) and more broadly for their human development. Three LDCs experienced a recession in 2012, since they had negative growth rates of real GDP.

The heterogeneity in real GDP growth rates among the LDCs is a consequence of wide disparities in other macroeconomic indicators. Most

notably, and most importantly for economic growth, the rates of gross capital formation differ widely across individual LDCs. The IPoA identified a gross capital formation rate of 25 per cent of GDP as a prerequisite for attaining real GDP growth rates of 7 per cent. Seventeen LDCs managed to reach, or even exceed, that benchmark in 2011. However, 31 others had an investment rate below the 25-per cent benchmark, and the rate in still other LDCs was even below the 10-per cent mark. Given the close relationship between investment and economic growth, these countries' growth prospects are not very bright.

Analysing developments over the course of a decade allows us to explore the extent and direction of the process of structural change in the LDCs. For these countries as a group, the average share of agriculture in GDP declined from 31.4 per cent in 1999–2001 to 25.6 per cent in 2009–2011. The share of manufacturing stayed the same, at around 10 per cent of GDP, while the average share of services declined somewhat. More generally, the trends suggest that for the LDCs as a group, over the period between 1999–2001 and 2009–2011 — which was characterized by the most rapid economic growth in decades — there was little structural change of the type that results in strong increases in productivity, incomes, technological intensity and high value added.

The current account deficit for the LDCs as a group also widened substantially, from \$10.5 billion in 2011 to \$28.8 billion in 2012. The deterioration of their current account was due mainly to a significant worsening of the merchandise trade balance, which expanded from a \$3.7-billion deficit in 2011 to a much larger one of \$18.5 billion in 2012. Their terms of trade continued to improve in the three years since the sharp deterioration of 2009. In 2011 and 2012 they reached a higher level than during the previous peak of 2008, just before the adverse impact of the crisis was first felt.

With respect to exports, the strong growth of about 25 per cent in both 2010 and 2011 stalled to a mere 0.6 per cent in 2012 for the LDCs as a group. This is in line with the worldwide deceleration of trade in goods mentioned earlier. While imports expanded by 21.9 per cent in 2011, one year later their growth had slowed to 7.8 per cent. Nonetheless, that was enough to widen the LDCs' merchandise trade deficit substantially.

External finance is of particular importance to the LDCs, given their low level of domestic savings relative to investment. Inflows of foreign direct investment (FDI) to LDCs hit a record high of almost \$26 billion in 2012, about

20 per cent more than in 2011. Inflows to African LDCs and Haiti rose from \$16.9 billion to \$19.8 billion over the same period. Asian LDCs also saw an increase, from \$4.2 billion to \$5.6 billion, while island LDCs suffered a reversal, from \$320 million to \$235 million.

The flow of workers' remittances to LDCs continued to expand in 2012, reaching a new record of \$30.5 billion. Remittances to these countries are much more stable than FDI inflows, and have risen even during the worst stage of the crisis. With respect to regional distribution, remittances are mostly a feature of Asian LDCs, where they increased from \$16.3 billion in 2010 to \$17.8 billion a year later.

After playing an important countercyclical role during the financial crisis, official development assistance (ODA) to the LDCs began to decline in 2011. According to data from the Development Assistance Committee (DAC) of the Organisation for Economic Co-operation and Development (OECD), net ODA disbursements from all donors to LDCs, excluding debt relief, fell slightly, from \$41.7 billion in 2010 to \$41.6 billion in 2011. According to preliminary data for 2012, bilateral net ODA to the LDCs shrunk by 12.8 per cent in real terms. If these estimates are confirmed, they will mark the largest decline in ODA to LDCs since 1997.

The total external debt of the LDCs expanded in 2012 to an estimated \$183 billion, up 6.7 per cent in nominal terms from 2011. The debt-to-GDP ratio grew slightly as well, from 26.3 per cent in 2011 to 26.7 per cent in 2012, while the ratio of total debt to exports rose from 78.7 to 82.5 per cent; both ratios were higher than those in other developing countries. The stock of short-term debt was up by \$2.5 billion in 2012, a 14-per-cent increase.

According to IMF forecasts, real GDP worldwide will expand by 3.3 per cent in 2013, a slight improvement over the 3.2 per cent of 2012. For the LDCs as a group, IMF forecasts a 5.7-per-cent growth rate for 2013, compared to 5.3 per cent for emerging and developing economies. The growth of the world economy should increase to 4.0 per cent in 2014 and to around 4.5 per cent in the subsequent four years. LDC growth should be around 6 per cent in the medium term.

For the LDCs, international trade has been the single most important channel of transmission of the recessionary impulses from the developed countries since the start of the crisis. The recent slowdown of world trade will thus have further negative impacts on the LDCs' prospects. While the

demand for imported goods in developed countries has been weak at best, the LDCs have avoided a sharp deceleration of growth by relying more on their domestic demand and on South-South trade. Both will continue to be necessary in the future, but the recent deceleration of economic growth in the large emerging economies will seriously limit further possibilities for such reorientation.

The availability of external financing is another precondition for strong growth of real GDP in the LDCs. As the analysis in chapter 1 of this Report suggests, external financing has undergone considerable fluctuations since the beginning of the crisis. Moreover, the prospect of a tighter monetary policy in developed countries over the course of 2014 and 2015 will change the relative profitability of investments between developed and developing countries' assets. Reduction in the interest rate differential between the two country groupings will also make it more difficult to finance the current account deficits. LDCs with large such deficits should start now to prepare for these future developments.

The third major factor affecting the external conditions for the LDCs is movements in international commodity prices. IMF projections suggest continued declines for prices of both oil and non-fuel primary commodities over the long term. But the short-term outlook for commodity prices is highly uncertain, not only because of possible supply-side disruptions (such as energy and food), but also because of demand uncertainties.

Against this background, the outlook for the LDCs in the short to medium term is not very good. Even if none of the downside risks materialize and the IMF growth rate forecasts prove accurate, the growth of the LDCs as a group will be below the 7-per-cent IPoA target. In that scenario, responding effectively to the employment challenge, whose future magnitude is analysed in this Report, will be even more difficult for the LDCs.

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## **Demographic dynamics in the LDCs**

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Demographic change affects the environmental and socio-economic development of all countries, but especially the most vulnerable of the LDCs. Although the proportion of people in these countries who live on less than US\$ 1.25 per day (i.e., in extreme poverty) has declined, the number has continued to rise due to high population growth.

The LDCs face a stark demographic challenge as their population, about 60 per cent of which is currently under 25 years of age, is projected to double to 1.7 billion by 2050. The LDC youth population (aged 15 to 24 years) is expected to soar from 168 million in 2010 to 300 million by 2050, an increase of 131.7 million. By 2050, one in four youths (aged 15–24 years) worldwide will live in an LDC.

As to the LDC working-age population, it will increase on average by 15.7 million people per year between 2010 and 2050, and in 11 LDCs, by at least 0.5 million a year. The projected increases are highest in African LDCs — Democratic Republic of the Congo, Ethiopia, Uganda and United Republic of Tanzania — where that population will expand by more than 1 million people a year. If, as expected, an additional 630 million people (equivalent to 37 per cent of the LDC population in 2050) enter the labour market by 2050, this will pose a major employment and development challenge for the LDCs.

LDC population growth rates also greatly surpass those of other country groupings: At 2.2 per cent per annum in 2011, they were roughly double those of other developing countries (ODCs) (1.2 per cent), and five times those of developed countries (0.4 per cent). Furthermore, LDCs have the highest fertility rates in the world, averaging 4.4 children per woman during the period 2005–2010, as compared to 2.4 in ODCs and 1.7 in developed countries.

For most LDCs, the realization of a potential demographic dividend (where the dependency ratio is at its lowest) will require increased investment in the training, education and employment of youths. Although LDC primary and secondary education enrolment and youth literacy rates have improved since 1990, they are still below the equivalent levels in ODCs and developed countries. In the medium term, LDC demographic growth dynamics, together with the expanding youth bulge, will mean declining dependency ratios but a growing labour supply.

Urbanization trends are another key factor in LDC demographics. The level of urbanization in LDCs in 2010 was 28 per cent, or about 20 percentage points below the world average (50.5 per cent). LDC urbanization should reach 39 per cent by 2020, largely as a result of rising rural–urban migration, high fertility rates and population growth.

Many LDCs are now at a critical stage of development where population growth is high and the nature of the employment challenge, especially in

rural areas, is changing. In the past, most new labour markets entrants were typically absorbed in low-productivity agriculture. However, as population densities rise, farm sizes decline, and farmers increasingly shift towards the cultivation of more ecologically fragile land, both on-farm incomes and agricultural productivity are likely to remain perilously low. Because of these factors, the LDCs' urbanization and emigration rates are expected to remain high.

Given the clear demographic challenges highlighted in this Report, then, the LDCs will need to make significant efforts to generate a sufficient quantity of jobs and offer decent employment opportunities to their young population in the medium term. The potential benefits arising from the demographic dividend are not automatic. Successful exploitation of the potential will depend on the ability of the LDC economies to absorb and productively employ both new labour market entrants and those who are presently unemployed or underemployed.

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## **Employment challenges in the LDCs: Creating quality employment in sufficient quantities**

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The central employment challenge in the LDCs is to create productive jobs and livelihoods for the millions of people who enter the labour force each year. Given the above-mentioned demographic trends, the scale of this challenge will be even greater in the coming years. To illustrate the magnitude of the problem, it is worth considering the estimated number of new labour market entrants in selected countries. In Ethiopia, for example, there were an estimated 1.4 million new entrants to the labour force in 2005, and their number will increase to 3.2 million by 2050. Similarly, in Haiti, new entrants in 2005 numbered about 204,000 — a figure that will reach 229,000 by 2035. In Bangladesh, there were 2.9 million new entrants in 2005, and this number will peak at 3.1 million by 2020 before beginning to decline. These are the numbers of productive and decent jobs and livelihoods which will have to be created in these countries each year. If this is not achieved, the likelihood is that poverty and international emigration rates will rise.

Indeed, the relative slackness of the LDC labour market largely explains why the 2002–2008 boom had relatively weak effects on poverty reduction in the LDCs. Although the incidence of extreme poverty declined from 59 to 53 per cent between 2000 and 2007, a period when GDP growth approached an average 7 per cent per year, the impact of growth on the incidence of poverty has been slower than that experienced in other developing regions. The relatively poor performance of the agricultural sector in most LDCs has been particularly detrimental, given that the poverty elasticity of growth in agriculture is typically much higher than the corresponding elasticity of growth in other sectors of the economy.

In most LDCs, the main source of employment for the growing labour force is still agriculture, largely through people cultivating new land. However, LDCs have been facing persistent constraints on agricultural growth, such as shrinking investment in research and development, missing and imperfect factor markets, and limited access to producer-risk mitigation tools, as well as poor infrastructure. With rising population growth, declining agricultural farm sizes and low productivity, agricultural production is becoming a less viable livelihood for the rural poor. In addition, most LDC farmers cannot afford the means for sustainable intensification of agricultural production. More and more young people are seeking work outside agriculture, and urban centres are increasingly becoming the main attraction.

Therefore, the LDC population is not only growing rapidly but is also quickly urbanizing. More of the LDC population than ever before is entering the labour market. The convergence of these trends makes the current decade critical for these countries, particularly with regard to employment. There is thus a clear need to strengthen the link between employment and growth. During the period 2000–2012, LDC employment growth was 2.9 per cent per annum, a rate slightly above the population growth rate but well below their average GDP growth rates for the period (7 per cent). Employment growth in the African and island LDCs also outpaced the LDC average and will continue to do so until at least 2018.

Furthermore, the historic labour productivity divide between LDCs and ODCs remains substantial, although it has narrowed since 2000. LDC output per worker in 2012 (in constant 1990 international \$) was just 22 per cent of the level in ODCs, 10 per cent of the European Union (EU) average and 7 per cent of the level in North America. The agricultural labour productivity gap between LDCs, ODCs and developed economies has also widened since

1985. Agricultural labour productivity fell in over a third of the LDCs (10 of the 27 for which there were comparable data) between 1985–1987 and 2009–2011.

Raising agricultural productivity is a *sine qua non* for LDC development and for the structural transformation of the sector. Increased agricultural labour productivity in these countries has the potential to both raise the real incomes of rural households and stimulate demand for rural non-farm goods and services. The employment-creating potential of investment in rural irrigation, drainage, provision of feeder channels, local land reclamation, forestation and so forth is considerable. This can be boosted if such investment, including through public work programmes, is embedded in a well-designed and well-targeted employment strategy.

The LDCs have a high labour force participation rate — an average 75 per cent, as compared to 68 per cent in ODCs. However, these figures should be interpreted with caution. The lack of a social security system, and limited family support due to low incomes, means that the poor in LDCs have no option but to seek work — no matter what kind of work. Generally low average earnings also mean that more members of a household need to enter the labour market in order to provide sufficient income to sustain the entire household. The LDCs' high labour force participation rate is thus largely a reflection of the desperate need of the poor to work for their survival, rather than an indicator of a well-functioning and effective labour market.

A breakdown of the labour force participation rate by gender and age group provides further insights into the distribution of the economically active population in LDCs. Although this distribution varies between different groups of LDCs, in general, women in the LDCs have a high propensity to work in the labour market. This is partly because women work predominantly in the informal sector (housekeeping, child-rearing, farming, etc.). Between 1990 and 2012, an estimated 290 million women entered the LDC labour force. During this period, women's labour force participation rates in LDCs rose by 3 percentage points, from 59 to 62 per cent on average.

An important source of income and employment for the poor in LDCs, and for women in particular, is rural non-farm economic activities. These activities are closely linked to farming, the food chain and the production of goods and services (often non-tradable) for local rural markets. With increasing urbanization and improvements in rural-urban transport networks, rural non-

farm activities also produce goods and services (both non-tradable and tradable) for distant markets. There are no accurate data based on household surveys of full- or part-time employment in rural non-farm activities in LDCs. Based on estimates, however, the rural non-farm economy accounts for about 30 per cent of full-time rural employment in Asia, 45 per cent in Latin America, 20 per cent in West Asia and 40–45 per cent in Africa. In fact, as GDP per capita levels increase, the share of rural on-farm (agricultural) income typically falls as the share of rural non-agricultural income rises. But evidence from case studies suggests that although rural non-farm employment is increasingly important in LDCs, on-farm production and jobs remain the mainstay for most of these countries.

On the positive side, indicators for vulnerable employment and working poor have improved somewhat since 2000. Nonetheless, vulnerable employment still accounts for about 80 per cent of total employment in the LDCs. By 2017, African LDCs will have the highest share of working poor in the LDCs as a group. In addition, for the group as a whole, the gender gap in vulnerable employment is not only wide but has increased marginally, averaging 11 percentage points during the period 2000–2012. In 2012, 85 per cent of women and 73 per cent of men on average were in vulnerable employment.

In LDCs, vulnerability of jobs and the incidence of working poor are closely linked to unemployment, which in these countries has a disproportionate effect on young people joining the labour force. In most LDCs, the youth unemployment rate (i.e., for those aged 15–24 years) is higher than the average LDC rate for both men and women, and in most cases is almost twice that rate. LDC youths typically find work in the informal sector, but often these jobs do not pay reasonable wages, improve skills or offer much job security. More than 70 per cent of youths in the Democratic Republic of Congo, Ethiopia, Malawi, Mali, Rwanda, Senegal and Uganda are either self-employed or contributing to family work. If the growing LDC youth population could be provided with the necessary skills, education and decent jobs, it could become a major force of production for meeting global and domestic demand and a significant driver of local consumption and investment.

Sadly, the LDCs' record for generating decent jobs, even in times of growth, is far from impressive. To the contrary, the evidence shows that countries with faster GDP growth achieved this with relatively less employment creation. In addition, employment elasticity declined in about half of the LDCs

in the period 2000–2008, and that elasticity tended to fall more frequently in precisely those LDCs that were growing faster. Although the reported LDC employment elasticities to growth have generally not been very low by international standards, given the demographic and economic challenges which these countries are likely to face, these elasticities will probably not be enough to reach the necessary employment levels.

This Report shows that during the period 2000–2010, the employment rate made a positive contribution to GDP per capita in only 3 of 11 LDCs surveyed: Cambodia (accounting for 9 per cent of the change in GDP per capita), Sierra Leone (6.3 per cent) and United Republic of Tanzania (4.7 per cent). This may reflect substantial positive changes for these economies in terms of the number of youths who continue their education for longer periods of time, which helps to build future productive capacities. But the Report also demonstrates that economic growth in the LDCs has tended over time to become less effective in terms of employment generation.

The available labour market and informal sector information for LDCs is sparse, however. There is an urgent need for more data collection and statistical analyses, which should figure prominently in the post-2015 debate on the Millennium Development Goals (MDGs).

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## **Policy framework for linking employment creation and development of productive capacities in the LDCs**

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For the past three decades, LDCs were advised to focus on economic growth as a strategy for economic diversification, poverty reduction and economic development. In hindsight, this appears to have been sound policy advice, since it is highly unlikely that LDCs will achieve economic and social development and halve their poverty levels in line with internationally agreed goals without a sustained period of growth. In fact, in recognition of this likely scenario, the IPoA states (paragraph 28) that in order for LDCs to achieve “sustained, equitable and inclusive economic growth [...] to at least the level of 7 per cent per annum”, they should strengthen their productive capacity in all sectors through structural transformation and overcome their marginalization through effective integration into the global economy.

The market-based reforms and policies pursued by the LDCs in the past two decades were motivated by this advice and were based on the assumption that a combination of macroeconomic austerity, rapid liberalization, privatization and deregulation would attract investment in sufficient quantity to generate rapid output growth, which in turn would automatically create jobs of adequate quantity and quality. But it is now evident that economic growth, although necessary, by itself neither guarantees job creation nor automatically results in inclusive development. To the contrary, it may even lead in some cases to an intensification of social inequality, rising unemployment and an increased incidence of poverty. In short, if employment creation and inclusive growth are the ultimate objectives, then the type of growth matters. It is evident that growth resulting from labour-intensive activities or originating in areas where the poor live is more likely to create jobs and contribute to inclusiveness than growth based on capital-intensive investments.

This Report proposes a policy framework that links investment with growth and employment creation to generate inclusive and sustainable development. The framework is based on the assumption that maximizing the employment creation potential of growth will not happen without the development of productive capacities. While initiatives to provide jobs through government-sponsored or internationally sponsored programmes might be valuable sources of employment in the short term, they do not provide long-term, sustainable solutions to the LDC employment challenge.

The proposed framework builds on two sets of ideas and concepts developed through UNCTAD's analytical work on LDCs and other developing countries.

First, it hypothesizes that:

- Economic growth which does not create decent jobs in sufficient quantity is unsustainable; and
- Job creation without the development of productive capacities is equally unsustainable.

Second, it provides a definition of productive capacity that is broad enough to incorporate all the elements essential for a country to build the competencies needed to produce goods and services but that is also sufficiently focused to identify priority areas for policies.

What is meant by productive capacities? At UNCTAD, the development of the concept in the LDC context was linked to earlier efforts to understand how structurally weak and underdeveloped economies like LDCs promote economic growth and how they initiate and then accelerate the growth process. Such efforts also sought to understand what the key factors or capabilities are that enable such economies to produce goods they can consume or sell, and what kinds of productive activities create quality jobs that contribute to poverty reduction.

The analytical work carried out at UNCTAD in search of answers to these questions led to the identification of a number of basic elements of productive capacity. Productive capacities are the productive resources, entrepreneurial capabilities and production linkages which together determine a country's capacity to produce goods and services and enable it to grow and develop.

*Productive resources* are factors of production and include natural resources, human resources, financial capital and physical capital.

*Entrepreneurial capabilities* are the skills, technology, knowledge and information needed to mobilize resources in order to build domestic enterprises that transform inputs into outputs – outputs that can competitively meet present and future demand. They also include abilities to invest, innovate, upgrade and create goods and services. As such, they refer to the competencies and technological learning needed to induce economic change.

*Production linkages* are flows of goods and services in the form of backward and forward linkages, flows of information and knowledge and flows of productive resources among enterprises and sectors of activities.

These three elements together determine not only the overall capacity of a country to produce goods and services, but also which goods and services a country can produce and sell. In this respect, therefore, productive capacities are country-specific and differ enormously from one country to the other. They also determine the quantity and the quality of the goods and services which a country can produce at a given time. Such potential production is obviously limited in the short term, but could be expanded in the medium and long term.

Based on this notion of productive capacity, in effect, a country's productive capacities are developing when that country shows improvements or progress

in all these areas — when, in other words, its productive resources are expanding, it is acquiring technological and entrepreneurial capabilities and it is also creating production linkages. All of these improvements will enable the country to produce a growing array of goods and services and to create jobs and integrate beneficially into the global economy on the basis of an internal growth momentum. If this type of development continues, then the country will have productive capacities which enable it to create jobs that pay higher wages and to acquire the capability needed to produce an increasing range of higher value added goods and services both efficiently and competitively.

The development of productive capacities occurs through three closely related core economic processes that all countries have to undergo if they are to achieve sustained development. These are: the investment necessary to build domestic capital stock (physical capital, human capital, and so forth), which economists refer to as capital accumulation; structural change (or structural transformation); and building the capabilities of the domestic enterprise sector.

Is it possible to conceive of a dynamic process that brings the different elements together in a virtuous circle? Such a process could, for example, use enterprise development to transform productive structures into higher value-added activities that involve more skilled and technology-intensive production, which in turn results in higher incomes that can fuel demand and stimulate new investment. Such capital accumulation in turn enables the development of new activities and further diversification of the economy away from traditional sectors, thereby intensifying the process of structural change. The question is how to integrate these synergies into a framework for optimizing employment, which also requires choosing policies that do not contradict one another.

The policy framework for maximizing employment creation proposed in this Report aims to achieve that objective. It does so by identifying the set of policies which Governments should implement if they wish to establish a strong link between growth, employment creation and the development of productive capacities. The policy framework is based on a pragmatic assessment of the challenges facing LDCs and on an explicit recognition that the key to inclusive development is not simply higher rates of economic growth but also a higher employment intensity of growth.

In terms of capital accumulation, the new element in the proposed framework is that it not only values policies for their potential to stimulate an investment-growth nexus but also adds employment as a third and integral element of the nexus. Thus, for LDC policymakers the primary goal of capital accumulation would be to promote growth *with employment*. This has implications for the manner in which resources are mobilized and investment decisions are taken. The critical entry point for creating a strong and sustainable investment-growth-employment nexus is investment. The aim would be — initially through public investment in priority areas (and particularly in infrastructure) — to set in motion a virtuous circle in which investment boosts growth and growth creates employment, which, in turn, entails increased income for workers, giving rise to consumption that supports the expansion of the aggregate demand. Import leakages apart, expanded aggregate demand ideally creates incentives for new or additional investment to meet the growing demand. This circle could then be reiterated at a higher level of investment, growth, employment and income.

Given that most LDCs are very open economies, they would not be able to put the nexus in motion in the whole economy. However, the non-tradable sector is still relatively insulated, and policy space there is larger than in other parts of the economy. Initially, therefore, the most pragmatic approach would be to start to stimulate the process of capital accumulation via that nexus in the non-tradable sector. Over time, and as domestic firms develop their technological and learning capabilities, it would be possible gradually to extend the nexus to modern services that have become tradable because of technological innovations, import substitution activities and exporting activities.

Given the relatively weak private sector in many LDCs, it is more likely and realistic that in the short to medium term, the investment push required to kick-start the growth process will originate in the public sector. The idea here is not to encourage public ownership, which would amount to returning to failed policies of the past. Rather, the idea is to ensure that the capital-mobilizing power of the State is used to provide the initial investment impulses needed to drive the virtuous cycle in the short term. In other words, while public investment is crucial for kick-starting the nexus, it should be limited to the short and medium term. In the long term, the private sector should have the primary role in the nexus, and the responsibility of the public sector would then be reduced to supporting the efficient functioning of the nexus through appropriate policies and incentives aimed at encouraging private-sector investment in priority areas.

While the sectors to which initial public investment should be directed will necessarily be country-specific, investment in infrastructure seems to be a natural starting point, since the lack of adequate infrastructure in most LDCs is a serious bottleneck to enterprise development and productive capacity-building. Both goals could be achieved using the factor of production that is abundant, namely, labour. The prerequisite for this is a reorientation of policies on infrastructure investment to ensure that technically viable, cost-effective and employment-intensive options are used instead of more capital-intensive ones. In other words, there is a need for adopting appropriate technology.

Social services are also strong candidates for initiating an investment-growth-employment nexus driven by public investment. Millions of LDC citizens still have very poor or inadequate access to the most basic requirements of decent life, such as nutrition, sanitation, electricity, water, transport and communication, health services and education. Other sectors that could be targeted because of their potential to create employment are construction, expansion of services in rural areas, textile and leather production, and food processing.

The policy framework also assigns greater importance to the upgrading of firms and farms of all sizes, in view of their potential role in contributing to growth, creating productive capacities and generating jobs for both unskilled and skilled workers. In most LDCs the distribution of enterprises by size is heavily skewed towards micro- and small enterprises, typically operating in the informal sector. At the other extreme are a small number of large firms, most of which are either State-owned enterprises or large private firms, frequently owned or controlled by foreigners. These large firms tend to be found in the most profitable sectors, such as extractive industries, air transport and modern financial activities, where a large size is needed to make capital-intensive investments. Medium-size firms are typically absent. This “missing middle” in the LDCs — as in many other developing countries — is a result of the inability of small firms to grow and attain minimum efficient production sizes. Thus, the most important task in the context of the LDCs is the creation of the missing middle.

Policies aimed specifically at helping enterprises to grow in size can be divided into four groups: policies for formalization of firms, policies for financing of firms, policies for strengthening the organizational and entrepreneurial capacities of firms, and policies for overcoming failures in information and cooperation (policies to encourage networking and clustering). If successful,

these policies will enable micro- and small enterprises to grow and become medium-sized or even large enterprises. Their growth will hopefully create employment for large numbers of workers and will thus be employment-intensive. This is simply because, in order to reach the optimum size of production, these enterprises need to increase the scale of production with the existing technology and methods of production. The benefits associated with economies of scale will then induce these firms to grow further. At the same time, the creation of medium-sized enterprises will foster conditions for technological progress. Once medium-sized enterprises have increased the scale of production beyond the optimal point with the existing production processes, they will be forced to innovate in order to maintain their profitability.

The policy framework proposed here suggests that enterprise development should be accompanied by the adoption of active policies to influence technological choice in different types of activities. A differentiation of the types of technology choice and corresponding policies is required in order to accommodate the frequently conflicting policy goals of technological progress and employment creation. Two different strategies should thus be followed: one for the modern sectors, involving acquisition of advanced technologies from developed countries, and another for the rest, involving so-called “appropriate” technology.

In terms of structural change, the challenge for LDCs is not that their economic structure is static, but rather that in most cases it is changing in a manner not conducive to building productive capacities and creating quality jobs in sufficient quantity. In order to position the LDCs’ economies on a job-rich growth and inclusive development path, the policy framework recommends a three-pronged approach to employment creation that focuses on the generation of foreign exchange through investment in both capital- and labour-intensive tradable activities; the expansion of the non-tradable sector and the concomitant creation of jobs; and productivity improvement in agriculture in general and subsistence agriculture in particular.

The three-pronged approach to employment creation recognizes that the process of structural change should ideally be led by the consolidation and expansion of the modernizing core of the economy, composed of high value added knowledge-intensive and competitive activities in manufacturing, mining, mechanized agriculture and modern services. In terms of labour, ideally this should be achieved through the transfer of workers from low-productivity, poorly paid work to more productive and better employment in other sectors (i.e., intersectoral transfer of labour).

However, the expansion of the modern sector needs to be complemented by an improvement in the quantity and quality of jobs in the remaining sectors of the economy. Given the prevalence of working poverty in LDCs, this implies raising productivity in traditional activities. All opportunities to improve livelihood opportunities and create employment in labour-intensive activities in these other sectors should be explored and promoted.

The logic behind the three-pronged approach to employment creation is that the increase in productivity in agriculture releases labour which should be absorbed by the rest of the economy, that is, tradable and non-tradable activities. Since the tradables are subject to intense competition, the extent to which they can absorb labour is limited. In other words, the choice of capital-labour ratio tends to be exogenously determined. As a consequence, non-tradable activities would have to provide the bulk of employment opportunities for new entrants and also for those released from subsistence activities. These sectors include infrastructure and housing; basic services (education, health, sanitation, communication, public administration); technical services, repair and maintenance, and most transportation services; insurance services, property and commercial brokerage; personal, social and community services; public administration; security and defence. Since these activities do not generally face international competition, the policy space to influence outcomes in these sectors is larger than in the tradable sector. This implies that there are much greater possibilities for increasing the employment intensity of growth in these activities.

However, it is important for policy to focus not only on employment generation, but also on productive transformation – in each of these sectors separately, and also in the economy as a whole. The three-pronged approach proposed here emphasizes that employment creation is crucial, but that it should be pursued simultaneously with modernization of economic activities and increase of productivity. The latter would ensure that not only the quantity of employment, but also the quality of jobs, improves.

The framework developed in this Report should not be viewed as a one-size-fits-all solution for the employment challenge faced by the LDCs. There is considerable room for diversity in applying the framework across LDCs, reflecting differences in resource endowments, size, geographical location, production structure and export structure. Such diversity implies different starting points and different policy choices. Policymakers in each country should carefully examine the specificities of their economies before deciding how to use the framework.

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## Policies for employment-rich growth

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Policies for employment-rich growth in LDCs should have two complementary objectives: expanding the number of jobs so as to absorb the growing labour force and the youth bulge, and raising the incomes generated by these jobs (by means of productivity gains) so as to combat the generalized prevalence of poverty and underemployment. Reaching these objectives will involve implementing a range of mutually supportive policies aimed at building productive capacity and fostering structural transformation. Policy interventions should cover three broad areas: macroeconomic policies, enterprise development and technological learning, and public-sector investment and actions for job creation.

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### Macroeconomic policies

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Inclusive development calls for a macroeconomic policy approach that goes beyond the narrower goal of macroeconomic stability. This broader approach calls for expanding the number of instruments and coordinating macroeconomic policies with other policies to stimulate the development of productive capacities. In this context, fiscal policy becomes more important than monetary policy. It should target financing public investment in physical and human capital by accelerating public investment in infrastructure and raising spending on education and training. To do so will require strengthening government capacity to mobilize and manage fiscal revenues, whether domestic or external. At the national level, this can be done initially through domestic resource mobilization, which entails changes in fiscal policy and tax administration. The measures most likely to raise fiscal revenues in the LDCs include the following: (i) introducing value added tax (VAT), reducing VAT exemptions and raising the VAT rate on luxury consumption; (ii) raising excise taxes on alcohol, tobacco and vehicles; (iii) reducing tax holidays and exemptions for corporations and high-income expatriates; (iv) increasing taxation on urban property (where the wealthiest live); (v) reforming the taxation of the financial sector; and (vi) refraining from further tariff cuts until alternative sources of revenue are put in place. Tax administration and collection, in turn, can be made more efficient, by streamlining information management, cross-checking statements and declarations and setting up a special unit for high-income taxpayers.

For resource-rich LDCs, fiscal revenue can be increased by modifying the extremely favourable terms currently offered to foreign investors in agriculture and mining. This may involve imposing a tax on land leased for large-scale investment projects, raising existing land taxes or revising the taxation of activities undertaken by those projects. Governments with mining resources can raise their revenues by adopting higher levies, royalties, income taxes or export taxes. LDC authorities should also strengthen the mobilization of external resources from both traditional and non-traditional aid donors and from multilateral and regional financial institutions.

Although fiscal policy may be more important than monetary policy in developing productive capacities, monetary policy is still critical. It should, however, be less fixated on attaining an inflation rate in the low single digits than on targeting full employment of productive resources and providing reasonable macroeconomic stability. Credit policy is of crucial importance in the LDCs, particularly for micro-, small- and medium-sized enterprises, which are typically credit-constrained in these countries. In that regard, public development banks can play an important role by providing credit when private financial institutions fail to do so.

LDCs are particularly vulnerable to external shocks. To protect themselves from such risks, they should also develop a capital account management system, including residence requirements on capital expatriation and stricter regulation of external borrowing. Large commodity-exporting countries may also consider setting up a stabilization fund to protect themselves against strong fluctuations in international commodity prices

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## Enterprise development

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Private sector development is a *sine qua non* for large-scale employment generation in LDCs, since it generates the bulk of jobs, both today and tomorrow. The main policies for developing their private sector are industrial policy, enterprise policy, rural development policies, and education and training policies

*Industrial policy* is designed to steer the economy towards structural transformation, by moving to higher-productivity activities both among and within sectors. There are two types of strategies that LDCs can pursue to

bolster the employment intensity of growth. The first is to build on activities of existing comparative advantage, by fostering backward and forward linkages and technological upgrading in these sectors. This typically means focusing on natural resource-based activities. Agriculture can be the basis for developing downstream industries, such as food processing, geared mainly to domestic and regional markets, but also global markets. It can also yield other types of products (e.g. agricultural raw materials) that can be further processed before exporting. To this end, such measures as the provision of industrial extension services, temporary export tariffs and support to firm clustering (see below) can be applied. Internationally, these actions should be complemented by enhanced regional cooperation on some agricultural commodity chains of production, processing and marketing (e.g. rice, maize, wheat, sugar, meat and dairy products) which have the potential to meet increasing regional demand through regional integration schemes. Governments should act simultaneously on transport, logistical, processing and market infrastructure to nurture regional value chains.

A second type of industrial policy strategy aims at changing the capital-labour ratio of the economy, by attracting investment in labour-intensive industries. Some LDCs will be able to take advantage of the window of opportunity opened by China's likely delocalization of the lower end of its manufacturing industry, through a combination of integrating domestic firms into manufacturing global value chains (GVCs) and attracting foreign direct investment (FDI). Domestically, this strategy should be complemented by policies on clustering, export promotion and labour costs. Clustering allows firms to benefit from technological and managerial economies of scale (externalities) and act collectively. Policymakers can support industrial clusters by ensuring a superior supply of infrastructure, logistical, customs, financial and legal services; providing preferential access to land; and facilitating easier administrative procedures. LDCs can promote exports (especially non-traditional exports) by means of export processing zones, export subsidies, public provision of trade finance, and trade promotion organizations. Labour costs can be kept competitive by ensuring an adequate supply of wage goods and services, particularly food (by means of agricultural policy – see below) and transport, housing and so forth.

International integration through global value chains (GVCs) and FDI will have a lasting developmental effect only if such undertakings are complemented by fostering continuous technological capacity-building on the part of participating domestic firms (so as to avoid being locked in to

labour-intensive, lower-productivity activities). Policies should also target the creation of linkages with other domestic firms that can learn and upgrade through interactive learning. In some cases, authorities may have to negotiate with foreign investors in order to induce domestic linkages and technology transfer to local firms.

Effective *enterprise policy* measures for stimulating the development of urban-based micro- and small enterprises (MSEs) include facilitating their access to capital and helping them upgrade into formal status. Policymakers need to expand the financing made available to these firms through national development banks or commercial banks. The former should open special credit lines for MSEs. Authorities can counteract the risk aversion of commercial banks and encourage them to expand their lending to MSEs by: (a) subsidizing or providing loan guarantees for commercial bank credit to such firms; (b) enacting lower asset-based reserve requirements for this market segment than for other types of lending; and (c) linking formal and informal financial institutions (e.g. rotating savings and credit societies), which have more information on borrowers' risks and operate with lower transaction costs. Public and private financial institutions should select those MSEs with high growth potential, based on current profitability and entrepreneurs' profiles. In order to facilitate the entry of MSEs to the formal sector, LDC authorities can simplify procedures and requirements for registry and reporting operations, reduce the cost of registry, allow for gradual compliance of regulations and establish a department or semi-autonomous body to lend managerial support and advice to MSEs.

*Rural development policy* is a special challenge, given the dismally low level of productivity of rural areas, and requires action on infrastructure, technology and financing. The State needs to invest heavily in rural infrastructure, especially irrigation, electricity, transport, storage (warehousing) and communication (ICTs) in order to boost rural productivity and foster backward and forward linkages of farms. Rural extension services need to be established or rehabilitated to provide advice and training on cultivation techniques, water management, choice of seeds and/or crops, warehousing, conditions of land quality and water access, avoiding soil degradation, and techniques for meeting market requirements. The technology content of such services should actively involve local communities and combine modern technology with traditional or indigenous knowledge systems. The services should focus on scale-neutral technologies that can be applied by smallholders. While typically provided by State institutions, the latter may

also work with domestic and international non-governmental organizations (NGOs) and farmer associations in delivering extension services. The main upstream policy direction involves increased funding of national or regional agricultural research centres that deal with agro-ecological zones or strategic food products. To this end, funding by regional partners should be pooled and possibly backed by international donors.

Providing rural producers with access to capital and finance requires offering both seasonal and long-term finance to farmers and rural non-farm economic agents. This should be undertaken by agricultural development banks, State banks, post office financial services, community credit cooperatives (which have better knowledge of borrowers' creditworthiness) and, in some cases, commercial banks. Such institutions also have the capacity to mobilize rural savings and turn them into credit. Larger financial institutions may also set up specialized rural/microfinance units. State-sponsored credit provision, in turn, may entail establishing or rehabilitating rural development banks that can offer financial services not provided by commercial banks or other financial institutions. Using insurance and warehouse receipt schemes is one way of allowing farmers to turn their agricultural produce into collateral. Where mining is concerned, building linkages is more challenging, but this can be done by encouraging local firms to provide inputs like labour-intensive services (catering, cleaning, etc.).

Most of the above-mentioned instruments of industrial, enterprise and rural development policy are targeted policies. They need to be complemented by horizontal policy measures aimed at increasing the knowledge intensity of the LDC economies, so as to make them more adaptable and better prepared to meet the requirements of a modern economy. This leads us to *education and training policy*. In primary education, the priority is to improve quality. In secondary and tertiary education and in technical and vocational training, LDCs need to both expand the supply of services and improve the quality. This includes revising curricula and teaching methods in order to make the labour force more adaptable and innovative, and adjusting education policies to meet future domestic labour market requirements.

There are three other policy measures for raising the knowledge intensity of the economy. The first is to foster cooperation between academia (university and research institutions) and businesses (e.g. in the context of clusters). The second is to set up or strengthen standard-setting bodies (e.g. for quality and sanitary certification), either through government initiative or through

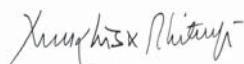
partnerships between government and industry or sectoral associations. The third is to apply tax breaks or training levies in order to provide industry-specific training for the labour force.

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## Public sector-led job creation

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But in addition to involving the private sector, the State itself must play a role in generating jobs, either directly or indirectly, especially in the earlier phases of development. Since infrastructure work is a non-tradable type of activity, and since it finances the bulk of projects, the State can influence the choice of technique so as to ensure the adoption of labour-intensive production processes. These have several advantages over capital-intensive technologies: they generate more jobs, have lower costs, can contribute to local enterprise development and capacity-building, provide more readily available maintenance and repair services, and can generate foreign exchange savings.



Dr. Mukhisa Kituyi

Secretary-General of UNCTAD





