SUPPORTING ECONOMIC TRANSFORMATION

BRIEFING PAPER

Why economic transformation?

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Key messages

Economic transformation is necessary to enhance the quality of economic growth, create jobs and reduce poverty in a long-term, sustainable and inclusive way.

The Supporting Economic Transformation (SET) programme proposes a multi-disciplinary approach to identifying opportunities, diagnosing constraints and mapping out realistic policy options, which countries could use to put their growth paths onto a more transformational footing. The approach covers questions around four dimensions:

- *What is happening (the achievements and limits of transformation to date)?*
- *Why is it happening (the political economy of past policy choices)?*
- *What should be done (the policies needed to facilitate transformation)?*
- *How to make it happen (technically sound, politically smart policy support)?*

The limits of recent growth[1]

As continuous and sometimes remarkably fast economic growth has become more usual in much of the developing world over recent decades, attention has shifted to the pattern, quality and resilience of this growth.

Issues of concern include the sectoral and social distributions associated with aggregate increases in gross domestic product (GDP), the low growth elasticity of extreme poverty in many countries and the weak capacity of the most dynamic sectors to generate sustained increases in productive employment.

Underlying these issues is the fact that much of the recent growth, especially in sub-Saharan Africa, has been the result of high commodity prices generating higher incomes within an economic structure that retains many features established in colonial times. Other sources of recent growth include buoyant urbanisation and the expansion of a services economy targeted at new upper and middle classes, without any prior transformation of staple agriculture or the emergence of a sizeable manufacturing sector.

[1] This briefing paper is drawn from a SET programme approach paper by the same authors (McMillan et al., 2017).

This pattern of growth is highly skewed and non-inclusive. **One way to express this is to say that countries are getting economic growth but not economic transformation – or growth with depth** (ACET, 2014).

The meaning of transformation

Economic transformation is understood as a process of moving labour and other resources from lower- to higher-productivity activities. This includes moving resources between sectors to higher-value activities (e.g. from agriculture to manufacturing) but also equivalent change within sectors (e.g. from low-productivity subsistence farming to high-value crops within sophisticated value chains). At the level of the national economy, it involves diversification, the creation of new subsectors of activity and increased domestic value addition in trade. At the level of firms and households, it implies the acquisition of new productive capabilities and the ability to compete in larger and more distant markets on a growing scale.

Unlike the current pattern of growth in many parts of the world, economic transformation 1) generates income broadly across the income distribution, because it is more employment intensive; 2) is robust against price shocks and price cycles, thanks to diversification; and 3) increases the opportunities for future economic growth, because it creates linkages and synergies.

The place of manufacturing

While there continue to be strong reasons for emphasising productivity gains in agriculture, especially in the early stages of development (Breisinger and Diao, 2008; Henley, 2015), convergence in labour productivity between poorer and richer countries has been fastest when investment has moved into manufacturing. This is because of **the exceptional scope within manufacturing activities for the acquisition of new technological capabilities** (Cimoli et al., 2009; Rodrik, 2013; Whitfield et al., 2015; Ansu et al., 2016).

Economic transformation is not a new concept (see e.g. Lewis, 1955); however, there is renewed interest in the concept, both in development policy debates (e.g. ECA and AU, 2014) and among those inside the academic community who have begun to analyse an improved range of datasets. Such analysis has also led to new policy insights and revival of interest in 'industrial policy', conceived as active promotion of structural change and new economic activities of high potential in all sectors (e.g. Rodrik, 2007; Chang, 2015).

The analysis of economic transformation in Africa has received new academic impetus through the work of McMillan and Rodrik (2011), who used newly available comparable datasets at sector level. There is increased attention to linking micro-level data on firms and households to economic transformation issues, and on learning for competitiveness at the level of firms and clusters of firms (Newman et al., 2016). Worrall et al. (2015) discuss the new policy interest in economic transformation in more depth.

Dealing with transformation deficits

Focusing on economic transformation involves understanding the determinants of growth and productivity at the micro (firm) and macro levels, including **how – under the right conditions – resources shift to higher-value uses, and the diversification of a country's productive capabilities, including its exports.** This calls for careful appraisal of the degree to which a country's economy has already experienced some transformation and what remains to be done, as judged by the gap between the current pattern and the equivalent measures for comparable countries or those that faced similar initial conditions.

However, before prescribing policies and policy combinations that may be technically optimal in moving the economy forward, it is more realistic to consider the **deep-seated political economy factors** that help explain how such deficits have arisen and survived. Experience across the world suggests that agreeing and sustaining economic policies that work for transformation is challenging and dependent on **progressive changes in the ways the incentives of political and economic actors are configured.** It is easiest to make headway with policy packages that are both technically sound and politically smart.

The longer version of this briefing sets out an approach to the above issues.

It suggests ways transformation can be measured. It discusses political-economy factors likely to constrain the choice of policies and makes the argument for a stepwise approach in which politically smart interventions relax the major constraints over time. We present a typology to assist thinking about technically suitable policy combinations and review country examples, paying attention to both the policy combinations adopted and the political-economy factors that have facilitated or hindered their implementation. Finally, we bring the above aspects together to produce a four-step multidisciplinary approach to diagnostic economic and policy analysis for economic transformation:

1. What is happening? (the achievements and limits of transformation to date)
2. Why is it happening? (the political economy of past policy choices)
3. What should be done? (the policies needed to facilitate transformation)
4. How to make it happen? (technically sound, politically smart policy support)

References available in McMillan, M., Page, J., Booth, D. and te Velde, D.W. (2017) *Supporting economic transformation: An approach paper.* London: Overseas Development Institute.

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