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Committee for  
Development Policy  
**POLICY NOTE**

**EXPANDING PRODUCTIVE CAPACITY:  
Lessons Learned  
from Graduating  
Least Developed Countries**



United Nations

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## DESA

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## Foreword

Lack of productive resources, entrepreneurial and institutional capabilities and production linkages, referred to collectively as lack of productive capacities, impedes the efforts of least developed countries (LDCs) to graduate from the LDC category and, more broadly, is a barrier to achieving the Sustainable Development Goals (SDGs). Consequently, the issue of building productive capacity has moved to the forefront of the international discourse. It is the first priority area in the Istanbul Programme of Action for the Least Developed Countries 2011–2020 and is also strongly reflected in the 2030 Agenda for Sustainable Development, in particular SDGs 8 and 9.

The strategies and policy choices of countries that have successfully graduated from the LDC category, or have made noteworthy progress towards graduation, contain important lessons on how productive capacities can be expanded and what policy interventions are most effective. The Committee for Development Policy, an independent expert body of the Economic and Social Council composed of 24 prominent scholars representing all regions of the world, analysed the experiences of fourteen countries—graduated and graduating LDCs, as well as non-LDCs—in expanding productive capacities.

This Policy Note reflects the conclusion of this analysis. It highlights the need for integrated policies across five broad policy areas: (I) development governance; (II) policies for creating positive synergies between social outcomes and productive capacity; (III) macroeconomic and financial policies that support productive capacity expansion and increase resilience to external shocks; (IV) industrial and sectoral policies; and (V) international support.

The Policy Note also stresses that the heterogeneity among LDCs requires different national strategies and different international support for various groups of LDCs. In this regard, the Committee identified three different pathways towards graduation while highlighting effective policies for each pathway.

This Policy Note is a valuable contribution to the efforts of countries and the international community to expand productive capacities in LDCs.



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## Executive summary

Over the past decades, least developed countries (LDCs) have made only limited progress in dynamically transforming and diversifying their economies. Their structural challenges and weak economic and social performance are rooted in the limited development of their productive capacity. Consequently, achieving the sustainable development goals (SDGs) requires concerted efforts to expand productive capacity in LDCs. Building productive capacities also moves LDCs towards graduation from the category. Moreover, it provides development momentum necessary to manage graduation and support for continued progress following graduation. Graduation from the LDC category is not only a policy objective for many countries and the international community; more importantly, it is a reflection that a country has been able to overcome or mitigate the most severe structural impediments to sustainable development.

While the importance of productive capacity is increasingly reflected in the political discourse at national and international levels, there is, however, less agreement on what policy actions are needed and which concrete policy measures play an important role. The Policy Note argues that integrated policies in five areas are needed: (1) development governance; (2) social policy; (3) macroeconomic and financial policies; (4) industrial and sectoral policies; and (5) international support measures. In this respect, the Policy Note provides a framework for how enhancing productive capacity can be improved in a way that signifies progress towards sustainable development.

The impact of concrete policies on productive capacities often depends on national characteristics. However, the policy choices made by countries that have graduated or that have made substantial progress towards graduation provide a wide range of lessons that all LDCs and the international community can learn from. This Policy Note distils examples of relevant policy options from fourteen case studies. It underlines that there are three different pathways to graduation. The identification of different pathways is an important recognition, and one that departs from the orthodoxy that similar solutions apply in all contexts. Each pathway has different implications for the process of expanding productive capacity. Whereas resource endowment and country size are important in this regard, policy choices are most critical.

The first pathway is characterized by rapid economic growth and rapid increase in income through natural resource exploitation, in conjunction with limited progress towards human asset development and the reduction of economic vulnerabilities. Abundance in natural resources moves LDCs towards graduation and constitute a potential to move

countries towards achieving the SDGs. However, development governance is the key factor that determines whether the potential can be realized. A good development governance system creates an inclusive development-oriented vision in a participatory way, engaging all citizens. Effective political leadership designs policy frameworks and institutions to promote the prioritized development goals, whereas competent planning institutions and meritocratic bureaucracies provide the possibility to develop specific and effective policies. Accountability and transparency ensures that policies are indeed implemented and, if necessary, adapted to achieve the goals. With weak development governance, however, natural resource revenues are not sufficiently channelled into building human assets and addressing inequalities. Consequently, whereas countries on the first pathway successfully graduate from the LDC category, making progress towards the SDGs requires policy changes towards building human assets and diversifying their economies based on strengthened development governance.

A second pathway combines economic specialization (typically in tourism or in natural resources) with progress in human asset development. Countries on this pathway are small, as country size limits the options for economic diversification, even more so if the small country has abundant natural resources. Still, economic specialization can provide resources to build human assets and boost income so that inherent vulnerabilities can be mitigated to some extent. In some small countries, certain challenges stemming from size can be overcome by effectively linking with diasporas. However, channelling resources from economic specialization or diasporas into social sectors and productive capacities more general requires policies embedded in a good development governance system. Good development governance is also the foundation of sound macroeconomic and financial policies that are supportive of expanding productive capacities.

The basis of good development governance is political legitimacy. Experience of the countries on this pathway shows, however, that while political legitimacy also requires actions, it may partly be more of an accident of history and geography rather than the result of enlightened governance alone. At the same time, countries on the second pathway remain vulnerable to economic and environmental shocks. Consequently, these countries still face significant challenges for making progress towards sustainable development. As these vulnerabilities are largely structural, international support, particularly official development assistance (ODA), is crucial for countries on this pathway. The country cases demonstrate the critical role of country ownership in the coordination of donor support and in ensuring that external development finance is in line with the country's national development objectives and planning process.

The third pathway is characterized by investment in human assets and structural transformation away from low-productivity agriculture into higher-productivity manufacturing and modern services, leading to more diversified economies. Countries on this pathway typically have larger economies. The country cases reveal that rural development can be an important launching pad for gaining the momentum for growth, expanding productive capacity and promoting structural transformation. Productivity enhancing agricultural reforms and massive investment in rural development are the first step to consistent and higher-level economic growth. Land use and tenure reforms as well as public support to farmers through agricultural extension services and subsidizing inputs have often been successful. This, in turn, prompted sustained growth and the transfer of labour from agriculture to more modern sectors, more specifically services and manufacturing.

The experience of countries on this pathway demonstrate that a wide range of social, macroeconomic, financial and industrial policies can be effective. The wide range of successful policies underscores that there is a clear need for having space for policy experimentation. Many effective social policies focus on women. Examples include the deployment of health extension workers, emphasizing female agency for service delivery and utilizing non-government service providers. Macroeconomic and financial policies can steer investments into infrastructure development and key sectors both through incentives for private investors and more directly through institutions such as development banks. Similarly, both hard industrial policies (such as sector-specific tax incentives and export subsidies or export processing zones) and soft industrial policies that aim at raising investments in infrastructure, improving the coordination between public and private sector, and attracting foreign direct investments can be effective.

The lessons from countries on the third pathway also highlight the potential of international support in the area of trade. Preferential market access has been effective only for few countries, as their usefulness also depends on existing basic capabilities, favourable external market conditions and complementary domestic policies. Naturally, the importance of international policies and a supportive international framework goes beyond the provision of preferential market access and ODA. Global rules and the functioning of international monetary, financial and trading systems (including access to and transfer of technology) matter for building productive capacities and promoting of dynamic structural change in LDCs.

## Explanatory notes

The designations employed and the presentation of the material in this publication do not imply the expression of any opinion whatsoever on the part of the Secretariat of the United Nations concerning the legal status of any country, territory, city or area or of its authorities, or concerning the delimitation of its frontiers or boundaries.

The term “country” as used in the text also refers, as appropriate, to territories or areas.

The designations of country groups are intended solely for statistical or analytical convenience and do not necessarily express a judgment about the stage of development reached by a particular country or area in the development process.

The views expressed in this publication are those of the Committee for Development Policy and do not necessarily reflect the opinions and policies of the United Nations.

The following abbreviations have been used:

<b>CDP</b>	United Nations Committee for Development Policy
<b>DESA</b>	United Nations Department of Economic and Social Affairs
<b>ESCAP</b>	United Nations Economic and Social Commission for Asia and the Pacific
<b>EVI</b>	Economic Vulnerability Index
<b>FDI</b>	foreign direct investment
<b>GDP</b>	gross domestic product
<b>GNI</b>	gross national income
<b>GVC</b>	global value chain
<b>HAI</b>	Human Asset Index
<b>IMF</b>	International Monetary Fund
<b>LDCs</b>	least developed countries
<b>ODA</b>	official development assistance
<b>SDGs</b>	Sustainable Development Goals
<b>UNCTAD</b>	United Nations Conference on Trade and Development
<b>UN-OHRLS</b>	United Nations Office of the High Representative for the Least Developed Countries, Landlocked Developing Countries and Small Island Developing States

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# Expanding Productive Capacity: Lessons Learned from Graduating Least Developed Countries

## I. Introduction

The lack of productive capacity is generally seen as a major constraint for least developed countries (LDCs), and developing countries in general, to overcome their development challenges. The issue is the first priority area in the Istanbul Programme of Action for the Least Developed Countries 2011-2020<sup>1</sup> and is the subject of various reports by international organizations working on LDCs.<sup>2</sup> Expanding productive capacity is also reflected in the United Nations 2030 Agenda for Sustainable Development and the Sustainable Development Goals (SDGs).<sup>3</sup> SDG-8 (Promote sustained, inclusive and sustainable economic growth, full and productive employment and decent work for all) and SDG-9 (Build resilient infrastructure, promote inclusive and sustainable industrialization and foster innovation) are cases in point. In addition, meeting other SDGs and targets (such as those on education, health and nutrition, institutions and energy) also contributes to building productive capacity. At the same time, building up productive capacity will also have an impact on a series of SDGs and targets (such as those on gender equality, employment, income growth and natural resources). In particular, building productive capacity is closely linked to SDG-1 on eradicating poverty.

Economic development is largely the result of improved efficiency in the use of available resources through the reallocation of labour towards activities subject to economies of scale (Ocampo, 2005). Thus, developing countries need to address two challenges: the first has to do with the promotion of the dynamic structural transformation of the economy, and the second has to do with developing the necessary capabilities or having the appropriate framework or fundamentals (policy regimes, skills and institutional capacity, infrastructure) for sustaining productivity growth across the entire economy. While improvements in fundamentals do not

**1** *Report of the Fourth United Nations Conference on the Least Developed Countries, Istanbul, Turkey, 9–13 May 2011* (United Nations publication, Sales No. 11.II.A.1), chap. II.

**2** See, for example, UNCTAD (2006), UN-OHRLLS (2013) and ESCAP (2015).

**3** General Assembly resolution 70/1.

trigger structural change and its resulting growth acceleration, growth cannot be sustained if not supported by an appropriate policy framework (Rodrik, 2013).

The move towards the more dynamic activities, however, is largely determined by countries' production experience. As countries learn by doing—and what a country produces reflects what it knows—the accumulation of productive knowledge is often the result of structural transformation. The higher the productive diversification of a country, the more complex its economy, and the greater the amount of productive knowledge available in that economy. By the same token, the loss of production experience may have a cumulative negative impact on growth. Diversifying into sectors where productive knowledge is absent or incipient is very difficult. It is also costly and risky. However, to the extent that economic policies are able to address these challenges and affect the structure of production, comparative advantages can be created (Ocampo, 2005).

The process of eradicating poverty is intrinsically linked to building productive capacity. It is widely accepted that the most effective and sustainable way to eradicate poverty and achieve inclusive and sustainable development is to create decent and productive jobs—that is, jobs offering higher wages and better working conditions—for the millions of people joining the labour market every year. According to UNCTAD, “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” (UNCTAD, 2013, p. II). Decent and productive jobs, however, are not created automatically as a result of economic growth or structural change, as often assumed.

Indeed, for the past three decades, LDCs have been advised to focus on economic growth as a strategy for poverty reduction, economic diversification and sustainable development. At one level, this has been sound policy advice, since growth enables countries to accumulate wealth and generate the resources, especially capital, needed for investment in economic and social development. Over the years, however, it has become apparent that not all types of growth create decent and productive jobs at sufficient quantities to enable countries to eradicate poverty and achieve inclusive and sustainable development. Growth caused from expanded productive capacity, however, enables countries to produce an increasing range of higher value-added goods and services, thereby creating jobs that pay higher wages, and allowing countries to upgrade their skills base and improve their technological capability.

Whereas structural transformation and building productive capacity are important issues for all developing countries, LDCs clearly deserve

special attention. Production systems in LDCs are generally characterized by low technological intensity, undiversified economic structures, and limited dynamism towards productive sectors. Hence, LDCs, compared with other developing countries, have lower productive capacity as well as fewer resources and limited capabilities for expansion. Moreover, extreme poverty in LDCs is more pervasive than in other developing countries. For these reasons, focusing support in building productive capacities in LDCs is also a means of ensuring that no country is left behind, thereby contributing to implementing the 'Leaving no one behind' principle that is a crucial element of the 2030 Agenda for Sustainable Development.

Understanding productive capacity in the context of sustainable development requires a broad definition to be able to capture the important linkages between sustainable development issues. Following the work by UNCTAD<sup>4</sup>, this Policy Note defines productive capacity as the productive resources (natural, human, physical and financial), entrepreneurial and institutional capabilities, and production linkages which together determine the capacity of a country to increase production and to diversify its economy into higher productivity sectors for faster growth and sustainable development. Building productive capacity is not a purely economic issue, but requires an integrated approach covering a wide range of sustainable development issues and policies. Moreover, and in particular for LDCs, it depends not only on domestic but also on international action.

At the domestic level, key elements include building development governance capability, creating positive synergies between social outcomes and productive capacity, establishing conducive macro-economic and financial frameworks as well as industrial and sectoral policies promoting technological upgrading and structural transformation. The agricultural sector requires special attention in many LDCs in this regard.

Countries need to build governance capabilities that enable them to design and implement appropriate policies for sustainably dynamic structural transformation. This in turn requires having development vision and leadership, establishing meritocratic bureaucracies and a fruitful cooperation between the government and the private sector. In this process, the demand for specific governance capabilities is not static over time, but rather depends on the overall development status as well as on country specific endowments and local conditions.

There are major linkages between social outcomes and productive capacity. With appropriate policies, the educational, nutritional and health outcomes can be improved in ways that end deprivation, reduce inequality, and boost productive capacity. At the same time, increasing productive

4 UNCTAD (2006).

capacity also impacts on social outcomes. In many cases, these impacts are distributed unequally. Whereas some groups will experience better social outcomes (for example, improved employment status), others may be negatively affected (for example, as a result of displacement caused by large infrastructure projects). However, in many cases policy measures can mitigate negative feedbacks between productive capacity and social outcomes while supporting positive feedbacks.

Macroeconomic and financial policies of LDCs should promote equitable long-term economic growth, ensure macroeconomic stability, contribute to environmental sustainability and reduce within-country inequalities. The process of dynamic transformation does not imply a neglect of agriculture. On the contrary, sustainable intensification of agriculture not only contributes to food security while maintaining ecosystems services; it also supports the allocation of labour into other more productive sectors in the economies. Industrial policies can help to channel resources into dynamic sectors (including resource-based and services) that contribute to sustainable development and assist countries to integrate into the global economy. Such policies may be effective, in particular, if they are successful in attracting foreign direct investment (FDI), while at the same time developing local capabilities that promote technological upgrading and innovation.

Trade can be an important engine to expand productive capacities. First, exporting firms are in general more productive than firms that only cater to domestic markets. Hence, a better export performance can be expected to increase overall productivity of the economy. Moreover, in most LDCs the domestic market is too small to allow for economies of scale and move towards high productivity activities. Participation in international trade can also facilitate the transfer of much needed technology. Nevertheless, it is important to consider the integration into the global economy as a strategic component of the path to sustainable development rather than as an end in itself.

At the global level, international support for building productive capacity in LDCs has focused on their integration into the global economy through trade. The main instrument has been to provide LDCs with a range of trade preferences, in particular through duty-free and quota-free regimes. However, trade preferences work by increasing the demand for LDC products, but do not directly address the supply side constraints prevalent in many LDCs. Nevertheless, preferential market access regimes have been successful in increasing exports of LDCs, but the capacity to benefit from trade has been uneven within the group. Therefore, increased attention has been paid to Aid for Trade as an additional tool to build productive capacities

for trade in developing countries, in particular in LDCs. At the same time, little has been done to facilitate the transfer and access to technology and knowledge to LDCs to develop such productive capacities.

Naturally, the importance of international policies and a supportive international framework goes beyond the provision of preferential market access and official development assistance (ODA). Global rules and the functioning of international monetary, financial and trading systems (including access to and transfer of technology) matter for the building of productive capacities and the promotion of dynamic structural change in LDCs. In fact, UNCTAD argues that “[in] general, the global economic regimes are much more powerful than the special international support measures for LDCs” (UNCTAD, 2010, p. 50).<sup>5</sup>

In short, making progress towards achieving the SDGs requires implementing a range of mutually supportive policies aimed at building productive capacity and fostering structural transformation. However, whereas this link gets increasingly recognized, the question of what policy interventions are necessary for expanding productive capacity often remains unanswered. This report attempts to provide answers to this crucial question by reviewing the experiences of countries that have already graduated from the LDC category and those that are currently due for graduation.

In doing so, the Policy Note is cautious in establishing causal relationships between policies and results. Similarly, drawing lessons from the development experience of one set of countries to inform strategies in another clearly requires considerable caution. Therefore, the report will give due attention to country characteristics and external conditions that played a role in determining the suitability of chosen policies and strategies. In select cases, lessons will also be drawn from policy failures. By incorporating the development environment in the analysis of policies and strategies, the Policy Note also attempts to shed light on the extent to which identified policies are replicable in other countries. While some policies and strategies are universal or cover many LDCs, other policies and strategies are contingent on country specific characteristics. The question is what kinds of lessons in developing productive capacity can and cannot be drawn, and how can they be applied in different contexts. This is of particular importance in the context of LDCs which form a very heterogeneous group. In fact, the United Nations Committee for Development Policy (CDP)<sup>6</sup> has stressed the need to take LDC heterogeneity into account. It has also identified specific clusters of LDCs facing similar development constraints, which

**5** These issues have been extensively analysed by the CDP in United Nations, Economic and Social Council (2014) and Alonso and Ocampo, eds. (2015).

**6** See, for example, United Nations, Economic and Social Council (2010).

require differentiated, country-specific policy measures beyond traditional support to LDCs.<sup>7</sup>

The Policy Note is organized as follows. Chapter II presents the analytical framework used for reviewing the experiences of graduated and graduating countries in developing productive capacities and the lessons therefrom. In addition, the chapter identifies three alternative pathways to graduation from the LDC category, utilizing the close relationship between the process of expanding productive capacity and graduation. The first pathway is characterized by rapid economic growth based on natural resource exploitation, which ensures fast income growth but does not necessarily contribute to greater human assets and reduced vulnerabilities. The second pathway is characterized by economic specialization through shifts to a more dynamic sector and complemented by investments in human capital, which helps countries increase income and human assets, but not necessarily reduce vulnerabilities. The third pathway is characterized by a structural transformation that leads to more diversified economies and results in progress towards all three criteria used for identifying LDCs: increased per capita income, expanded human assets and reduced economic and environmental vulnerability.

On the basis of this classification of graduation pathways and the five broad policy areas noted above, chapter III will present key lessons learned from the experiences of select countries on these three pathways in developing productive capacity and the implications for graduation and economic transformation.<sup>8</sup> For comparative purposes, the range of countries selected includes two non-LDC developing countries that are still at an earlier stage of development but that do not face the types of structural impediments typically observed among LDCs. The lessons from these countries will help to affirm and/or reinforce the lessons learned from graduated and graduating LDCs. Finally, Chapter IV concludes.

<sup>7</sup> Cornia and Scognamillo (2016).

<sup>8</sup> A more comprehensive analysis of the experiences of the fourteen countries studied by the CDP is forthcoming, Committee for Development Policy Secretariat (2017).

## II. Analytical framework

### A. Expanding productive capacity for achieving the Sustainable Development Goals

The framework on expanding productive capacity for achieving the SDGs, developed by the CDP in 2016<sup>9</sup>, emphasizes the interlinkages between goals directly associated with productive capacity (Goal 8 and Goal 9)<sup>10</sup> and other SDGs and, consequently, stresses the need for an integrated approach that simultaneously considers social, economic and environmental objectives. Indeed, meeting many of the SDGs would require expanding productive capacity, upgrading technological capability, improving productivity, and creating more and better jobs. Thus, to achieve the SDGs in a balanced manner, countries will need to pursue a development strategy focused on the development of productive capacity.

The framework developed by the CDP understands productive capacity as: (1) productive resources (natural, human, physical and financial); (2) entrepreneurial and institutional capabilities; and (3) production linkages. All together, these determine the capacity of a country to increase production and to diversify its economy into higher productivity sectors for faster growth and sustainable development. For the purposes of analysis, this broad definition of productive capacity is useful for two reasons.

First, it is not only broad enough to incorporate all the elements that are essential for a country to build the competencies needed to produce a growing array of goods and services, but also sufficiently focused to identify priority areas for policy action. The three elements that characterize productive capacity are not simply given but are created and transformed over time. Even natural resources, which are a given, have no economic value until they are discovered and transformed through the application of a range of policies, capital and knowledge. In addition, the process of expanding productive capacity through improvements or progress in all three areas does not happen overnight. It takes time and most countries, especially LDCs, do not have the resources needed to expand all the competencies at the same time. Hence, the analytical framework applied in this Policy Note focuses more on the process (i.e., the process of expanding) rather than measuring the level of development of the productive capacity at a particular point. Moreover, the framework emphasizes that enhanced

**9** See United Nations, Economic and Social Council (2016), chap. II.

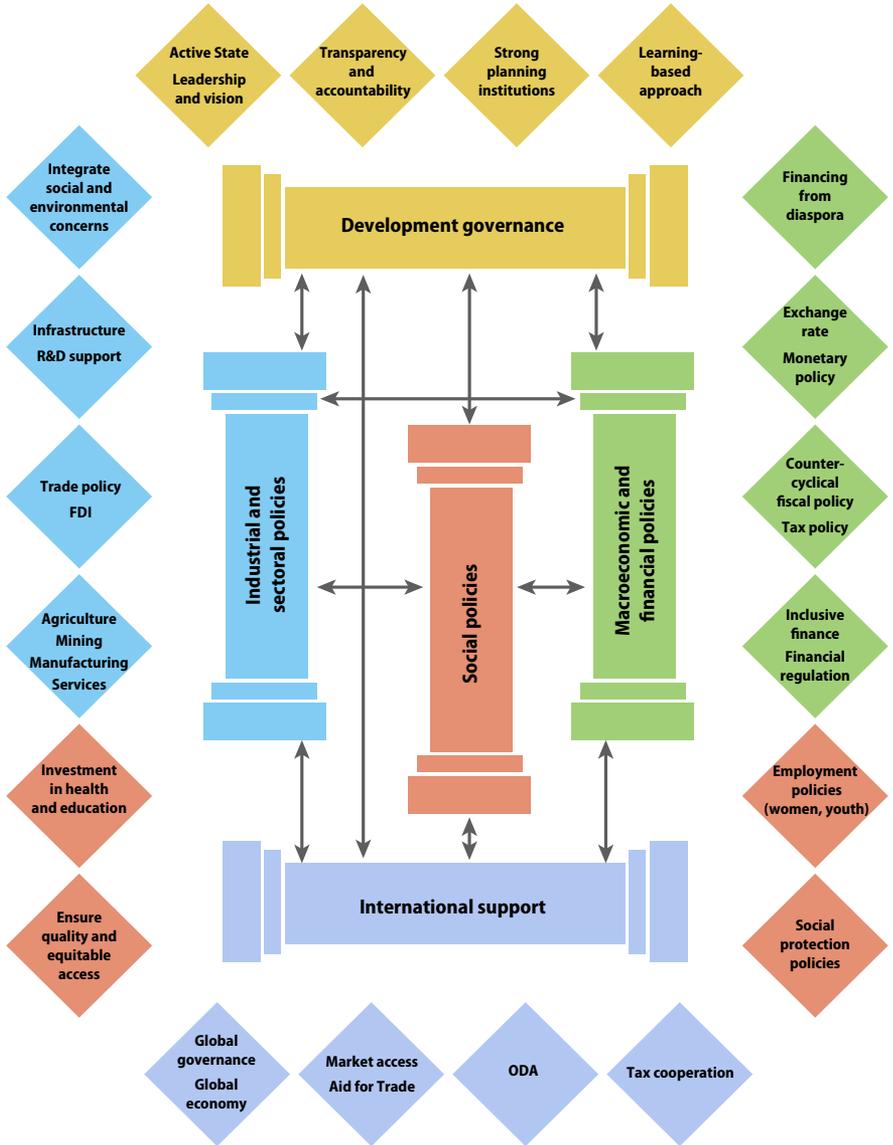
**10** SDG 8: Promote sustained, inclusive and sustainable economic growth, full and productive employment and decent work for all; SDG 9: Build resilient infrastructure, promote inclusive and sustainable industrialization and foster innovation.

productive capacity is not a stand-alone goal but rather a component of broader progress towards sustainable development.

Second, the broader understanding of productive capacity assigns greater importance to structural change and improvements in productivity. Structural change is a central feature of the process of developing productive capacity and moving economies into the right development trajectory. The challenge for LDCs is not that their economic structure is static. On the contrary, due to economic growth and improvements in productivity, the relative contribution of different sectors to gross domestic product (GDP) always changes. For example, in most LDCs, the share of agriculture to GDP is lower now than it was some three decades ago. The services sector, consisting of mainly low-productivity activities producing non-tradeable products, is the dominant sector in most LDCs. However, this form of structural change is qualitatively different from structural transformation, which depicts a shift towards a more diversified economy and the development of the capacity to produce higher-value, higher-productivity and increasingly more sophisticated goods and services, and to create jobs that pay decent wages. Central to this process is improvements in productivity which, along with the development of productive capacity, will create economic dynamism and enable the LDCs to redress their structural impediments.

While there are innumerable policy instruments that countries can utilize to develop their productive capacity depending on national specificities and priorities, the framework used in this Policy Note identifies five broad policy areas, four of them domestic and one international, that are considered critical for expanding productive capacity and enhancing the synergy between productive capacity and social and economic development. These are: (1) development governance; (2) social policy; (3) macroeconomic and financial policies; (4) industrial and sectoral policies; and (5) international support measures. Policies in all these five areas need to be pursued in an integrated manner in order to expand productive capacity in a way that signifies progress towards sustainable development. Figure 1 illustrates the framework.

Figure 1: CDP Framework on expanding productive capacity



### 1. *Development governance*

Good development governance includes the notion of a developmental State that enjoys both legitimacy and authority, and that implements an inclusive development-oriented vision through participatory, transparent and accountable mechanisms and institutions. Development governance goes beyond good governance by injecting a strong developmental dimension to the governance reform agenda. At the same time, it encompasses key elements of the good governance institutional reform agenda such as the importance of a participatory political system based on elections, predictable and transparent rules and policies, respect for rule of law and human rights, accountable public institutions especially in the collection and expenditure of public revenue, as well as a market-based and private sector-driven economic system. The concept of development governance explains why some governments are more successful in promoting development and achieving transformative growth than others.

Good development governance is concerned with getting the processes right and also with achieving specific developmental outcomes. It emanates from a State that “should seek to harness local, bottom up problem solving energies through stake holder involvement and citizen participation that creates and renews the micro-foundations of democratic practice. It includes modalities and mechanisms within a mixed economy model to nearness private enterprise, through public action, to achieve a national development vision” (UNCTAD, 2009, p.iv). Development governance relies on the authority of the State to promote development and to facilitate a sustainable dynamic transformation of the economy while ensuring that costs and benefits are fairly distributed. The role of the State is thus critical because it is the largest economic and political actor in most national economies and it is the institution that implements the business and legal framework for development.

Building development governance capacity requires, first of all, formulating a homegrown, inclusive and development-focused vision aimed at expanding productive capacity, creating productive employment, increasing national wealth, raising national living standards, protecting the environment and accelerating the structural transformation of the economy while ensuring a fair distribution of costs and benefits. It requires, moreover, a strong legitimate State managed by a political leadership that puts economic development at the top of the national policy agenda and that designs policies and institutions to promote the prioritized development goals. It requires, furthermore, developing powerful and accountable planning institutions, and meritocratic bureaucracies with broad education and knowledge, and the ability not only to formulate an appropriate mix of

policies but also to learn from failed policies. Finally, building development governance capacity requires ensuring citizens' participation in development and governance processes.

Building development governance with a strong developmental State will take time and requires an evolutionary approach. For LDCs, the main challenge is to build the kind of development governance that combines the basic principles of good governance but focuses on delivering developmental outcomes, including the development of productive capacity and the implementation of the SDGs. Aspiring in this direction will mean learning from the experiences of other developing countries that have successfully developed an effective development governance system and adjusting them to national conditions, as effective institutional setups cannot simply be transferred from other countries (in particular, not from advanced countries with very different development status and conditions). The experiences of countries that have already graduated or have made significant progress towards graduation are particularly relevant in this regard.

## 2. *Social policy*

Social policies are needed to ensure positive synergies between social outcomes and increases in productive capacities. Improved social outcomes can contribute to increasing productive capacity; and increased productive capacity can support improved social outcomes. Progress towards poverty eradication, health and well-being, quality education for all, reduced inequality, gender equality, and full and productive employment and decent work is necessary for expanding productive capacity, rather than objectives to be addressed after structural transformation has happened. This requires not only sufficient investments in services such as education, but also close attention to quality and access.

It also requires creating sufficient productive and remunerative employment opportunities across the entire population, in particular among the youth, women and disadvantaged groups, with productivity high enough to sustain incomes above the poverty line. Closing the gender gap in educational enrolment and attainment (through raising the enrolment and attainment of girls) is also important, because it tends to have a positive impact on economic growth besides improving social outcomes for women (Klasen and Lamanna, 2009). In addition to combating discrimination and segregation of labour markets and redistributing the unpaid care work that constrains women's participation in the labour market, policies need to be adopted to reduce the gender wage gap. Higher levels of educational attainment for women can also enhance the possibility of a country

benefiting further from the demographic dividend, in which economic growth can be potentially boosted by a fall in the dependency ratio as better educated and prepared women join the work force.

Improvements in nutrition and health are also important for increasing productive capacity. Better nourished and healthier workers have higher productivity; better nourished and healthier children learn more effectively. Therefore, policies are required to channel both public and private spending in ways to enhance nutrition and health outcomes. This requires public investments not only in efficient and equitable health systems, but also in water and sanitation; and in supporting small-scale food producers to increase their productivity and incomes.

Measures that directly increase the productive capacity of a country do not necessarily generate positive impacts for all; they may enhance income and social outcomes of some groups while compromising the livelihoods of others. Benefit-sharing approaches can ensure that potential trade-offs (e.g., between large-scale infrastructure and displacement of local populations) are addressed at the more local level, to ensure that compensatory measures are adopted that guarantee local communities benefit as well. Moreover, proceeds from increased production can also be used to finance social protection schemes and further investments in social sectors.

### ***3. Macroeconomic and financial policies***

Sound macroeconomic and financial policies are essential conditions for expanding productive capacity, promoting structural transformation and increasing the resilience of the economy to external shocks. These policies determine how countries mobilize the public and private resources needed to invest in productive capacity and human asset development. Through the central bank, interest rate policies can also influence the credit market and the ability of local enterprises to contribute to productive capacity building.

As LDCs are very heterogeneous, there is no universal package of macroeconomic policies for expanding production capacity. Yet, some broad principles may apply fairly generally (Rodrik, 2005). These should focus on maintaining acceptable macroeconomic balances, while orienting the key policy tools (interest rate, exchange rate and financial regulation) to capacity expansion, increasing resilience to external shocks and the prevention of internal economic crises. The volatility of growth and key relative prices (real interest rates and real exchange rates) hurts investment and long-term macroeconomic performance. Thus, macroeconomic stability is not only about low inflation and sustained fiscal deficits, but also about smooth business cycles, sustainable current account deficits, and healthy financial sector and private-sector balance sheets (Ocampo, 2005).

Given the relatively weak private sector in many LDCs, in the short- to medium-term, the investment push required to trigger social development, to expand productive capacity and to kick-start the growth process is likely to originate from the public sector. Moreover, in many LDCs, the public sector is a major purchaser of goods and services and, in smaller LDCs, the largest formal sector employer in the economy. Public investment in physical and social infrastructure also contributes to productive capacity building and generates opportunities for private sector development and linkages between enterprises.

However, in LDCs, public revenue accounts for only 10 per cent to 20 per cent of GDP, around half of the level in most other developing countries. Strengthening local capacity to mobilize resources through tax administration reforms and the application of appropriate fiscal policies is therefore a high priority for LDCs. This could reduce dependence on ODA, increase policy autonomy and provide the policy space and flexibility needed to make investment decisions based on national development priorities. However, even with higher revenue, most LDCs, especially the small island States, will continue to rely on FDI, ODA and remittances to finance the infrastructure, supplement household income and other investments needed to build productive capacity, diversify the economy and to achieve the SDGs. Obviously, fuel and mineral producing and exporting LDCs tend to have less of a financial constraint than other LDCs. For these groups of countries, fiscal rules and stabilization funds and prudent management of recovered revenue can help ensure that fiscal policy is counter-cyclical during both booms and crises and contribute to building productive capacity.

Another effective macroeconomic policy tool is the exchange rate. For countries in a position to manage their exchange rate (for example, countries that are not members of a currency union), maintaining a stable and competitive real exchange rate can become an important policy tool. In the area of financial policies, access to finance by the poor and marginalized, agricultural finance, small and medium enterprise financing and infrastructure financing are most pressing. Hence, improving financial regulation and supervision as well as enhancing the role of inclusive finance vehicles and integrating them in the financial sector are critical policy interventions for most LDCs.

#### **4. Industrial and sectoral policies**

The experience of developed economies has shown that productive capacity building and structural transformation do not occur automatically, but rather require proactive policy action to address some of the structural

impediments and obstacles that make it difficult to shift production to new and more dynamic sectors. Industrial policies cover a range of incentives and policy instruments that are designed to direct resources (capital and labour), and to encourage potential entrepreneurs, domestic or foreign, to move from lower- to higher-value and higher-productivity sectors and activities. Therefore, they can be important instruments for economic diversification and technological upgrading. However, to be effective, they need to be tailored to national conditions and potential comparative advantages. Furthermore, effectiveness requires recognizing the need for proper policy sequencing and striking the right balance in policy choices and implementation. Issues such as the intensity of current exploitation of natural resources and implications for future generation and sustainability, the balance between import-substitution and export-focused development and the balance between investing in rural development and other sectoral priorities are all elements that will have to be considered in designing and implementing industrial and sectoral policies.

Furthermore, different sectors and activities have very different levels of productivity, and varying potential for employment creation, value addition, investment, innovation, economies of scale, as well as different impacts on the environment. Thus, the selection of sectors for targeted policy intervention and the balance between sectors and between activities within sectors, have implications for the kinds of policies that governments use to steer investment into the right direction. Generally, the sectors need to exhibit localized industry-level knowledge spillovers and input-output linkages, giving rise to a geographic agglomeration of industries. The country also needs to have a latent or dynamic comparative advantage in the sector. Moreover, the benefits from industrial policies must outweigh the costs in terms of government expenditures or foregone revenue, requiring that the dynamic forces which increase productivity realize quickly. While these requirements are valid for all countries, the latter point may be particularly important for LDCs given the scarcity of government resources in most of them and the high competing demand for government expenditures in other sectors.

As policy instruments, countries can use both hard industrial policies such as tariffs, tax incentives, export subsidies, local content requirements or export processing zones as well as soft industrial policies that aim more at increasing the cooperation within the private sector and between private sector and the State, for example in the form of investments in basic infrastructure, vocational training aimed at specific skills, and leveraging ODA for productive investment.

Foreign direct investment can be a key vehicle for productive capacity building and structural transformation, but investment promotion

policies need to ensure that investments generate technology transfer and employment. For FDI promotion to be effective, it should be part of a broader effort to achieve technological upgrading rather than be pursued in isolation (Harrison and Rodríguez-Clare, 2010). As Chandra and Kolavalli (2006, p. 19) have put it, “without host-country policies to develop local capabilities, multinational company-led exports are likely to remain technologically stagnant, leaving developing countries unable to progress beyond the assembly of imported components.” Similarly, participation in global value chains (GVCs) is no panacea; patterns of GVC insertion matter. That is, the capture of value added within the chain, including product development, design, branding and marketing, depends on strategies that promote the creation of domestic capabilities, support innovation and technological upgrading (Lee and Mathews, 2013).

Generally, industrial policies need to be part of a broader effort to achieve industrial and technological upgrading, while ensuring social and environmental protection. Successful industrial policies are those that are designed in coordination with and complementing science, technology and innovation policies. Knowledge generation and dissemination must be critical features of industrial policy. This is particularly so in the LDCs where a mismatch is often observed between skill formation and job opportunities in knowledge intensive activities.

In most LDCs, agriculture can be the basis for developing downstream industries, such as food processing, geared mainly to domestic and regional markets, but also global markets. Unfortunately, agriculture has been neglected in many LDCs, so improving agricultural productivity by increasing investments in sustainable agriculture, comprehensive use of extension services, scaling-up research and removing gendered constraints will be essential. Light manufacturing remains a promising sector for a number of LDCs, not least owing to preferential market access in many developed and major developing countries. For other LDCs, natural resource-based industries are important entry points for structural transformation that goes beyond the simple extraction and export of mineral products. Among services, tourism has been critical for many LDCs in expanding economic activities and as a driver of growth, but often with very limited forward and backward linkages to other sectors.

## **5. *International support measures***

Building productive capacities in LDCs depends not only on domestic policies, but to a large extent also on international policies and support measures specifically aimed at LDCs. Existing international support measures for LDCs encompass a range of measures and commitments across

the fields of development aid, trade, technology and technical assistance. For small economies within the LDC category, the role of ODA is critical and when managed prudently, it could be an effective tool for financing social development, raising income, financing infrastructure development and supplementing gaps in public revenue.

Preferential market access based on lower tariffs and the duty-free-quota-free arrangement is a major international support measure available to LDCs. The main thrust of international support to LDCs in this regard has been to offset the higher production and trade costs associated with their limited productive capacity and structural and geographical disadvantages, thereby increasing the global demand for products produced in LDCs despite their limited domestic markets. A total of 22 countries offer preferential market access opportunities to LDCs, although with varying degrees of product coverage.

Preferential market access has been successful, but benefits are concentrated in a few LDCs that have developed the capacity to export low-productivity manufacturing goods. Generally, the utilization of the preferences available to LDCs has been limited by supply-side constraints, trade policy-related obstacles (for example, stringent rules of origin, low preference margins, limited product coverage and non-tariff measures) and lack of awareness. In this respect, Aid for Trade has strong potential to become aid for innovation and to increase supply capacity through infrastructure-building, enhancing firm productivity and trade policy reforms in LDCs. However, Aid for Trade needs to be better targeted to LDCs and to consider their impact on trade as well as on inequality.

As an additional element, international support is also needed in the area of tax cooperation as illicit flows and tax evasion are often linked to trade and investment flows, in particular those related to natural resources.

## **B. Graduation pathways**

A key feature of LDCs as a group is that the countries vary with regard to economic structure and external conditions. Given the heterogeneity of LDCs, one-size-fits-all policies in the five policy areas discussed above are unlikely to yield benefits for all. At the same time, different LDCs often share key characteristics, so that considering groups of LDCs together can facilitate the process of identifying shared experiences and lessons learned in developing productive capacities. As the focus is on countries that have graduated or are graduating from the LDC category, the countries considered for this Policy Note are grouped according to their pathways towards graduation.

The graduation of LDCs from the LDC category is determined by their social and economic performance and progress towards the three graduation criteria defined by the CDP: income (measured by gross national income (GNI) per capita), low human asset base (measured by a set of social development indicators through the human asset index (HAI)), and vulnerability to economic and environmental shocks (measured by a set of indicators reflecting impact of and exposure to natural and economic shocks through the economic vulnerability index (EVI)).<sup>11</sup> A country may be recommended by the CDP for graduation if it passes the graduation thresholds for at least two criteria in two consecutive triennial reviews. As an alternative, a country may also be recommended if its income passes an income-only threshold (which is twice the normal income threshold) in two consecutive reviews, even if its human assets remain low and its vulnerability to economic and environmental shocks high. The CDP believes that such countries could overcome their impediments primarily by relying on their own means. Graduation and productive capacity are closely linked, as developing productive capacity enhances the potential for LDCs to meet the criteria necessary to graduate from the category. Appendix A contains a closer discussion on the nexus between graduation and expanding productive capacity, highlighting both commonalities and differences.

Based on the experiences of recently graduated countries, as well as LDCs that have made significant progress in recent years towards meeting the graduation criteria, we can distinguish at least three different pathways towards graduation from the LDC category. To a large extent, the graduation processes in the different pathways are influenced by the pattern and level of development of productive capacity for sustainable development.

The first pathway involves rapid economic growth through exploitation of natural resources, which often does not require broad investments in human assets. This path entails structural change away from agriculture into mostly other primary activities. In terms of the LDC criteria, this path will be reflected in rapidly increasing GNI per capita, very limited progress in terms of HAI and increasing or constantly high EVI scores. LDCs graduating through this pathway usually do so without undergoing structural transformation as defined in this report. Angola (scheduled for graduation in 2021) and Equatorial Guinea (graduated in June 2017) are the two focus countries representing this pathway.

In the second pathway, graduation is driven by investment in human assets and economic specialization in a single sector or a few economic activities within a particular sector. Graduation through progress

**11** See United Nations CDP and United Nations DESA (2015) for details.

in human asset development and economic specialization implies that the country has begun to lay down the foundations of the policy and investment conditions necessary for expanding productive capacity for sustainable development. It is possible, however, that the changes in the structure of the economy reflect a shift in the relative importance of different sectors and changes in employment patterns rather than the beginnings of a structural transformation process. This pathway will lead to increasing GNI per capita and HAI, while EVI scores will remain elevated. The pathway is represented by seven countries: The first four countries that have graduated (Botswana, Cabo Verde, Maldives and Samoa), Vanuatu (scheduled to graduate in 2020) and two of the six countries that will be considered for graduation in 2018, Bhutan and the Solomon Islands. Whereas Botswana, Bhutan and, to some extent, the Solomon Islands specialized in natural resources, tourism has been a main driver in the other three countries.

The third pathway, like the second pathway, is characterized by investment in human assets and structural transformation away from low-productivity agriculture into higher-productivity manufacturing and modern services, leading to more diversified economies. In terms of the LDC criteria, under this pathway, countries typically experience (gradually) increasing GNI per capita and HAI scores and, possibly after a transitional stage, decreasing EVI scores. This can be seen as the desirable path to graduation, as it ensures a sustainable transformation as well as progress towards sustainable development. In this sense, building productive capacity for sustainable development creates an ideal and sustainable environment for graduation from the LDC category, even though the process can be lengthy. Bangladesh, Ethiopia and Rwanda represent this third pathway in view of their traditional approach to structural transformation through improvements in agricultural productivity and a shift towards light manufacturing and modern services while building human assets. Finally, two non-LDCs that shared key characteristics with LDCs in the past, Ghana and Viet Nam, are considered for comparative purposes.

Table 1 presents key indicators on LDC graduation and productive capacity of the focus countries related to policy areas discussed in chapter II.

The three pathways are likely to differ with regard to graduation timeframes, though obviously starting positions and exogenous country characteristics play an important role. Graduation through rapid natural resource exploitation is normally the fastest route to graduation, whereas the third pathway with economic diversification and structural transformation is the slowest. Most importantly, for most LDCs the graduation path is not a choice variable. Small, remote countries may lack the opportunities to build productive capacities for economic diversification, so specialization may be the only viable option. The discovery of natural resources almost

always will lead to their exploitation, so the key question is how to manage the proceeds in order to use them in a way that supports a sustainable transformation of the economy that harnesses social synergies, safeguards the environment and leads to economic diversification.

Grouping LDCs by graduation pathways is obviously not the only possibility for analysing experiences in expanding productive capacities in LDCs. As noted in the introduction, Cornia and Scognamiglio (2016) categorize the current LDCs into six different clusters, with the five graduated countries as comparator group. Two clusters are based on non-economic prior dominant criteria, namely, “being at war” and “smallness” (population less than one million inhabitants). The remaining four clusters are determined depending on the sectors (agricultural, mining, manufacturing and services) that exhibit an increase in share of GDP over the past twenty years. Of the seven focus countries that are currently LDCs, three are in the small country cluster (Bhutan, Solomon Islands and Vanuatu). Unsurprisingly, they are on the second pathway, as economic specialization is a response to their small size. The other four focus countries cover the oil and mining cluster (Angola), manufacturing cluster (Bangladesh) and services cluster (Ethiopia and Rwanda). Armed conflict clearly prevents progress towards sustainable development, so it not surprising that no focus country is in the “at war” cluster. Similarly, structural transformation includes a shift in economic activities away from agriculture, so that no country in the agricultural cluster has made sufficient progress towards graduation to be included as one of the focus countries.

**Table 1: Key indicators on least developed country graduation and expanding productive capacity**

		Angola	Equatorial Guinea	Bhutan	Botswana	Cabo Verde	Maldives	Samoa	Solomon Islands
LDC criteria (2017)	Per capita GNI (in US Dollars)	5,186	13,275	2,385	7,000	3,407	7,260	4,079	1,805
	HAI	46.7	58.1	75.1	80.5	91.0	90.5	94.1	72.8
	EVI	37.1	28.4	36.2	44.9	36.3	59.6	39.1	52.2
Health	Life expectancy	52.3	57.6	69.5	64.4	73.1	76.8	73.5	67.9
Education	Mean years of schooling	4.9	7.0	4.2	6.3	4.5	5.9	11.5	7.0
Poverty	Poverty rate (\$1.90 per day)	30.1	n/a	2.2	18.2	8.1	7.3	0.8	45.6
	Access to water	49.0	47.9	100	96.2	91.7	98.6	99.0	80.8
	Access to electricity	37.0	66.0	75.6	53.2	70.6	100	100	22.8
Inequality	Gini coefficient (net)	45.8	n/a	38.9	50.3	49.9	37.6	n/a	n/a
	Female labour participation	63.5	80.7	66.9	71.9	51.9	56.6	23.7	53.4
	Gender parity index (sec.)	0.65	0.72	1.07	1.06	1.14	1.13	1.12	0.94
Governance	Government effectiveness	-1.12	-1.49	0.36	0.43	0.11	-0.35	0.32	-0.97
Investment	Investment rate (% of GDP)	23.3	38.2	53.5	31.6	31.4	20.0	9.0	20.1
Energy	Per capita energy use	27.6	105.6	82.2	37.8	17.7	42.6	22.6	11.1
	Share in renewable electricity	70.9	12.2	100	0.2	15.2	0	30.7	0
ICT	Mobile telephones per 1,000	63.5	66.4	82.1	167.3	121.8	189.4	55.5	65.8
Agriculture	Cereal yield	8.8	n/a	10.3	8.2	705	10.2	n/a	10.5
	Agricultural labour productivity	7.7	7.5	6.9	7.2	7.6	8.2	n/a	7.22
Structural change	Share of agriculture in GDP	7.1	1.2	17.3	2.4	9.4	3.4	9.4	28.3
	Share of agriculture in employment	46.9	24.3	56.3	22.3	34.5	13.9	n/a	67.1
	Share of manufacturing in GDP	4.8	19.4	8.8	6.3	6.5	4.9	10.2	8.4
	Long term GDP growth rate	6.6	17.1	7.4	4.6	5.7	7.1	3.0	3.1
	Marginal capital efficiency	0.15	-0.14	0.08	0.14	0.04	0.24	0.19	0.18
Demographic	Total fertility rate	6.08	4.84	2.03	2.84	2.30	2.12	4.09	4.0
	Urbanization rate	44.1	39.9	38.6	57.4	65.5	45.5	19.1	22.3
Diaspora	Remittances (% of GNI)	0.01	n/a	0.78	0.25	10.83	0.11	19.5	1.7
International flows	FDI inflows (% of GDP)	1.62	2.47	1.61	2.89	5.63	11.04	2.65	3.2
	Share of exports in GDP	42.3	66.4	37.3	58.0	39.2	104.6	32.3	52.3

*(continued)*

Table 1 (continued)

Vanuatu	Bangladesh	Ethiopia	Rwanda	LDCs - median	Ghana	Viet Nam	Non-LDCs - median		
3,039	1,087	368	686	841	1,585	1,843	6,267	Per capita GNI (in US Dollar)	LDC criteria (2017)
80.6	68.7	48.4	58.9	55.2	74.5	88.2	91.0	HAI	
48.3	25.1	32.2	37.2	37.2	34.3	30.1	28.9	EVI	
71.9	71.6	64.0	64.0	62.0	61.3	75.6	73.4	Life expectancy	Health
8.1	4.5	3.3	4.5	4.4	7.0	8.6	9.0	Mean years of schooling	Education
15.4	18.5	33.5	60.4	44.5	25.2	3.1	5.7	Poverty rate (\$1.90 per day)	Poverty
94.5	86.9	57.3	76.1	75.6	88.7	97.6	95.1	Access to water	
27.1	59.6	26.6	18.0	31.3	64.1	99.0	97.7	Access to electricity	
n/a	40.4	30.6	49.4	38.8	37.3	37.9	40.9	Gini coefficient (net)	Inequality
61.5	57.6	78.3	86.2	66.9	67.5	73.2	51.1	Female labour participation	
1.00	1.08	0.91	1.10	0.89	0.95	0.90	1.02	Gender parity index (sec.)	
-0.51	-0.77	-0.56	-0.01	-0.97	-0.21	-0.08	-0.14	Government effectiveness	Governance
25.8	28.6	37.1	26.3	25.4	26.4	27.1	25.0	Investment rate (% of GDP)	Investment
10.8	10.2	14.7	8.4	12.3	12.0	28.8	42.6	Per capita energy use	Energy
15.3	1.8	99.7	41.7	34.1	65.3	43.1	12.2	Share in renewable electricity	
60.4	80.0	31.6	61.0	64.8	114.8	147.1	111.1	Mobile telephones per 1,000	ICT
8.7	10.7	9.9	10.0	9.6	9.7	10.9	10.2	Cereal yield	Agriculture
n/a	6.18	5.70	5.80	6.23	7.29	6.30	8.11	Agricultural labour productivity	
26.8	16.0	42.1	34.9	25.3	21.0	19.5	7.6	Share of agriculture in GDP	
n/a	44.1	72.7	76.3	63.1	44.7	46.8	21.2	Share of agriculture in employment	Structural change
3.5	17.4	4.1	5.2	8.3	5.0	14.9	12.4	Share of manufacturing in GDP	
2.9	5.6	7.6	6.8	4.3	5.7	6.9	3.7	Long term GDP growth rate	
0.04	0.23	0.22	0.26	0.18	0.20	0.19	0.15	Marginal capital efficiency	
3.35	2.2	4.4	3.9	4.6	4.2	2.0	2.3	Total fertility rate	Demographic
26.1	34.3	19.5	28.8	34.9	54.0	33.6	60.2	Urbanization rate	Diaspora
3.22	8.6	1.1	1.8	3.0	7.5	6.6	2.1	Remittances (% of GNI)	
4.40	1.6	3.1	3.7	2.9	8.0	5.4	3.0	FDI inflows (% of GDP)	
48.4	18.6	11.3	14.6	25.3	39.3	86.6	39.2	Share of exports in GDP	International flows

Sources: CDP Secretariat. Data value is latest available year. See appendix B for original data sources.

## II. Learning from the experiences of graduated and graduating least developed countries and non-LDC developing economies

### A. Pathway I: Rapid growth through natural resource exploitation: Angola and Equatorial Guinea

The first pathway refers to the two countries, Angola and Equatorial Guinea, that have met the income-only criteria for graduation through rapid growth of their GNI per capita income, driven largely by exploitation of natural resources. Both countries have not yet reached the human asset and economic vulnerability thresholds. The key message and the most important lesson emerging from the development experiences of these countries is that failure to use policies in a transparent and strategic manner and through accountable governance systems leaves countries with an economic structure which scores high in GNI per capita income, but low in social development and economic diversification, despite generating sufficient resources to expand their productive capacity without needing special international support measures. Their experience demonstrates that it is possible to meet the graduation threshold without necessarily expanding productive capacity or undergoing meaningful social and economic transformation.

#### *Pitfalls of natural resources as a source for development*

While graduation from the LDC category in itself is a positive development, doing so without laying the foundations for building productive capacity and achieving progress in human asset development and economic diversification poses its own challenges. In particular, it would hinder post-graduation efforts to continue with inclusive economic growth and development, including in the context of the 2030 Agenda for Sustainable Development.

Both countries depend on oil exports, which account for more than 90 per cent of exports earnings. In fact, Equatorial Guinea can almost be characterized as an oil-only economy, as the share of mining in total value added is almost 90 per cent, whereas in Angola, the share is only 30 per cent. Until the recent decline in oil prices, the resource gap of oil-exporting LDCs such as Angola and Equatorial Guinea had been positive, implying that their savings rate has been higher than their investment rate.

Thus, financing social services, developing adequate infrastructure through public investment, and expanding the knowledge-base and institutions needed to diversify the economy should have been relatively easy. However, the lack of progress in HAI and EVI indicates that having financing capacity may be necessary but it is not by itself a sufficient condition for registering meaningful progress towards the human asset development and the expansion of productive capacity, which are essential for structural transformation and creating a diversified economy.

As is typical for many oil exporters, governance structures in both Angola and Equatorial Guinea tend to be characterized by low transparency, which in turn contributes to low accountability in public expenditure, high inequality, and the concentration of power and resources to a few individuals and groups. Both countries have planning instruments which give high prominence to health and education,<sup>12</sup> understandably so given the poor status of human assets in both economies. Both countries also give priority to economic diversification and the need to reduce excessive reliance on oil production and exports. However, evidence indicates that public investment in both countries has been directed more towards mega infrastructure projects than the social sectors such as education and health. Although investment in infrastructure is a key element in promoting diversification, the relative neglect of the planned investment in social sectors indicates the low level of accountability and transparency in the governance system of the two countries.

### *Dealing with commodity price volatility*

The imbalance of public spending has been exacerbated by the recent decline in oil prices. Angola and Equatorial Guinea responded to the decline in public revenues by reducing social expenditures relatively more than reducing infrastructure spending, despite the poor status of human assets. It demonstrates that low transparency is a key constraint to effectively harnessing natural resource revenues for building productive capacity for sustainable development. First, low transparency reduces the share of resource revenues that is available for public investments, though a substantial amount can still be undertaken. Second, low transparency skews the allocation of public resources away from social sector investments. In the case of Equatorial Guinea, the problem is exacerbated by fiscal rules. The country follows a variant of the non-resource current budget balance rule, investing resource wealth exclusively in physical assets with a view to foster economic diversification. However, while beneficial in many circumstances,

<sup>12</sup> Angola's Vision 2025 and its National Development Plan 2013-2017; Equatorial Guinea's National Economic and Social Development Plan (NESDP) 2008-2020.

the rule implies underinvestment in human assets if almost all fiscal revenue originates from resource rent.

Maintaining a development-oriented, stable macroeconomic policy regime is inherently difficult for natural resource-dependent economies, given the volatility of global commodity markets. In this regard, resource-rich LDCs will be better-off following the Solow-Hartwick sustainability rule of non-declining total wealth, which requires successful recovery and reinvestment of the resource rent<sup>13</sup>. While recovery of the resource rent is a necessary precondition, it is not sufficient to ensure sustainability unless a part of it is reinvested in alternative forms of capital to ensure long-term non-declining consumption, thereby providing future generations with at least the same level of employment and income opportunities lost due to exploitation of non-renewable natural assets. The experience of Angola shows that it is feasible for LDCs to devise production sharing agreements between private operators and a State-owned company that ensure a significant share of revenues is channelled to the State.

However, while other countries with considerable natural resource exploitation such as Bhutan and Botswana demonstrate that LDCs can, in principle, channel natural resource revenues into expanding productive capacities for sustainable development if backed by appropriate development governance institutions, Angola and Equatorial Guinea demonstrate the difficulty of appropriately investing resources. Establishment of stabilization funds from the proceeds of exploiting natural resource and introducing fiscal rules that guide spending patterns are ways that the reinvestment of recovered resource rent could be managed.<sup>14</sup> The experience of both Angola and Equatorial Guinea show that creating stabilization funds is insufficient if these funds are not well governed. As a consequence of the failure to establish a credible fiscal stabilization programme and fiscal rules, neither the Angolan nor the Equatorial Guinean Governments were adequately equipped to face the effects of a prolonged reduction in oil prices, including fiscal and current account deficits, which began in 2013 and has not been reversed since.

Overall, in LDCs on this pathway, macroeconomic and fiscal policies tend to be less stable, manifesting the excessive exposure of the economy to erratic and externally determined price changes. Moreover, the dependence on the extraction and exports of primary products, in particular, oil, tends to reduce the urgency for economic diversification and, consequently, reinforce dependence on primary commodities. This political-economy effect is

**13** See Hartwick (1977) and Solow (1986).

**14** Botswana's Sustainable Budget Index (SBI) monitors the extent to which the revenue from liquidating mineral resources is used to fund current government consumption expenditure and provides one good rule and fiscal policy practice for prudent management of the resource rent.

in addition to the development governance channel and the traditional “Dutch disease” effect due to domestic price distortions. Generally, it should be acknowledged that the options for effective application of industrial and sectoral policies in these countries are, in practice, often limited. However, despite the limitations, the financial resources generated from natural resources provide opportunities for expanding productive capacity through investment in human asset development and the promotion of intersectoral linkages, especially between agriculture and industry. Angola and Equatorial Guinea rely on imports of agricultural products, including food, while they have the potential, particularly in Angola, to improve agricultural productivity, create food security and maintain competitiveness by making wage goods cheap. Lack of transparency in public investment decisions, along with lack of a clear development vision backed by effective institutions, prioritization in sectoral policies and consistency in the implementation of planned investments are some of the factors that contributed to the mismatch between resource endowment and poor performance in productive capacity building.

In fact, the main negative impact of excessive dependence on exploitation of natural resources tends to be that it reinforces the non-transparent governance structure and lack of accountability in the management of resource rent. Low level of transparency tends to create a misalignment in allocation of public expenditure between sectors that are identified as priority areas (for example, social sectors) and those where the actual public investment takes place, often consisting of mega infrastructure projects. An important lesson for other LDCs that are resource-rich is to build a system of good governance combined with a planning process designed to match resources with social and productive sector public investments and to monitor implementation regularly. Both Angola and Equatorial Guinea demonstrate that it is possible for an LDC to reach the income level necessary for graduation with limited progress in both human assets and reduction of economic vulnerability and without laying the foundations for expanding productive capacity and structural transformation.

The important lesson for LDCs, where growth is based on an extractive sector that operates essentially as an enclave, is that graduation without effectively using the resource rent to support a deeper and more broad-based development process may provide a very weak basis for post-graduation development. At the same time, graduation in itself does not provide for any specific constraints for the development progress. As oil faces zero tariffs on most markets and oil-rich countries typically do not receive ODA due to their less constrained financial situation, graduation does not lead to a reduction of international support.

## **B. Pathway II: Graduation through building human assets and economic specialization: Bhutan, Botswana, Cabo Verde, Maldives, Samoa, Solomon Islands and Vanuatu**

The second pathway covers four countries that have graduated to date (Botswana, Cabo Verde, Maldives and Samoa) and three that have made significant progress towards graduation through economic specialization and improvements in human assets (Bhutan, Solomon Islands and Vanuatu). The seven countries specialize in natural resource-based activities (mining, hydropower generation or forestry) or in tourism. Notably, none of these countries has a sizeable manufacturing sector. Essentially all of them are small countries with fewer than 1 million inhabitants, with the exception of Botswana with a population of more than 2.2 million. Though resource endowments are important for Botswana (a leading diamond exporter) and Bhutan (a hydropower exporter to neighbouring India), the graduation and progress towards graduation of these seven countries were, to a large extent, the results of deliberate and concrete actions taken by their Governments to lay the foundations for building productive capacity and structural transformation. They utilized, in varying degrees, policies, incentives and planning techniques to direct investment into the social sector, in particular education and health. They maintained macroeconomic stability and leveraged financial resources such as FDI, ODA, remittances and domestic capital and labour for productive investment. More importantly, they created the institutions and regulations necessary for good development governance and ensured that their natural endowment or comparative advantages contribute to a broad based and inclusive sustainable development. Vulnerability to economic and environmental shocks in all seven countries remains high and inequalities within their societies persist. Therefore, these countries still face development challenges. Nevertheless, they set good examples for other LDCs on how progress towards expanding productive capacity can be attained with the prudent and strategic application of policies and improvements in development governance.

### ***Homegrown development governance models***

A key element of their development progress was the quality of good development governance, in some cases complemented by traditional and customary laws, and supported by concerted efforts in institution building and the maintenance (or reestablishment, in the case of Solomon Islands) of peace and political stability. The lesson for other LDCs is that

good development governance is not a given but needs to be developed through proactive policies aimed at building institutions, employing an inclusive approach to policy design and implementation and introducing rules and regulations that instil transparency and accountability in public administration and budget allocation. An important element in this has been the strengthening of State legitimacy based on a national vision designed to generate and reinforce national identity. This approach to good development governance is particularly relevant for LDCs where State legitimacy is often in question because of ethnic and geographical diversity. The perception that the State is acting broadly in the long-term interests of various disparate groups, even if short-term events might be against the immediate interests of one or more of these groups, can help ensure consent for difficult policy decisions. The need to disagree and consent, or at least to tolerate government actions for the greater good, has been an essential characteristic of most successful countries.

Interestingly, whereas development governance in all seven countries has been key to development progress, institutions and policies differ quite substantially. This underscores the importance of homegrown governance structures tailored to local conditions. In Botswana, State-building had to be done in its entirety upon independence. In a predominantly hunter-gatherer agropastoralist society, it fell to the State to drive the modernization agenda and map out how the transformation to modernity and higher levels of productivity would proceed under limited resources. A key element in building development governance was the rapid development of local expertise and competencies (Selolwane, 2004), enabling the country to develop negotiation skills within the bureaucracy to ensure that the proceeds of natural resources exploitation accrue to the State rather than foreign investors. Cabo Verde built upon existing governance structures during a smooth and peaceful transition from colonial rule and built a democratic, transparent and participatory political system after independence. Participation and representation contributed to formulating a shared vision of development that has been carried across changes in Government. The Pacific Island States have tried, with success particularly in Samoa and in Vanuatu,<sup>15</sup> to blend a traditional and customary law-based governance system with modern constitutional democracy to create a governance structure that delivers on social and economic development. Bhutan demonstrates how an inspiring national vision (gross national happiness) can help create a common national identity and to rally all citizens around mutually accepted national development objectives and goals and enhance accountability and transparency in the governance structure.

<sup>15</sup> Agaiva (2014); Gay (2009).

This development governance framework enabled the countries in this pathway to allocate significant resources in human asset development, mainly in education but also in the health sector. Countries typically gave priority to education early in the development process, leading, for example, to a rapid increase in school enrolment and completion rates particularly in Botswana, Cabo Verde and the Maldives. Social policies often had multiple objectives, beyond the overall goal of providing social protection. Botswana's social policy also had the objective to build national cohesiveness, stability and peace by distributing wealth as evenly as possible across various ethnic and racial groups. Education clearly had an effect on reducing ethnic inequality, but inequality in income and quality of life still remains high. Similar problems of persistent social inequities are faced by other countries on this pathway, such as Maldives and Vanuatu. Another key objective of social policy in Botswana was facilitating economic growth and employment. However, there are now more qualified and educated people than the labour market is able to absorb, which can be seen as a result of the gap between the Government's successful social policy, on the one hand, and the slow process of economic diversification on the other.

In all seven countries, good development governance also supported the adoption of prudent macroeconomic and fiscal policy frameworks. Fiscal policies have been the main instrument, as the scope for using the exchange rate or other monetary policy instruments as policy tools is limited for small economies following pathway II. Bhutan and Botswana show that negotiating smartly and strategically pays by enabling the country to retain more of the resource rent generated from the exploitation of its natural resources. By establishing transparent and accountable institutions, countries can also make progress towards sustainable use of natural resources. Botswana used the Sustainable Budget Index, defined as the ratio of non-investment spending to non-mineral revenues, to monitor the extent to which the revenues from liquidating mineral resources are used to fund current government expenditure. Thereby, spending patterns broadly adhere to the Solow-Hartwick sustainability rule where the depletion of natural resources is compensated by reinvestment of the recovered revenue in other forms of capital that generate income well after the mineral income has declined.

### *Aligning social, economic and industrial policies to country characteristics*

Experiences also show benefits of a prudent but active and expansionary stance of fiscal policy. Countries that followed this approach such as Vanuatu have been more successful in investing in building public infrastructure

and maintaining a high investment share in GDP than countries such as the Solomon Islands which implemented more restrictive policies. Countries in this pathway also demonstrate how domestic policies can be used to ensure that external flows generate the maximum benefit for the country. For some countries with a large diaspora, such as Cabo Verde and Samoa, remittances play a critical role as sources of foreign exchange and in supplementing household income and financing children's education. In this respect, remittances contribute to the improvement to human asset and the expansion of productive capacity. However, the positive impact of remittances is not automatic, but requires far-sighted diaspora and remittances policies aimed at increasing remittance inflows and enhancing its contributions to productive capacity building. For example, Cabo Verde adopted measures that facilitated emigrants to open and maintain bank accounts in the country and allowed them to benefit from special interest rates related to financing construction and productive activities. Again, these specific measures were embedded in a broader development-oriented governance framework, in this case through the establishment of a dedicated Ministry of Diaspora Affairs.

All countries on this pathway have applied some form of industrial and sectoral policies to kick-start the growth and transformation process, but the thrust, scope and depth of the policies utilized vary between countries and areas of specialization. In Botswana, for example, economic diversification to reduce the excessive dependence on primary products has been the main thrust of industrial policy. However, efforts to overcome the constraints of small economies by focusing on an export led manufacturing capacity have been unsuccessful despite special incentives in the form of tax concessions and subsidies. Diversification into non-bank financial sectors as well as into property development showed that policy measures can have positive effects, though they had only limited impact on employment. Generally, this experience underscores the difficulty for small economies in achieving economic diversification even if effective development governance systems are in place.

Other countries on this pathway like Cabo Verde, Maldives, Samoa and Vanuatu, focused their industrial policies on intensive exploitation of the sector where their current comparative advantage lies—tourism. Similarly, for countries where the role of the diaspora is considered critical for the development of the home country, for example, in Cabo Verde, more emphasis is given in the design of the industrial policy framework to incentives and regulations aimed specifically at attracting diaspora investment and their direct engagement in knowledge-transfer.

The nature and method of implementation of industrial policies seem also to vary depending on the institutional capacity of the country and the

degree of importance attached to the role of the State. For example, Vanuatu's tourism-driven growth and transformation was achieved largely through soft industrial policies, consisting of market-based policy reforms, creating a liberal regulatory environment, the provision of basic infrastructure necessary for tourism-related investment, generous incentives aimed at attracting foreign investment into the sector and the mobilization of donor support, including for the development of the tourism sector. On the other hand, countries like Cabo Verde and Maldives have opted to apply bold and direct policies involving active State engagement through strategic planning, public investment in tourism-related construction and infrastructure development and the formulation of sector-specific industrial policy.

### *International support matters*

In contrast to countries under pathway I, international support, in particular ODA, has played an important role in the development of countries on pathway II. One success factor for harnessing ODA for development in countries like Botswana or Samoa has been the importance of effective coordination of donor support, including by mainstreaming ODA into national development plans. This is a valuable lesson for LDCs that continue to rely on ODA for social sector investment, infrastructure development and job creation through public expenditure.

Trade support measures generally played only a small role in the countries considered, because these countries mostly specialized in services or natural resource exploitation for which LDC specific support is not available or not relevant. Nevertheless, in the case of Maldives, the utilization of trade preferences for fish products and the management of the ultimate phasing-out of these preferences due to graduation from the LDC category showed that trade preferences can be meaningful to support sustainable economic diversification even for small countries.

## **C. Pathway III: Graduation through economic diversification, structural transformation and the development of human capital: Bangladesh, Ethiopia and Rwanda**

The three countries considered under pathway III—Bangladesh, Ethiopia and Rwanda—represent larger LDCs that are characterized by investment in human assets and structural transformation away from low-productivity agriculture into higher-productivity manufacturing and modern services, leading to more diversified economies, though up to now only Bangladesh

has managed to come close to meeting the LDC graduation criteria. Like many other LDCs, they are also agrarian-based economies with large populations and an urgent need to create decent jobs for the hundreds of thousands of youth joining the labour market every year. Consequently, the starting point for expanding productive capacity, boosting investment and promoting economic diversification in the case of Bangladesh, Ethiopia and Rwanda has been agriculture and the transformation of the rural economy. Therefore, the policies pursued by these three countries to advance towards graduation through diversification and structural transformation could serve as useful lessons for many other LDCs.

All three countries started their development progress emerging from armed conflict. Hence, their experiences reinforce the importance of peace and security as critical foundations for development and progress towards graduation. The State plays a leading role in the development models of all three countries. The governance approach of Ethiopia and Rwanda can be seen as an attempt to replicate the “Developmental State” model followed by East Asian countries in the past. An important feature of the Ethiopian development governance model has been the emphasis given to integrated and coordinated participation of the public at large in the formulation of the national development strategy. Since the fall of the military regime in 1991, Ethiopia has developed a strong bureaucracy, by putting emphasis on the development of human capital and competent governance capabilities. Another interesting feature of development governance in Ethiopia has been the emphasis given to continuous policy learning and refinement based on feedback from consultations and changes in the national and global economic environment. For example, whereas early development plans assigned no priority to institutions relevant for building manufacturing capacities, the current plan envisages the deepening of the existing institutional setup to accelerate industrial development. Moreover, sector-specific institutions have been established to provide financial and technical support and extension services to firms.

### *Rural economy as a launching pad for development*

While non-State actors arguably played and continue to play a stronger role in the development process in Bangladesh than in the other countries included under this pathway, the development-focused governance structure in the country has nevertheless been a major factor in transforming the country. For example, in the early stages of transformation that focused on the rural economy, the Government recognized that rural sector development was constrained by limited physical access to markets, limited food processing capacities as well as absence of a functional market to

channel the agricultural surplus into productive investment. Therefore, the State had to step in through measures such as setting “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” (UNCTAD, 2010, p.117). These interventions led to a rapid growth of agricultural productivity and food production, contributing to food security, wage competitiveness and an expansion of non-farm rural economic activities.

The development experiences of Ethiopia and Rwanda further validate the traditional view that rural development can be an important launching pad for gaining the momentum for growth, expanding productive capacity and promoting structural transformation. In Rwanda, addressing the question of land ownership after the 1994 genocide was a key factor for rising agricultural production. The country adopted legislation and policies that established definitive rights and security of land tenure in general (including formalization of customary rights), and to improve rights of disadvantaged groups (particularly women). The land tenure regularization programme created a complete public registry of titles to all landholdings. The programme succeeded in improving the land rights of women, stimulating investment, improving soil conservation and better resolutions to land disputes. However, in order to significantly increase agricultural productivity, complementary policy measures are needed. Some of the key policies adopted in this regard by Rwanda include: (1) channeling a substantial share of public expenditures into productivity-enhancing inputs and practices by smallholder farmers (e.g., improved seeds, fertilizers, irrigation, etc.); (2) assisting smallholder farmers to establish soil conservation and other hillside terracing and marshland development infrastructures; and (3) introducing a voluntary scheme to promote consolidation of land use by joining small plots of several owners to be planted as one large unit.

A key factor for Ethiopia achieving rapid and long lasting agricultural growth (more than 8 per cent on an annual basis over the past decade) has been the development of the world’s largest extension system. Specialized institutions trained development agents, who in turn provided on-site training to farmers on how to diversify into more valuable and exportable agricultural products, how to increase quality, and how to adopt modern technology. This system has made extension services readily available, with 21 development agents per 10,000 farmers in Ethiopia, a higher ratio not only than in African LDCs but also than in East Asian developing countries such as China or Indonesia (Davis and others, 2010). In addition, the Government established a series of support institutes with specific tasks

(such as disseminating best practices, introducing new technologies to increase the quality and crop yield, strengthening value chains and introducing new technologies to cope with weather and climate change) that in totality contributed to rising agricultural productivity. To bring agricultural products to the market, the Government invested heavily in the expansion of physical infrastructure and in the provision of rural public services to ensure more efficient utilization of land and labour resources in rural areas.

### *Unorthodox social and macroeconomic policies*

Bangladesh, Ethiopia and Rwanda have made impressive progress in building human assets. Whereas in all three countries this performance is grounded in the political priority attached to the social sectors, the actual policy approaches vary substantially. In Ethiopia and Rwanda, rising public budget allocation to social sectors has been critical. In Ethiopia, innovative social policies include the establishment of health posts and health centres in all areas providing essential health services accessible to all citizens, as well as the deployment of 38,000 health-extension workers all over the country, ensuring that 98 per cent of the population is covered by public health programmes. Moreover, rising access to education (in particular, for girls, facilitated by the provision of free schooling and free school lunches in rural areas) as well as a participative governance structure, stimulated community engagement. The participation of women groups, in particular, contributed to changing traditional habits leading to health improvements, disease prevention, primary treatment, and socio-economic changes. This demonstrates how important it is that a country mobilizes its citizens in the implementation of development goals.

In Bangladesh, however, neither budget prioritization nor external aid were crucial factors in the development of the country's human assets (Asadullah, Savoia and Mahmud, 2014). Rather, Bangladesh designed a specific institutional setup under which the public provision of health and education services has been engineered by non-government service providers, combining low-cost solutions with public awareness campaigns (Mahmud, 2008). Hence, the pursuit of an inclusive development strategy involving non-governmental actors appears to be a key lesson from Bangladesh.

As in the case of social policies, macroeconomic and financial policies in all three countries are embedded in the development governance systems, but can generally be seen as unorthodox. Ethiopia emphasized creating fiscal space to direct public investment into priority productive sectors, infrastructure development, improvements in health and education, and institutional building. Though FDI and ODA were also important, the

mobilization of domestic resources had been critical. A main element has been the Government's control over financial institutions, which enabled it to ensure that long term financing is available for productive investment through the Development Bank of Ethiopia, and through endowment-owned businesses and substantial regional development organizations. Specific policies adopted include low government consumption, low interest rates, directing credit towards public infrastructure, and monetary expansion through the Central Bank (including through direct monetary financing of the budget).

Bangladesh has been successful in diversifying its economy from being an exporter of raw materials and agricultural products to becoming the second largest exporter of ready-made garments in the world. In addition to sector-specific policies discussed below, the expansion of manufacturing also benefitted from macroeconomic policies that stimulated investment in the sector. These policies included strengthening the banking sector to ease access to credit, public investments in energy and transportation to remove infrastructure bottlenecks, and simplifying procedures for establishing manufacturing enterprises.

### *The importance of combining domestic industrial policies and international market access*

In addition to macroeconomic policies, Bangladesh's emergence as a major player in the garment sector also benefitted from existing capabilities and conditions. Bangladesh already had an established clothing and textile industry from the colonial times. For the recent boom in the sector, the abundance of female labour was also a key element, as these workers quickly acquired the basic skills required and were willing to work for the low wages offered in the sector. More critical, however, were the domestic industrial and sectoral policy measures that consecutive Governments implemented.

The first act of the Government was to conduct an in-depth dialogue with entrepreneurs in the sector to understand their basic constraints and also to identify market failures in the allocation of resources. Then specific measures were introduced to address the most important constraints. Successful policy interventions included bonded warehouse facilities, so that producers did not have to pay tariffs on imported fabrics. Moreover, enterprises in the sector were allowed to use back-to-back letters of credit, which basically permitted producers to use orders from their buyers to finance fabrics. In addition, Bangladesh also provided subsidies to domestic fabric manufacturers, thereby enabling them to remain competitive vis-à-vis imported fabrics. This policy was instrumental in the development

of domestic supply capacity through domestic backward linkages. Hence, Bangladesh's experience shows that targeted support to selected industries can indeed contribute to building productive capacities. However, it needs to be acknowledged that similar policies were also available to other industries, which did not develop in the same way as the garment sector. Thus, a key lesson from Bangladesh's strategy to target multiple sectors as priority areas is that, while targeted industrial policies can be successful, the strategy of picking winners may not always work, especially if the country has not yet developed the capacity for intersectoral policy coordination and does not have adequate resources to provide sufficient support to all targeted sectors.

Besides exemplifying the importance of domestic policies and existing productive capacities, the success of Bangladesh in the garment sector also shows that preferential market access can indeed play a significant role in structurally transforming economies.<sup>16</sup> As an LDC, Bangladesh has duty-free access to major developed markets. The margin of preferences in the garment sector is substantial, as non-LDC developing countries face average tariffs between 6 per cent and 11 per cent in Australia, Canada, Japan, the Republic of Korea and the European Union (EU).<sup>17</sup> Bangladesh has also benefited from a relaxation of rules of origin in Canada (in 2003), and Japan and the EU (in 2011). In the 1990s, Bangladesh benefitted from the Multi Fibre Arrangement, as it was unaffected by quotas in the EU and a less binding quota in the United States. More importantly, Bangladesh gained sufficient competitiveness during the Arrangement so that the country, contrary to many expectations, actually benefitted from its expiration in 2005. The end of the Multi Fibre Arrangement contributed to the fast growth of the global market and rendered a number of countries with unfavourable cost structures uncompetitive. In addition, certain characteristics of the international garment sectors also facilitated the success of Bangladesh. The buyer-driven market structure facilitated the entry into the global market by eliminating the need for producers to invest in marketing and distribution<sup>18</sup> and, ultimately, resulted in the dominance of domestic producers in a sector that initially was dominated by joint ventures.

**16** For a detailed discussion, see, for example, Rahman (2014).

**17** The notable exception is the United States, where garments are excluded from LDC preferences and where many non-LDCs have access to other preferential rates.

**18** However, this feature also contributes to the fact that producers appropriate only a small amount of the value added, which, together with the low bargaining position of workers, is a key explanation for the low wages in the sector.

## D. Policy lessons from non-LDC developing countries: Ghana and Viet Nam

Learning from the past development experiences of one set of countries to inform policies and strategies in other countries requires caution. The countries selected for comparative purposes—Ghana and Viet Nam—are countries that had a similar level of development and economic challenges as current LDCs when they started major reforms about three decades ago that enabled them to achieve growth and transform their economies. Although both Ghana and Viet Nam have reached middle-income status, they continue to face challenges that hinder their prospects for sustaining growth and structural transformation. This is a reminder that, in preparing for graduation from the LDC category, LDCs should regard graduation as a milestone in a country's long-term development rather than as an ultimate goal in itself. This, in effect, means that LDCs should recognize that they will need to continue to expand productive capacity and promote policies and strategies for economic diversification, structural transformation, poverty reduction and sustainable development well after graduating from the LDC category.

The experiences of both Ghana and Viet Nam show that major economic reforms can lead to growth and revitalization of the economy. Ghana implemented more market-based reforms, driven and designed by the International Monetary Fund (IMF) and other donors, while in Viet Nam, the reforms were led by strong political leadership, and were based on a homegrown vision developed in response to changes in the external environment.

### *Key lessons from Ghana*

Ghana introduced orthodox and market-driven policy reforms beginning in 1983 on the insistence of the IMF, the World Bank and major donors, who required these reforms as a condition for providing financial assistance to overcome Ghana's deep economic crisis. The reforms contributed to the return of high economic growth. While enabling Ghana to reach middle-income status, economic growth was fuelled by the extractive sector and the rapid expansion of services. Resource depletion (combining oil, mineral and timber) increased from 8 per cent of GNI in 2000 to 15 per cent in 2012 (Twerefou and others, 2015), but simultaneous increases in investments have not been commensurate. This demonstrates again that natural resource-induced economic growth can provide a misleading impression of economic progress if recovered rent is not reinvested in areas that generate alternative sources of income and contribute to sustainable

development. Economic reforms in modern services such as finance and information and communications technology have led to high growth in these sectors, but still generate only limited opportunities for creating decent jobs. Consequently, over 80 per cent of the Ghanaian urban labour force now works in the informal sector which is known for its low earnings, job insecurity and inadequate social protection. Another lesson from Ghana is that orthodox macroeconomic reforms alone do not remove bottlenecks in infrastructure. Although the economically important mining sector is energy intensive, and the expansion of the urban-based services sector also requires reliable and affordable energy, the country's achievement in the development of energy supply capacity has been insufficient.

Moreover, the structural adjustment period negatively impacted social sectors as it reduced the resources spent previously for providing free universal education at all levels and publicly-funded public health services for all. The experience illustrates that publicly-funded human asset development requires a concomitant expansion in productive capacity, economic growth and economic diversification so that it can be sustainably financed from domestic resources. In fact, even after notable improvements in human asset development and significant progress in reducing the levels of poverty since the re-emergence of economic growth in the 2000s, Ghana still faces formidable social sector challenges such as widespread malnutrition and increasing inequality.

### *Key lessons from Viet Nam*

Viet Nam introduced sweeping policy reform and abandoned the Soviet-style planning system in 1986 in response to the crisis caused by the collapse of the former Soviet Union. Viet Nam pursued a dual-track economic reform where the role of the State was maintained in certain sectors or economic spheres while opening others. Like the economies discussed in the previous section, Viet Nam focused initially on the agricultural sector. This was followed by reforms deregulating the price and banking systems, attracting FDI, and enabling the private sector (both foreign and local) to become an important driver of the economy. The market-oriented reforms on the agricultural sector assigned transferable land user rights to farmers (while maintaining State ownership of agricultural land) as well as the abolition of fixed prices. The reforms transformed the farmer's ability to mobilize capital, produce goods that are on demand in the market, and sell produce without any barriers to internal and external trade in agricultural goods. This in turn led to a massive increase in the farmer's income and agricultural production, and also stimulated rural-based agro-processing activities.

Another key lesson from Viet Nam's experience is that while bold policy reform can liberate the economy from unnecessary constraints and initiate rapid growth, economic diversification and structural transformation, the sustainability of the growth and development momentum depends on whether the policy reforms are also supported by complementary institutional reforms and good development governance. Whereas strong political leadership provided the basis of the reforms in Viet Nam, progress in political and institutional reform is lagging behind. However, transparency and accountability are an essential requirement for sustaining growth and maintaining competitiveness, especially as the economy advances and operates in an open and interdependent regional and global economic system.

### III. Conclusion

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. Developing productive capacity requires integrated policies in five areas: development governance; social policies; macroeconomic and financial policies; industrial and sectoral policies; and international support measures.

Good development governance includes the notion of a developmental State that enjoys both legitimacy and authority, and that implements an inclusive development-oriented vision through participatory, transparent and accountable mechanisms and institutions. Development governance builds on, but goes beyond, good governance. Inclusive social policies ensure access to improved nutrition, health, education and social protection, as well as harnessing synergies between productive capacity building and social objectives. Sound macroeconomic and financial policies can support capacity expansion and increase the resilience of the economy to external shocks. Building productive capacity and structural transformation do not occur automatically, but rather require proactive industrial and sectoral policy action to address some of the structural impediments and obstacles that make it difficult to shift production to new and more dynamic sectors. Building productive capacities in LDCs depends not only on domestic policies, but also on a conducive international environment, development-oriented global rules and support measures specifically aimed at LDCs.

Lessons learned point out that there are at least three pathways leading to graduation with different implications for productive capacity and overall progress towards sustainable development. One pathway

to graduation is through rapid but volatile income growth from natural resource exploitation. However, without sufficient investments in human assets and a lack of economic diversification, this pathway does not move countries towards achieving the SDGs and often leaves large parts of the population in poverty. Weak development governance is the key constraint that prevents countries on this pathway from channeling natural resource revenues into social sectors. Not counting expenditures for human assets formation as investment in budgetary rules further exacerbates a neglect of social sectors.

A number of mostly small countries are on a second pathway that combines income growth with investment in human assets. These economies typically specialize in sectors such as tourism or natural resources with low employment and limited forward and backward linkages to other sectors, reinforcing vulnerabilities and, in some cases, inequalities. Good development governance underpins success in these countries, based on State legitimacy and institution-building. This facilitates human assets development, prudent macroeconomic policies, as well as a pragmatic and strategic application of industrial and sectoral policies. Some countries on this pathway harnessed ODA by effective national coordination of donor support and adopted far-sighted diaspora and remittances policies.

A third pathway, typically associated with economies having large populations and internal markets, is characterized by investments in human assets and structural transformation towards high-productivity manufacturing and services, contributing to a steady, albeit slow, progress towards sustainable development, including the eradication of poverty. Productivity-enhancing agricultural reforms focusing on small-scale agriculture and massive investments in rural infrastructure is the launching pad of development. On this pathway, the State plays an active and crucial role in designing appropriate policies in all relevant areas and creating and constantly adapting development-focused governance structures.

In all pathways to graduation, peace and security are critical foundations for productive capacity and sustainable development. Strong national ownership of the development agenda and building of development-oriented institutions enables countries to successfully develop and adopt unorthodox social and macroeconomic policies, enabling resource-poor countries to rapidly increase access to health and education and create employment opportunities, in particular for women.

## Appendix

### A. The nexus between productive capacity and graduation criteria: Similarities and differences

As the United Nations Committee for Development Policy (CDP) defines LDCs as low-income countries facing the most severe impediments to sustainable development, countries become candidates for graduation when their structural impediments become significantly less severe and/or their income increases rapidly. For purposes of the LDC criteria, income is measured by gross national income (GNI) per capita. The CDP determined a low human asset base and a high vulnerability to economic and environmental shocks as the main structural impediments. As shown in Figure 2, these impediments are measured through two composite indices, the human asset index (HAI) and the economic vulnerability index (EVI).<sup>19</sup>

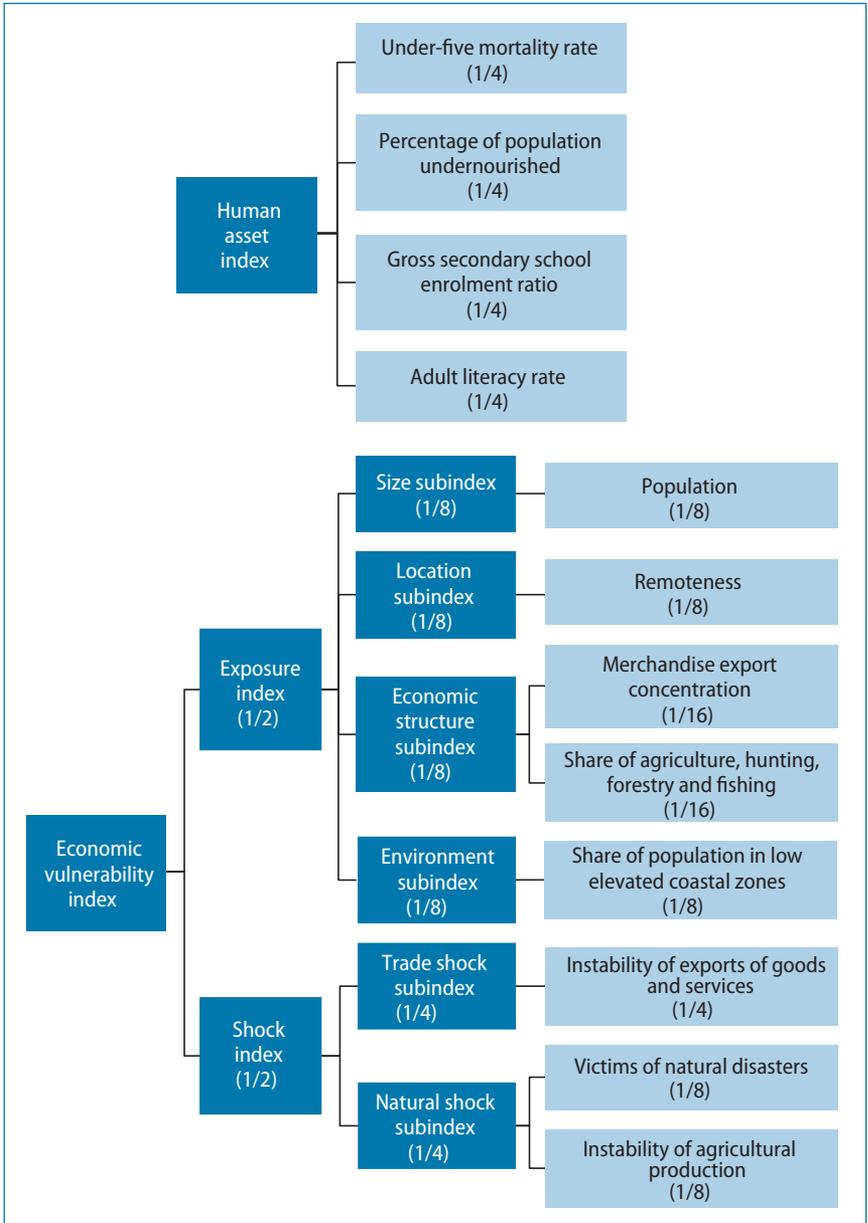
Countries may be recommended for graduation by the CDP if a country passes the graduation thresholds for at least two criteria in two consecutive triennial reviews. As an alternative, a country may also be recommended if its income passes the far higher income-only threshold in two consecutive reviews, even if its human assets remain low and its vulnerability to economic and environmental shocks high. CDP believes that such countries could overcome their impediments primarily by relying on their own means.

There are strong linkages between expanding productive capacity and progress towards graduation, but also notable differences. First, increasing productive capacity for sustainable development could lead to increased production, which in turn increases income. However, production can be increased without necessarily expanding productive capacity for sustainable development as defined by the CDP. Production could, for example, be increased by exploiting natural resources through mining activities. Similarly, income can increase without production by increasing proceeds from licenses granted to other countries to exploit natural resources, such as fish stocks.<sup>20</sup>

**19** For a detailed discussion on the LDC criteria, see United Nations CDP and United Nations DESA (2015). For an extensive discussion of the historic evolution of the LDC criteria and their theoretical and empirical underpinnings, see also Guillaumont (2009).

**20** Production can also increase without raising income, for example, if proceeds from productive activities are fully appropriated by foreign investors. However, this is probably most relevant in cases of natural resource exploitation that do not contribute to expanding productive capacity for sustainable development.

**Figure 2: Composition of the Human Asset Index and the Economic Vulnerability Index**



Source: United Nations CDP and United Nations DESA (2015).

Note: Refers to HAI and EVI valid at the time of writing the Policy Note. The HAI will be refined for 2018, see United Nations, Economic and Social Council (2017).

In addition, there are clear linkages between productive capacity and HAI and EVI. Building productive capacity in a way that harnesses positive synergies with social outcomes directly increases the human assets (in case of investments in health and education), moving a country closer to graduation. However, increased human assets may not necessarily imply higher productive capacity if these assets are not harnessed for economic activities, for example owing to institutional failures or a lack of complementary physical capital. Moreover, social protection schemes and inclusive policies targeting small sub-groups, do not necessarily increase aggregate levels of human assets captured by the HAI, even though they are critical for building productive capacity for sustainable development. Generally, though, the link between productive capacity for sustainable development and human assets is clearly positive and two-directional.

The link between expanding productive capacity and reducing the economic vulnerability as measured by EVI, however, is more complex. Effective industrial and trade policies, supportive macroeconomic and financial policies, and international support through preferential market access and other means could lead to increased exports, economic diversification and a better integration into the world economy. A reduction in export concentration and export instability will result in an improved EVI score. However, as the instability component of the EVI is measured over a twenty-year period, a sudden increase in exports could initially result in a higher instability measure before leading to a marked decline. Moreover, a decline in export instability can be caused not only by current progress in structural transformation and economic transformation, but also simply by the fact that past economic shocks begin to fall outside the twenty-year timeframe used to calculate the export instability measure.

Raising agricultural productivity, a key ingredient of expanding productive capacity in many LDCs, ultimately reduces economic vulnerability as the share of agriculture in GDP would decline (as labour formerly active in agriculture could move to more productive manufacturing or services sectors) and agricultural instability would fall. However, as in the case of export instability, this may be achieved only after an initial overshooting. For countries exposed to natural disasters, building productive capacities without increasing resilience to disasters could actually increase vulnerability as it could lead to higher victim rates if productive capacity is particularly increased in disaster prone areas (such as coastal areas). However, it could be argued that expanding productive capacities without reducing disaster risks would not constitute progress towards sustainable development. Hence, even if the present CDP framework may not explicitly stress disaster risk, the building of productive capacity for achieving the SDGs may require simultaneous disaster risk reduction efforts.

Generally, and after time lags, enhancing productive capacity will, in most cases, lead to lower EVI scores and move countries closer to graduation. However, it should be taken into account that several components of EVI reflect structural constraints that are policy-invariant exogenous factors, at least from the perspective of an LDC. Changes in population only marginally change the EVI score (moreover, in most LDCs, increasing population growth would not be seen as progress towards sustainable development); remoteness changes over time due to shifts in world trade patterns rather than trade performance of individual LDCs; and the share of people living in low elevated coastal zones reacts only slowly to changes in land use policies. Consequently, a large part of the EVI score is fixed even in the medium term. This also explains why even many non-LDCs have EVI scores above the LDC graduation threshold. This includes Botswana, Cabo Verde, Equatorial Guinea, Maldives and Samoa—all five countries that have graduated from the LDC category.

## B. Data sources and definitions for table 1

Indicator	Definition	Unit	Time	Main data source
Per capita GNI (in US Dollar)	Gross national income per capita	\$ per capita	2013-2015 average	CDP Secretariat, based on UNSD NAMAD
HAI (2017)	Human asset index	n/a	Latest available year	CDP Secretariat
EVI (2017)	Economic vulnerability index	n/a	Varying by component	CDP Secretariat
Life expectancy	Life expectancy at birth	Years	2014	UNPD WPP 2015
Mean years of schooling	Average number of schools of persons age 15+	Years	2015	Institute for Health Metrics and Evaluation
Poverty rate (\$1.90 per day)	Poverty headcount ratio at \$ 1,90 (2011 PPP)	Per cent of population	2009-2013 (Latest available year)	World Bank
Access to water	Percentage of population with access to improved water source	Per cent of population	2011-2015 (Latest available year)	WHO/UNICEF JMP
Access to electricity	Percentage of population with access to electricity	Per cent of population	2012	World Bank
Gini coefficient (net)	Gini index of income distribution after taxes and transfers	n/a	2010-2015 (Latest available year)	Standardized World Income Inequality Database
Female labour participation	Labour force participation rate of female population age 15+	Per cent	2014	ILO estimate
Gender parity index (sec.)	Ratio of girls to boys in enrolled in secondary schools	n/a	2010-2014 (Latest available year)	UNESCO
Government effectiveness	Index capturing perceptions of quality of government services and policies	n/a	2015	World Bank WGI
Investment rate (% of GDP)	Gross fixed capital formation as per cent of GDP	Per cent	2013-2015 average	UNSD NAMAD
Per capita energy use	Total energy supply per capita	Mj per capita	2011-2013 average	UNSD Energy Statistics

(continued)

## B. Data sources and definitions for table 1 (continued)

Indicator	Definition	Unit	Time	Main data source
Share in renewable electricity	Share of electricity produced from renewable sources (hydro, wind, solar, geothermal)	Per cent	2011-2013 average	UNSD Energy Statistics
Mobile telephones per 100	Mobile-cellular telephone subscriptions per 100 inhabitants	Per cent	2012-2014 average	ITU
Cereal yield	Cereal yield per hectare	Kg/ha	2012-2014 average	FAO
Agricultural labour productivity	Value added per person employed in agriculture, forestry, hunting and fishing	\$ per person	2013-2015 average	CDP Secretariat based on UNSD NAMAD and ILO WESO
Share of agriculture in GDP	Share of agriculture, forestry, hunting and fishing in total value added	Per cent	2013-2015 average	UNSD NAMAD
Share of agriculture in employment	Share of agriculture, forestry, hunting and fishing in total employment	Per cent	2013-2015 average	ILO WESO
Share of manufacturing in GDP	Share of manufacturing in total value added	Per cent	2013-2015 average	UNSD NAMAD
Long term GDP growth rate	Annualized 20 year GDP growth rate	Per cent	2013-2015 average	UNSD NAMAD
Marginal capital efficiency	Inverse of incremental capital-output ratio (two-year lag)	n/a	2013-2015 average	CDP Secretariat based on UNSD NAMAD
Total fertility rate	Expected number of births per woman	Children per woman	2014	UNPD WPP 2015
Urbanization rate	Share of population living in urban areas	Per cent	2015	UNPD WPP 2015
Remittances (% of GDP)	Personal remittances as per cent of GDP	Per cent	2013-2015 average	World Bank
FDI inflows (% of GDP)	Foreign direct investment as per cent of GDP	Per cent	2013-2015 average	World Bank
Share of exports in GDP	Share of exports of goods and services in GDP	Per cent	2013-2015 average	UNSD NAMAD

Note: All data as of March 2017.

## C. Members of the Committee for Development Policy

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**The Committee for Development Policy** is a subsidiary body of the United Nations Economic and Social Council. It provides inputs and independent advice to the Council on emerging cross-sectoral development issues and on international cooperation for development, focusing on medium- and long-term aspects. The Committee is also responsible for reviewing the status of least developed countries and for monitoring their progress after graduation from the category.

The members of the Committee are nominated by the United Nations Secretary-General in their personal capacity, and are appointed by the Council for a period of three years. Membership is geared to reflect a wide range of development experience as well as geographical and gender balance.

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