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Developing Productive Capacities is the Basis of Growth and Poverty Reduction in the Least Developed Countries

In a globalized economy, developing productive capacities has a pivotal place on the agenda to tackle poverty in least developed countries (LDCs). The effectiveness of poverty reduction strategies in LDCs could be improved if policymakers and donors focused on developing the productive capacities of these countries. Productive capacities are central to sustained economic growth, the expansion of employment opportunities and rising household incomes. This issue of *LDC Report Highlights* considers the nature of productive capacities, how they develop and their importance for economic growth and poverty reduction in LDCs.

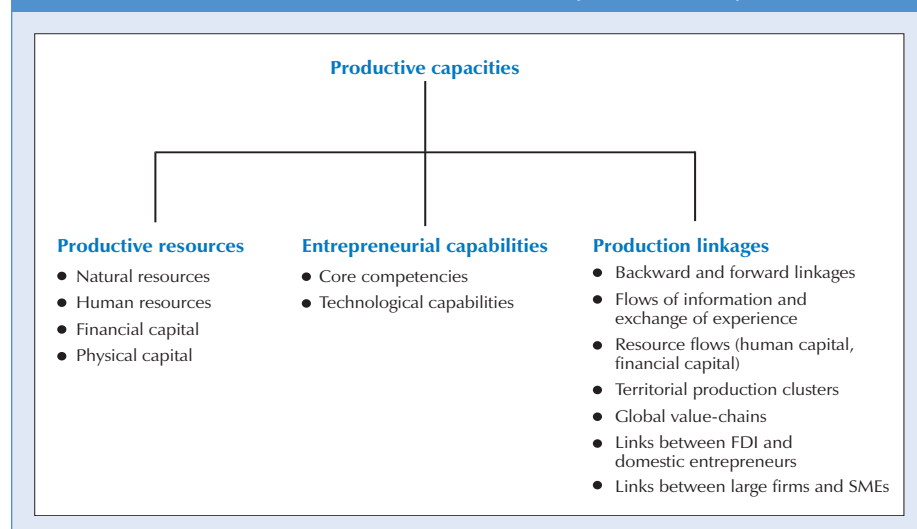
Defining productive capacities

Although the term “productive capacities” is increasingly used in international development circles, there are differing views about what it means. *The Least Developed Countries Report 2006* adopts a broad approach which is relevant not only to LDCs but also to other developing countries. It defines productive capacities as “the productive resources, entrepreneurial capabilities and production linkages

which together determine the capacity of a country to produce goods and services and enable it to grow and develop”. The three basic elements of productive capacities are:

- **Productive resources** – factors of production which include human, physical, financial and natural capital;
- **Productive linkages** – the backward and forward linkages between small and large enterprises, informal and formal enterprises, domestic and foreign enterprises, and different sectors of economic activity, including between the agricultural and non-agricultural sectors (see chart 1).

Chart 1. The three basic elements of productive capacities



- **Entrepreneurial capabilities** – the combination of core competencies and technological capabilities. The former enable entrepreneurs to effectively use the factors of production to transform raw inputs into internationally competitive goods and services. The latter refer to the ability to build and reconfigure competences to increase productivity, competitiveness and profitability and to respond to changing demand conditions;

According to this definition, the development of productive capacities is an interdependent process. For example, focusing on physical infrastructure alone might not work if technological capabilities are neglected. Moreover, the challenge of developing productive capacities involves sectoral development, structural change and diversification, as LDCs move toward sectors with higher domestic value addition.

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How do productive capacities develop?

The productive capacities of a country indicate its potential for economic growth. At any given moment, they set a ceiling on how much an economy could produce. But more important than this static potential is the dynamic potential which arises from the fact that productive resources, entrepreneurial capabilities and production linkages are in a constant state of flux and transformation. As this occurs, the potential output of an economy increases, wealth is created and living standards can rise.

Policymakers should therefore focus not only on what productive capacities are but, more importantly, on what they can become. Policymakers need to understand how productive capacities develop and to identify the constraints on these processes. In this regard, three key insights relate to:

- The core supply-side processes;
- The importance of demand and cumulative causation;

(i) capital accumulation – increasing stocks of physical, financial and human capital as well as ensuring sustainable use of natural assets through investment; (ii) technological progress – introducing new goods and services, new or improved methods of production and ways of organizing production and breaking into new markets through technological learning and innovation; and (iii) structural change – changes in the structure of production over time, with an increasing specialization in higher value-added activities and increasing domestic linkages in an economy.

These core processes are closely interrelated (see chart 2). Investment and innovation and chains of linkages underlie the process of structural change. The latter, in turn, facilitates investment and innovation, particularly through the emergence of leading sectors.

Demand and cumulative causation

The level of utilization of existing productive capacities at any moment in time depends on, among other

Demand originates from three sources: domestic private and public consumption; domestic private and public investment; and net exports (i.e. exports minus imports). All three sources are important to the development of productive capacities. But in successful economies, it is possible to observe a virtuous circle of cumulative causation in which the growth of productivity stimulates the growth of demand, and expanding demand, in turn, stimulates the development of productive capacities and productivity growth. An important challenge for policymakers aiming to develop productive capacities is to start and to sustain a cumulative process in which the development of productive capacities and the growth of demand mutually reinforce each other.

The influence of international integration and institutions

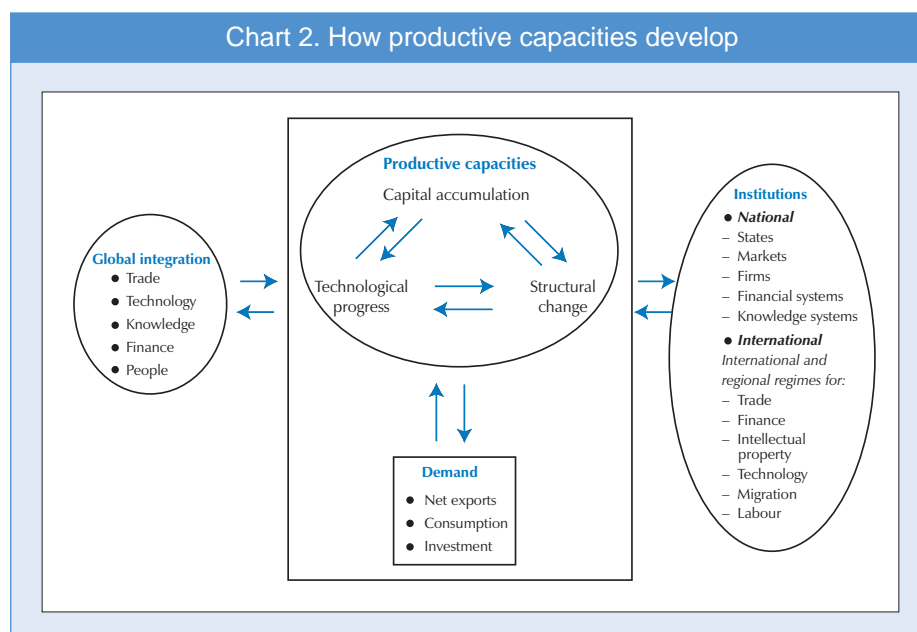
The relationship of a country with the rest of the world strongly influences capital accumulation, technological progress and structural change in that country. Globalization can bring enhanced access to markets, knowledge, technology and capital. But unless domestic producers are internationally competitive they face major demand constraints and, against a background of trade liberalization, competing even in home markets has proved difficult for many. Managing integration into the global economy in a way that facilitates the development of productive capacities is a key policy challenge.

National and international institutions play a critical role in promoting, or hampering, the development of productive capacities within LDCs. In this regard, domestic financial and knowledge systems are critical for investment and innovation. International regimes governing private capital flows and aid, technology transfer, intellectual property rights and international migration have an important role to play in enabling or constraining the development of productive capacities in LDCs.

Why do productive capacities matter for poverty reduction?

The expansion, development and

Chart 2. How productive capacities develop



- The degree and form of international integration and the nature of national and international institutions.

Core supply-side processes

The core process through which productive capacities develop are:

things, the existence of effective demand from both the private and the public sector. If domestic and external demand is weak, productive capacities are likely to be underutilized. The role of demand is essential in creating productive capacities through investment and innovation.

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utilization of productive capacities are at the heart of processes of economic growth. Only by focusing on the development of productive capacities and their full utilization can policymakers promote economic growth. But, beyond this, how productive capacities and economic growth impact on poverty will critically depend on whether productive employment opportunities are being generated.

Chart 3 is a schematic representation of the key links between economic growth, productive capacities and poverty reduction. The left-hand side of the diagram depicts a virtuous circle between the development of productive capacities and economic growth. In this case, economic growth provides a demand-side stimulus for the development and fuller realization of productive capacities. At the same time, the development of productive capacities eases supply-side constraints, thus enabling faster growth. The right-hand side of the diagram shows the further feedback loops between the development and utilization of productive capacities on the one hand and poverty reduction on the other.

The development of productive capacities can lead to poverty reduction via three main mechanisms:

- **Employment:** Developing productive capacities enables the progressive absorption of the un-

employed and underemployed into expanding economic activities with higher productivity. This causes real wages to rise and/or employment opportunities to expand, particularly where there is a labour surplus;

- **Prices:** Strengthening productive capacities can lead to a fall in the prices of wage goods – essential consumption goods purchased on a regular basis such as food, clothing and household items – and a reduction in the instability of these prices;
- **Government revenue:** Enhancing the productive base of an economy leads to increased government revenue. This gives scope to improve public services and provides the fiscal space essential for better governance.

As chart 3 shows, poverty reduction can support the development and utilization of productive capacities through three main channels:

- **Human development:** Higher incomes and earnings allow poor people to spend more on education, health, nutrition and skills formation;
- **Consumption demand:** Poverty reduction increases demand from consumers and stimulates the full use and development of productive capacities;

- **Entrepreneurship:** Declining poverty is associated with reduced insecurity, enabling less “short-termism” and more entrepreneurial risk-taking.

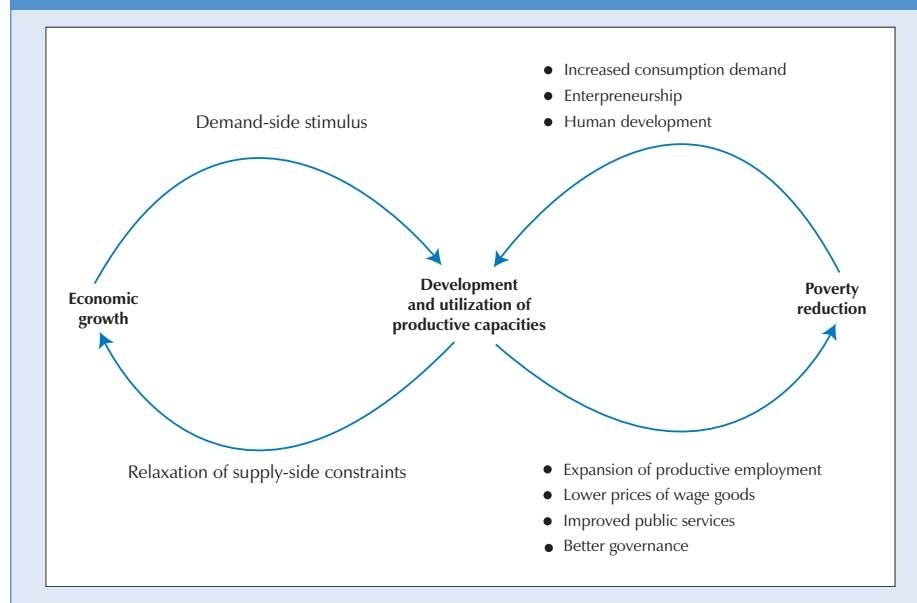
Thus, the virtuous circle linking the development of productive capacities and poverty reduction can reinforce the virtuous circle linking the development of productive capacities and economic growth. But this is unlikely to be a straightforward, uninterrupted or conflict-free process. There may be, for example, a trade-off between employment expansion and productivity growth. For any given rate of economic growth, the higher the rate of labour productivity growth, the lower the rate of employment growth. Moreover, there is a trade-off between increases in consumer demand and increases in household savings.

Where do LDCs stand?

The processes through which productive capacities develop are weak in most LDCs:

- **Capital accumulation:** Many LDCs have relatively low levels of human capital formation, due to low levels of education and relatively high levels of “brain drain” (see *LDC Report Highlights* no. 4 “New initiatives to mitigate brain drain in the least developed countries”). Furthermore, although capital formation has been increasing as a share of GDP, domestic public fixed investment and domestic private fixed investment are very low in most LDCs. This is reflected in poor physical infrastructure and lack of modern machinery and equipment. In 2002 the electricity consumption per capita of LDCs was only 7 per cent of the level in other developing countries and 1.6 per cent of the level in OECD countries. In 1999, only 22 per cent of the roads in LDCs were paved, compared with 43 per cent in other developing countries and 88 per cent in OECD countries;
- **Technological progress:** Most LDCs spend little on importing technology in the form of capital goods or on licensing new technologies, and hardly invest in developing new technologies. Most

Chart 3. The relationship between economic growth, productive capacities and poverty reduction



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LDCs can be classified as “scientifically-lagging countries”. It is not surprising, therefore, that they neither focus on the development of new technologies nor spend money on copying new technologies. It is, however, worrying that LDCs do not import more capital goods. This is because for these countries, which are typically unable to produce capital goods at home, importing capital goods is the only way to upgrade their production.

- **Structural change:** There has been little structural change in the LDCs as a group and most LDCs continue to be dominated by agriculture and petty service activities. Both industry and services are slowly becoming more important. However, for many LDCs the expansion of industrial activities is typically attributable to extractive industries (e.g. mining and oil) or, to a lesser extent, low value-added manufacturing (e.g. garment production). The growth of service sector activities is due mainly to low value-added services (e.g. wholesale and retail trade, hotels and restaurants) rather than high value-added services (e.g. banking and business services). These forms of specialization do

not create sufficient productive, non-agricultural employment opportunities.

In almost all LDCs, there is an imbalance between the rate of growth of the labour force, which is very rapid owing to population growth, and the rate of capital accumulation and technological progress, which is generally slow. As a result most workers have to earn their living using their raw labour, with rudimentary tools and equipment, little education and training and poor infrastructure. Labour productivity is low and there is widespread underemployment.

On average, in 2000–2003, it required five workers in the LDCs to produce what one worker produces in other developing countries and 94 LDC workers to produce what one worker produces in developed countries. Worse still, the productivity gap was wider than 20 years earlier.

This is the basic cause of persistent mass poverty in the LDCs.

In addition, the growing pressure of population on land resources is making it increasingly difficult for many people to derive an adequate livelihood from agriculture. A rapidly increasing number of people are looking for productive jobs in non-agricultural sectors. But most of them

will be disappointed. In the United Republic of Tanzania, for example, the labour force in the non-agricultural sector grew by 2.26 million between 1991/1992 and 2000/2002, but wage employment outside agriculture grew by only 172,000 over the same period. As a result, a large share of those searching for employment in the non-agricultural sector and migrating to urban areas will be either unemployed or severely underemployed.

These factors have led to widespread underemployment of non-agricultural workers and a decline in non-agricultural labour productivity. Today, four fifths of all LDCs have lower non-agricultural labour productivity than in the early 1980s.

The way forward: shifting the paradigm in development policies

By focusing on the development and fuller utilization of productive capacities, policymakers in LDCs can design more effective development and poverty reduction strategies, and their development partners can provide more effective support. Productive capacity development should therefore become the central concern of development and poverty reduction strategies in LDCs.

This issue of *LDCR Highlights* is based on UNCTAD, *The Least Developed Countries Report 2006: Developing Productive Capacities*, part two, chapter 1. The Report is available on the UNCTAD website (www.unctad.org).