



## Expanding productive capacity for achieving the sustainable development goals\*

### Recommendations

In response to the theme adopted by the Economic and Social Council for its 2016 session, entitled “Implementing the post -2015 development agenda: moving from commitment to results”, the Committee for Development Policy considered the question of expanding productive capacity of the least developed countries to enable them to achieve the Sustainable Development Goals. International support is crucial for expanding productive capacity in those countries. Many least developed countries have been experiencing re-primarization, deindustrialization and informalization of their economies as well as increased food insecurity. Given the diversity among least developed countries, national strategies and international support measures cannot be of the one-size-fits-all variety, but instead should be targeted at the various key conditions and governance capabilities affecting different groups of least developed countries. The Committee recommends that the Council:

- a) Call upon the Governments of least developed countries to design and implement strategies that aim to simultaneously accelerate economic growth, promote dynamic transformation of their economies and ensure that no one is left behind, that the disadvantaged are not made worse off and that the environment is not harmed. However, countries may need to address potential trade-offs and harness synergies between increasing productive capacity and other sustainable development objectives;
- b) Request the international community to strengthen support measures in favour of least developed countries. In this regard, preferential market access for least developed countries should be retained and enhanced, and aid-for-trade allocations should target countries most in need. These and other relevant measures should support structural transformation, enable building of innovation capabilities and contribute to the broader set of Sustainable Development Goals, including the goals of reducing inequalities and promoting gender equality;
- c) Urge the international community to strengthen international tax cooperation so as to guarantee that foreign investors make an adequate contribution to tax revenues in least developed countries, including in oil and mining and other natural resource sectors, and that adequate action is taken to avert illicit capital flows associated with tax evasion.

### Main Observations

Least developed countries face the challenge of promoting the dynamic structural transformation of their economies while building the necessary capabilities and policy frameworks for sustaining productivity growth across the entire country. In many least developed countries, improving agricultural productivity in a sustainable way by overcoming policy neglect of this sector and investing in sustainable agriculture, scaling up research and removing gendered constraints will be a priority, while increasing productivity in manufacturing, natural resource-based industries and tourism is also key in many least developed countries. There are, however, potential trade-offs between increasing productive capacity and other sustainable development objectives which need to be addressed by domestic and international policies.

Industrial policies, especially when combined with competition, can play an important role in expanding productivity. In most least developed countries, soft industrial policies that aim at raising investments in infrastructure, improving the coordination between the public and private sectors and increasing human capital are appropriate. Least developed countries may also choose from a wider range of policy measures, including vertical policies such as public-private joint research and development (R&D), promoting backward and forward linkages and domestic content requirements. While foreign direct investment (FDI) can be an important vehicle for industrial and technological upgrading in least developed countries, it requires parallel development of local capabilities in order to harness production linkages and promote local value creation. Least developed countries also need to ensure that their macroeconomic and financial policies are supportive of expanding capacities and ensure a fair distribution of benefits within their societies.

Synergies between productive capacity and the Sustainable Development Goals are enhanced by adopting inclusive social policies so as to ensure that everyone has access to improved nutrition, health, education and social protection. There is also a need to further close the gender gaps in education, employment opportunities, wages and distribution of unpaid care work in families and to address the issue of youth unemployment on a priority basis.

\* Excerpt from Committee for Development Policy, Report on the eighteenth session, See Official Records of the Economic and Social Council, 2016, Supplement No. 13 (E/2016/33)

## 1. Introduction

The international development policy debate increasingly emphasizes expanding productive capacity as an element key to achieving development progress, in particular in least developed countries. The shift in emphasis is reflected in the Istanbul Programme of Action for the Least Developed Countries for the Decade 2011-2020<sup>1</sup>, in which productive capacity is the first of the eight priority areas. In respect of the newly adopted Sustainable Development Goals, a number of Goals and targets refer directly to productive capacity, in particular Goal 8 (“Promote sustained, inclusive and sustainable economic growth, full and productive employment and decent work for all”) and Goal 9 (“Build resilient infrastructure, promote inclusive and sustainable industrialization and foster innovation”). In addition, meeting other Sustainable Development Goals and targets (such as those on education, health and nutrition, institutions and energy) may further contribute to increasing productive capacity. Building productive capacity will also impact on a number of Sustainable Development Goals and targets (such as those on gender equality, employment, income growth, and natural resources).

Expanding productive capacity and achieving the Sustainable Development Goals require an integrated approach to development at the national and international levels. Whereas international support is required for essentially all developing countries, priority needs to be given to the least developed countries. Those countries have lower productive capacity as well as fewer resources and limited capabilities for expanding them. Focusing support to least developed countries towards on expanding productive capacity is a means of ensuring that no country is left behind. This support also needs to be designed in such a way as to leverage national-level efforts to ensure that no one is left behind at the national level.

Despite their increased economic growth and participation in global trade since the turn of the millennium, least developed countries have made only limited and uneven progress in dynamically transforming and diversifying their economies. Instead of improving efficiency in the use of available resources through the reallocation of labour towards dynamic activities, structural change in those economies has been largely characterized by re-primarization towards (often subsistence) agriculture and mining, very limited industrialization and informalization (which is often centred on service sectors with low, rather than high, productivity). If current trends persist, it is unlikely that the goals established under the 2030 Agenda for Sustainable Development will be met — and not only those goals directly related to the promotion of productive capacity. Consequently, new policy approaches to implementing the Sustainable Development Goals are needed at the domestic and international levels.

## 2. Identifying priority areas for different groups of least developed countries

Least developed countries vary with regard to economic structure and external conditions. Given the heterogeneity within least developed countries, one-size-fits-all policies are unlikely to yield benefits for all. While manufacturing offers great potential for achieving economies of scale and productivity growth, pursuing structural transformation through industrialization is unlikely to succeed in all countries, particularly in small and remote States such as the Pacific islands. Similarly, while trade integration potentially expands domestic demand and brings opportunities for industrial and technological upgrading and fast income growth, adoption of an export-led approach should not be to the detriment of industries catering to the domestic market in countries with large populations.

In a large number of least developed countries, low agricultural productivity is a major cause of food insecurity and a constraint on shifting economic activities towards manufacturing and modern services. In those countries, sustainable agriculture can be the backbone of economic development. This requires policies that boost productivity by providing access to advanced agricultural inputs, extension services, infrastructure and credit, as well as removing gender-specific constraints on the sector. At the same time, policies must prevent environmental degradation, protect the interests of smallholders and ensure that increased agricultural productivity contributes to enhanced food security.

Extractive industries such as oil and mining have been a major driver of economic growth in a number of least developed countries. Harnessing those sectors for expansion of productive capacity and sustainable development requires industrial policies that build domestic linkages both downstream (with firms providing inputs to extractive firms) and upstream (with firms processing extracted resources) as well as policies that address natural resource-related inequalities and negative environmental impacts. Moreover, countries need to manage macroeconomic challenges associated with natural resource extraction, for example, through instituting stabilization funds and sterilizing sudden surges in monetary inflows.

As shown by the performance of several least developed countries, the low-skill segments of the manufacturing sector can be important entry points for structural transformation. Rising prices and wages in major non-least developed developing countries as well as the increasing importance of global value chains enlarge opportunities for least developed countries. At the same time, moving gradually from low-skill activities to medium- and higher-skill activities becomes increasingly important for raising overall productivity and increasing labour incomes.

For most small island least developed countries, fisheries and tourism will continue to be the main export-oriented economic activities. Ensuring that these sectors contribute to achieving

<sup>1</sup> A/69/95-E/2014/81.

the whole range of Sustainable Development Goals is therefore crucial. Given the importance of remittances, further harnessing economic links to the large diasporas will also be beneficial.

In addition to confronting the aforementioned differences between groups of least developed countries, strategies for productivity growth and structural transformation need to address cross-cutting issues. For example, in least developed countries affected by armed conflicts, reconstruction and prevention of (re-) emerging conflicts are a priority.

Different strategies are needed for different groups of least developed countries, taking into account specific features of the economy and its development trajectory. While country-specific policies are necessary, past experience has also indicated some common elements, naturally tailored to country characteristics, in those countries that have succeeded in promoting a sustainable dynamic transformation of their economy.

### **3. Building development governance capacity**

Expanding productive capacity requires an active and strong role for the State. Good “development governance” is concerned with getting the governance processes right and also with achieving specific developmental outcomes. Hence, it goes beyond “good governance”, which focuses on certain subsets of national-level mechanisms. Development governance relies on the ability of the State to promote development and facilitate a sustainable dynamic transformation of the economy while ensuring that costs and benefits are fairly distributed. The role of the State is critical because it is the largest economic and political actor in most national economies and the institution that implements the business and legal framework for development.

A successful developmental State requires political leadership that drives the process of moulding a national development vision in partnership with all relevant national stakeholders. Powerful and accountable planning institutions that have effective control over financial resources and are able to adapt plans to changing national conditions are also essential. Human capabilities need to be commensurate with evolving requirements. In earlier stages of development in particular, this requires meritocratic bureaucracies characterized by broad education in both social and technical fields and the pragmatic knowledge needed to prepare and implement national development plans.

For the purpose of developing successful governance capabilities, least developed countries could consider the experiences of other developing countries that successfully transformed their economies and adapt those approaches to their own national conditions. Such a learning-based approach is more promising than one underpinned by the attempt to emulate the institutions of advanced countries.

### **4. Industrial policies**

Industrial policies can be an important instrument for promoting diversification and industrial and technological upgrading of domestic production structures, if they are tailored to national conditions and potential comparative advantages. Generally, for least developed countries, industrial policies need to take into account the fact that most of those countries have small economies and are latecomers into global markets compared with developing countries that implemented industrial policies in the past. Moreover, given the important role of service activities in many least developed countries, industrial policies should target not only manufacturing but also services. Least developed countries need to weigh the benefits and costs of industrial policy instruments and take the scarcity of their resources into account. Least developed countries are also limited by the reduction in policy space arising from World Trade Organization and other international obligations, although the reduction is smaller than that experienced by other developing countries. Instead, lack of institutional and human capacities and resources are more binding constraints on industrial policy.

Industrial policies that use trade and fiscal instruments appear to be most successful when they are associated with increasing exposure to trade or foreign direct investment (FDI). Interventions such as export promotion or short-term tax holidays for new investors are often more promising than external tariffs or domestic content requirements. Instruments such as tax breaks for specific investments are beneficial only if those investments generate significant technology transfer and employment-creation. Generally, policies directed towards FDI promotion are effective in achieving structural transformation only when they are part of a broader effort to achieve industrial and technological upgrading. Instead of providing blanket subsidies for exports and FDI, countries should attract FDI to produce key inputs or to acquire the specific knowledge needed by the clusters of economic production with the ability to absorb them. This requires such host country policies as public-private joint research programmes and training to develop local capabilities for progressing beyond assembling imported inputs. The higher the investment in domestic R&D, the greater the potential for absorbing and utilizing external research and innovation, which can further support and accelerate structural transformation.

In addition to adopting vertical (or sectoral) industrial policies (including tariffs, infrastructure provisions and tax holidays) supporting specific firms or industries, least developed countries can also utilize horizontal (“soft” or generic) industrial policies or processes whereby government, industry and private organizations collaborate on interventions that can directly increase productivity (such as support for research and development, quality standard regulations and business incubators). The idea is to focus attention on interventions that deal directly with the coordination problems that keep productivity low in existing sectors. In comparison with the more traditional approach to industrial

policy, the soft approach reduces the scope for corruption and rent-seeking and is more compatible with the multilateral and bilateral trade and investment agreements that have been implemented by many least developed countries over the last decades. Under this approach, new institutional arrangements can facilitate the growth of innovation as a key input into the industrial upgrading process.

## **5. Creating positive synergies**

Governments need to ensure that there is a positive synergy between social outcomes and increases in productive capacity. This can be achieved through adoption of policies that build positive social outcomes (such as poverty eradication, health and well-being, quality education for all, reduced inequality, gender equality, full and productive employment and decent work) into the transformed structures of production, rather than policies underpinned by the attempt to grow first and redistribute later. For the creation of positive social outcomes, attention must be given not only to the amount of investment in services, such as education and health, but also to quality and access. Inclusive social policies, in particular those targeting women and girls, are essential. Special attention also needs to be focused on improving the employment prospects of youth, women and other disadvantaged groups.

Of equal importance is having the necessary social protection policies in place to shield people from the eventual costs and negative impacts resulting from structural transformation. In many cases, potential trade-offs – for example, between improving infrastructure through large-scale investments in dams, for example, and displacement of local populations, or between large-scale plantations or agro-processing facilities and the livelihoods of smallholders – can be addressed through benefit-sharing approaches. Other potential trade-offs, for example, between increasing employment in low-skill manufactures and unsafe working conditions, may disappear once the negative impact on productivity of increased staff turnover and absenteeism are factored in. However, this requires an understanding of the risks of negative synergies between productive capacity and social outcomes and the putting in place of measures to counteract them.

## **6. Supportive macroeconomic and financial policies**

The key to rapid economic growth in the developing world is a combination of strategies aimed at the dynamic transformation of production structures, with appropriate macroeconomic conditions and stability. Thus, macroeconomic policies should support capacity expansion and increase the resilience of the economy to external shocks and internal crisis, reducing external and internal imbalances, while orienting the key policy tools (the interest rate, the exchange rate and financial regulation) towards capacity expansion. Rather than target only inflation, monetary

policy needs to accommodate these multiple objectives. Least developed countries with access to exchange rates as a policy instrument should aim at maintaining stable and competitive real effective exchange rates. Establishing fiscal rules and, for commodity-dependent least developed countries, stabilization funds can help ensure that fiscal policy is counter-cyclical. While capital account management can also contribute to increased stability of the macroeconomic framework, it is no substitute for sound fiscal and monetary policy. Most least developed countries have space within which to increase tax shares by broadening tax bases and increasing the progressivity of tax regimes, thereby providing additional financial resources for capacity expansion.

Policies should ensure that the financial sector contributes to economic growth, financial stability and equity. The most pressing needs centre around access to finance by the poor and marginalized groups, agricultural finance and financing of small and medium-sized enterprises, as well as infrastructure financing. Addressing these needs requires improved regulation and supervision of the sector as well as enhancement of the role of inclusive finance vehicles such as microfinance, mobile banking and credit unions and their further integration into the regulatory framework. Giving stronger roles to national development banks can also be important, but this requires sufficiently strong governance capabilities. Least developed countries should aim, whenever possible, at reducing dependence on foreign savings, lowering foreign indebtedness and maximizing domestic savings. Capital accumulation needs to be funded mainly through the strengthening of indigenous savings and banking institutions, and incentives for firms to invest

## **7. International support for expanding productive capacity**

The main thrust of international support to enhancing productive capacity in least developed countries has been a better integration of these economies into the global trading system through improving both demand and supply conditions. Providing preferential market access has aimed at removing the constraints of small domestic market size and offsetting higher costs due to structural constraints. Preferences have evolved over time and are increasingly being provided not only by developed but also by developing countries. Yet, coverage of markets and products is still incomplete, while rules of origins, product regulations and administrative procedures often remain as barriers to trade. Nevertheless, preferential market access has been successful in boosting least developed countries exports, on average. Further increasing coverage and simplifying access to preferential schemes remain important, in particular as their impact varies among providers.

The main beneficiaries of trade preferences are least developed countries in Asia that specialize in garment exports. Remote Pacific least developed countries still lack the potential for exporting

goods and most African least developed countries remain commodity exporters. Preferential market access has not yet enabled least developed countries to move towards more skill-intensive and higher-productivity manufacturing activities, while the impact of enhanced market access on social and environmental outcomes requires further investigation. The implementation of the World Trade Organization waiver allowing for preferential access in services could play an important role, but only if it includes sectors and modes of supply in which least developed countries have a potential comparative advantage.

As improved market access does not directly solve the problem of the lack of productive capacity, supply-side oriented support to infrastructure-building, enhancing firm productivity and trade policy reform, as envisioned under the Aid for Trade initiative<sup>2</sup>, can be instrumental. However, there is an urgent need to shift Aid for Trade allocation towards countries most in need of such support, i.e., the least developed countries in particular. A more precise definition of Aid for Trade is also needed to enable the evaluation of its impacts and effectiveness. In many least developed countries, support is also needed for better identifying and addressing trade constraints. Moreover, additional resources should be channelled to regional projects, as some trade-related issues, such as that of transport corridors, can be tackled only within a regional framework.

Aid for Trade projects need to consider their impact on trade as well as on different groups (for example, formal versus informal workers, male versus female workers, and large versus small businesses) so that inequality does not rise in recipient countries. There is potential for Aid for Trade to become aid for innovation, if support for basic research and science and technology becomes part of it. To strengthen national ownership, matching Aid for Trade with dedicated domestic support may be explored further.

International cooperation in trade and investment can be coupled with international tax cooperation, as increased trade and investment flows are in certain cases also linked to illicit flows out of developing countries. Improved tax cooperation can help least developed countries increase their tax revenues by curbing tax evasion and ensuring a fairer distribution of natural resource rents among foreign investors, national Governments and local populations.

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<sup>2</sup> The Aid for Trade initiative, inaugurated by the World Trade Organization in 2005, is a platform for providing support to developing countries, in particular least developed countries, to help them develop their capacity to trade.