SUPPORTING ECONOMIC TRANSFORMATION

ECONOMIC TRANSFORMATION: A NEW APPROACH TO INCLUSIVE GROWTH

Event report

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WELCOME FROM DIRK WILLEM TE VELDE

Dr. Dirk Willem te Velde (Head of the International Economic Development Group, ODI and Director of the Supporting Economic Transformation programme) introduced the speakers:

- **David Booth** – Senior Research Fellow, ODI
- **Debapriya Bhattacharya** – Distinguished Fellow, Centre for Policy Dialogue
- **Edward Brown** – Director of Policy Advisory Service, African Centre for Economic Transformation
- **Louise Fox** – Chief Economist, USAID
- **Margaret McMillan** – Associate Professor of Economics, Tufts University and Research Associate, National Bureau of Economic Research
- **Melinda Bohannon** – Deputy Director, Growth & Resilience Department, Department for International Development

This panel event saw the launch of ODI's Supporting Economic Transformation (SET) programme's flagship approach paper, and brings together key figures driving forward the transformation agenda to discuss: what is economic transformation, what does it mean for the world's poorest, and how it can be supported in practice?

INTRODUCTION AND PANEL STATEMENTS

The panel began by discussing the definition and importance of economic transformation (ET) and then moved on to its implications and ways to support ET in practice.

Introduction - Dirk Willem te Velde, SET Programme Director, ODI

It is very easy to go to low income countries, for example Tanzania or Mozambique, and see the need for economic transformation. In those countries, only 1-3% of the manufacturing sector is employed. Low productivity is a concern across all sectors as well. Even developed countries like the UK or USA are tackling issues around job creation.

In low income countries, growth has occurred, but hasn't transformed economies—we need to create jobs. The International Development Association's lending programme will help the situation, marginally, and these low-income countries seem committed to solving the problems. However, a new approach is needed. This panel will discuss the new strategy discussed in the SET Approach Paper.

DFID perspective - Melinda Bohannon, Deputy Director, Growth & Resilience Department (GRD), DFID

Economic transformation, along with inclusive growth, is fundamental to poverty eradication. ET is about increasing productivity within sectors and shifting labour from low productivity areas to high productivity areas—increasing incomes and the benefits to work in the process. DFID has undertaken several country inclusive growth diagnostics and identified binding constraints to growth. From this, we have identified a number of priority areas to make a significant contribution in terms of economic transformation.

DFID's economic development strategy includes a few sector shifts. Firstly, we must do more in the manufacturing sector. A new programme, called "Invest Africa," builds on the approach in Uganda, Rwanda and a bit in Tanzania, but also thinks about business-to-business engagement through bilateral programmes and influence. Urbanisation, infrastructure and energy are three other sectors which also need a more coherent portfolio. In Burma, Uganda and Zambia, DFID will take a more integrated approach to urban planning by focusing on linking transport to highly concentrated living areas and, further, on how goods are exported to market. DFID will also extend financial sector deepening, giving businesses better

access to capital at better rates and increased agribusiness investing will help integrate small businesses into global value chains.

Transformation is not only about investment - to achieve inclusive transformation we must tackle informal barriers as well. DFID examines women's economic empowerment in particular; the overall transformation story must tackle gender inclusion. Finally, the role of export and international trade, is critical to ensuring high productivity sectors are able to grow. As the UK leaves the EU, it must negotiate many new trade deals with the rest of the world; yet a focus on African and south Asian countries is necessary. Attracting investment and helping to trade these countries out of poverty are huge goals for DFID and vital to the success of the new economic transformation approach.

What is economic transformation? – Margaret McMillan, Associate Professor of Economics, Tufts University

Economic transformation, in a broader sense, is the continuous process of bridging the productivity gap across sectors and firms and between rich countries and poor countries. One of two mechanisms are essential to close this gap: raising within-sector productivity through shifting resources or raising productivity of existing activity and through structural change, which is the process of moving resources from lower-to-higher productivity sectors.

Measuring this can be accomplished by utilising production based or trade based analytical measures. Production is based on output per worker, while trade is computed through trade diversification and competitiveness.

RESEARCHERS AND EVIDENCE

Measuring economic transformation – Margaret McMillan

Structural change, in poor countries especially, is extremely important—with large productivity gaps, comes a large payoff in a short period. In Africa and other low income countries, it is the primary driver of growth. However, in the middle-income countries, the source of growth has stemmed from within sector productivity growth, which is an unsurprising result.

A new, and slightly worrisome, result is the low level of within sector productivity growth outside the agriculture sector in low income countries in Africa. In Tanzania, the employment share in manufacturing and services is rising, but in mostly informal activities — this is a big problem. If this trend continues, the growth from structural change will eventually peter out—everyone will be even at a low level of productivity. In order to counteract this, the focus must be investing in high productivity activities.

Ethiopia and Tanzania, both countries currently experiencing this issue, offer two strategies to combat this problem. In Ethiopia, manufacturing firms are unproductive. Therefore, the government has prioritised attracting FDI—how helpful is this in practice? Results offer direct evidence of a link between FDI domestic

firms; specifically, an FDI plant is associated with an increase in TFP, increased firm entry and a rise in firm profits for domestic firms (over a three-year period). Tanzania, on the other hand, has experienced large employment growth in the private informal sector—small, unproductive firms. Results have illustrated similar characteristics across the most productive firms. For example, firm owners would not quit for a full-time job, firms hired paid workers and the owner has a formal bank account. Therefore, potential for productivity and employment growth in these small firms exists. To take full advantage of this potential, a joint project with the National Microfinance bank in Tanzania has developed a loan product targeting the most productive businesses.

Political economy – David Booth, Senior Research Fellow, ODI

The new approach to economic transformation integrates economics and political science. We can explain this simply with three points. First, we limit prior assumptions regarding institutional needs of economic transformation. We stress credible commitment to investors, sufficient provision of public goods, investment coordination and learning costs for firms. Second, conflicts between those requirements and the inner workings of politics in these low-income countries (based on political science studies) are substantial and cannot be avoided. Third, many countries—especially in East Asia and despite these constraints—have made headway in transformation. These methods have been diverse in nature and difficult to predict; it has involved a lot of learning by doing, as seen in China, a role for new ideas, and new forms of public-private collaboration.

In defining this integration, one can conclude that there are two essential elements to guiding any external support for economic transformation: support actions which are technically sound and to deliver politically smart support. For example, research which illustrates the higher productivity of some firms in a particular sector creates the opportunity for actions to have a larger impact compared to those not “technically sound.” Technically sound public actions can be categorised as either supporting structural change or supporting within-sector productivity growth, and into enabling interventions or targeted interventions. Being ‘politically smart’, on the other hand, implies a deep understanding of what the political economy of any particular country is; possessing the ability to pick your battles and not taking on changes destined for failure given the nature of political environment. Also included in this definition is the notion to keep an open mind. Currently, in East Africa, the understanding of manufacturing is skewed towards domestic substitution for imports, a belief in need of change. This change is, at least partly, a battle of ideas rather than one of political interests.

REGIONAL PERSPECTIVES

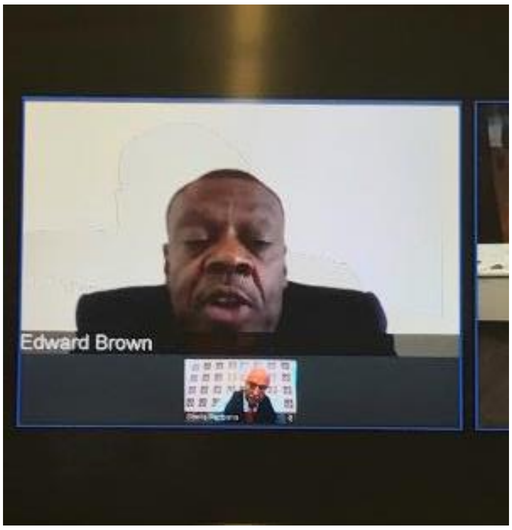
Inclusion and a personal perspective – Louse Fox, Chief Economist, USAID

In recent years, the Asian pathway to ET has been in focus; developing Asian nations achieved economic transformation, sustained growth and economic inclusion. However, more discussion regarding the pre-growth period in Asia and the enabling factors that allowed for such success is necessary. If the enablers are not already in place throughout Africa and in other developing regions, what can we do to ensure success, and what should we expect as results?

Enablers observed in the Asian pathway must be in place in low income countries in Africa to see similar results. Education and health—specifically fertility rate decline—are two important and interrelated factors. As fertility declines, more public expenditure can be spent on infrastructure (e.g. schools), while private sector saving increases as well. One current African issue is a high fertility rate *within* cities—as compared to Asian levels about 30 years ago—which speeds up the process of urbanisation while countries are poorer. This leads to high-cost cities in Africa, not seen in Asia during development. Baseline levels of agricultural productivity were higher in Asia (pre-Green Revolution) in comparison to African LICs as well. A final enabler is land reform—specifically family farms with secure access to land--facilitated investments leading to increased agricultural productivity.

These, among other missing or incomplete factors, lead us to expect a different strategy for Africa than Asia. Economic transformation in sub-Saharan Africa must include rural and agricultural transformation, as well as urban transformation. USAID, in response to this conclusion, allocates money budget to treating HIV/AIDS or Malaria control and prevention, amongst others. Countries view these funding lines and work with USAID to pick and choose funding that would best suit the nation. Manufacturing itself is somewhat neglected, but the enablers, like trade logistics and trade facilitation, do have funding lines. Although not all-encompassing, the USAID economic transformation strategy complements other government plans extraordinarily well.

Ghana's experience – Edward Brown, Director of Policy Advisory Service, African Center for Economic Transformation



In the 1960s, Ghana mirrored South Korea in terms of human resources, human capital and natural endowments. Today, South Korea's GDP and per capita income far exceeds those of Ghana— we need to look at what happened. Africa is growing, but it is not creating jobs; the structural composition of African economies has not really shifted away from agriculture and manufacturing productivity is worse now than it was 20 years ago.

How can we spur transformation today? Policy tools (measurements) allow policy makers to assess progress in transformation in a straightforward manner. A framework, entitled 'DEPTH', created by the African Centre for Economic Transformation to better measure ET, contains 5 components: diversification of production (including manufacturing and export), export competitiveness (sustainable domestic firms must compete internationally), productivity increases, technological upgrading (since the 1980s, medium-to-high technology has dropped to lower technology inputs), and improving human well-being. The DEPTH framework allows policy makers to measure transformation so that they can better push economic transformation.

Political economy analysis is also of utmost importance when implementing economic transformation. In Ghana, for example, the new government is pushing to put categorical emphasis areas critical to the country. Infrastructure, specifically railways, is one critical sector. The government has defined a “champion,” along with a plan, who will drive this growth while also across sectors—this process occurs in other critical areas as well. Understanding the government’s new goals and strategy simplifies any strategic approach in a country.

Creating a community of countries that identify with the transformation agenda is another challenge Countries could learn from each other’s successes and failures, all while pressuring each other to reach higher goals. Eight pathways and drivers to transformation have been identified to reach this goal. One driver of transformation, modernising agriculture, will be discussed at length in a report in the coming year.

The south-Asian perspective - Debapriya Bhattacharya, Distinguished Fellow, Centre for Policy Dialogue

In Asia, specifically in low/middle-income countries, the concept of economic transformation has been embraced warmly. We can see this through four points of reference. First, the number of low income countries that are graduating out of LIC status—Bangladesh, Nepal, Bhutan, and more. These graduations from a “low-income country” are a milestone, but not a “winning post.” The next milestone for these countries to hit is in fact structural transformation. Secondly, there exists a middle-income trap. Graduating from an LIC to a middle-income country does not guarantee a transition to a middle-high income country. Structural transformation has been discussed as a possible solution to this trap; looking at the Latin American countries stuck in the trap for decades may teach us something about the present situations. The third point of reference is around SDG’s— the Sustainable Development Goals. SDG’s have brought in a new transformative agenda which is inclusive, integrated and universal. The link between this agenda and the economic transformation is of great interest. The fourth point is the new global economic environment; specifically, how it relates to the pursuit of structural transformation.

Structural transformation, however, is not one-dimensional and can have negative aspects such as deindustrialisation. It will be useful to look at the pluralism of structural transformation instead of simply supplying scope for policy flexibility. Questions must be asked regarding structural transformation. Does it necessarily lead to inclusive growth? Maybe not. First, empirical evidence has shown that even with an increase the share of labour in the formal sector, the share of labour/wages in GDP has not risen in many cases. Changes in sectoral GDP also do not mirror changes in the labour composition; evidence has revealed a stickier labour composition compared to changes in GDP. Secondly, a higher level of productivity growth has not led to a higher share of employment. Technology, especially in Asia, has played a huge role in productivity increases, yet many technological improvements have created literally zero jobs. Lastly, there is a strong relationship between structural transformation and human development indicators. We must look beyond the number of people graduation and understand the competencies of these large numbers of people. The quality of education has become a major issue, so simply increasing graduation numbers does not necessarily mean true inclusive growth.

In terms of policy, much of the new strategy is based on trade and production. However, recent experiences illustrate that policies dependent on external trade have been relatively unhelpful in creating resilient economies. The breakdown of world-wide multilateralism and increase in productivism is another reason to revisit trade heavy policies.

There is no elegant, intelligent measurement of economic transformation as in the real world, the concept is very complex. How we relate these policies with the rest of the world is an exciting development in the study of ET and must be handled correctly to support inclusive growth.

DISCUSSION

Question/Comment: Anna Thomas – Action Aid

Women need to be involved in inclusive growth. How can we ensure that inclusive growth is gender inclusive? Also, how can we measure that this is ensured?

Response: Louise Fox

Enabling conditions are underestimated. Women's education, and learning something. Health and fertility control, which make it easier around the house and give more choices of leisure and consumption. Land titles, which give women a choice of less farming and shifting into the non-farming economy. Mobility, safety allows people to move out of the house. Norms need to change—sometimes it's through economic change. Bangladesh garment industry changed the norm for women to work in the city. However, we cannot expect economic change to change the norms in every case (as seen with higher paying jobs). A place like Egypt has seen much economic change, but no corresponding change in social norms.

Question/Comment: Max Mendez-Parra, ODI

Do you see a role for services within structural change? If there is, what would be the issues to consider?

Response: Margaret McMillan

It has already played a role in structural change. Average productivity in service sector is higher than average productivity in agriculture. How to make services more productive is the real question!

Question/Comment: University of Westminster

Jobless growth still exists in South Africa and other countries. How can we move away from just words as policies towards policies that are on the ground and legitimately transforming the economy?

Response: David Booth

This idea of growth has been loosely used for a long time in South Africa. There are still questions about the political system in South Africa and its ability to move towards a position that lends itself well to economic transformation. However, we cannot always wait for the political system to transform. We must be politically smart and target issues within the current political system. Modest objectives are our best option.

Countries in sub-Saharan Africa have huge amounts of self-employment that will be the future middle class. For this to occur we must support the middle class in an intelligent manner—targeting will be very important.

Question/Comment: Estella Aryada, Independent Trade and Development Consultant

How feasible is it to focus on productivity growth in manufacturing, specifically in land-locked Africa, in light of the lack of competitiveness, availability of cheap imports, and high population growth?

Response: Margaret McMillan

Cannot change being land-locked, but you can change all other factors. Rwanda is a great example of a country that has achieved productivity in manufacturing and attracting FDI.

Question/Comment: Keith Palmer, Chairman of AgDevCo

What lessons can be learned from the declined African manufacturing industry? Can it be brought back?

Response: Edward Brown

Because of import substitution run by the state in the 1960’s, state run companies lost out to outside competition. In order to ramp up manufacturing with high unemployment, we must learn from Ethiopia, Senegal and Rwanda -bring in FDI and support textile garment industries. Low-income countries must focus on an export push; it subjects industries to the same level of competitiveness as others. Competitiveness is key.