SUPPORTING ECONOMIC TRANSFORMATION

BRIEFING PAPER

# Economic transformation: a new approach to inclusive growth

Margaret McMillan, John Page, David Booth and Dirk Willem te Velde

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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 challenge many developing countries now face is that of economic transformation – that is, **moving labour and other resources from lower- to higher-productivity activities.** This briefing[1] sets out a comprehensive response to meeting this challenge.

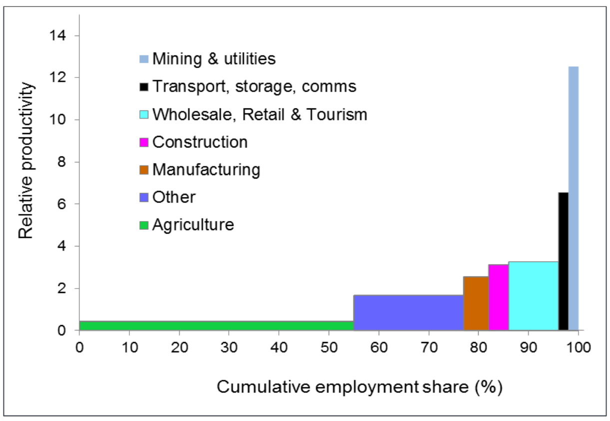
It suggests ways to measure transformation, discusses political-economy factors likely to constrain policy choices and argues for a stepwise approach in which politically smart interventions relax the major constraints over time. It presents a typology to assist thinking on technically suitable policy combinations and reviews a set of country examples, paying attention to both the policies adopted and the political-economy factors that facilitated or hindered their implementation. Finally, it brings these aspects together and describes a four-step multidisciplinary approach to diagnostic economic and policy analysis for economic transformation.

## Measuring economic transformation

We develop **practical ways to measure economic transformation**, taking into account the quality of the available data. Our framework allows researchers to decompose labour productivity growth into a within- and a between-sector component. Other measurement issues relate to export diversification, value chains and value addition in exports.

Using the above definition and a range of relevant measures, we conclude that many low-income countries today suffer from **more or less severe transformation deficits**. That is, the recent pattern of economic growth involves little structural change (employment in Africa is still mostly in agriculture and has not changed much) and hardly any within-sector productivity growth (Figure 1, Table 1).

### Figure 1: Relative labour productivity gap sub-Saharan Africa, 2013




Source: McMillan et al. (2017).

[1] This briefing is concerned with developing an approach on how to promote economic transformation. For in-depth discussions on how economic transformation affects different groups of people see e.g. Fox (2015) on gender aspects; for discussions on how industrial development helps job creation and resilience to shocks see Ansu et al. (2016b) and Balchin et al. (2016b); and on how the development of services relates to job creation see Khanna et al. (2016) and Hoekman and te Velde (2017).

## Table 1: Productivity decompositions

| Study | Period | Region | Labour productivity growth (annual %) | | |
|---|---|---|---|---|---|
| | | | Total | Within sectors | Between sectors |
| McMillan and Rodrik (2011) | 1990-2005 | Africa | 0.9 | 2.1 | -1.3 |
| | | Latin America | 1.4 | 2.2 | -0.9 |
| | | Asia | 3.9 | 3.3 | 0.6 |
| | | Developed | 1.5 | 1.5 | -0.1 |
| McMillan and Harttgen (2014) | 2000-2010 | Africa (weighted) | 2.9 | 2.1 | 0.7 |
| Timmer et al. (2014) | 1990-2010 | Africa | 1.9 | 1.7 | 0.1 |
| | | Asia | 3.6 | 3.1 | 0.6 |
| | | Latin America | 0.9 | 1.1 | -0.1 |
| Kucera and Boncolato (2012) | 1991-2008 | Sub-Saharan Africa | 3.0 | 2.4 | 0.5 |
| | | Asia | 3.8 | 2.9 | 1.0 |
| | | Latin America | 1.2 | 1.1 | 0.0 |
| | | Developed | 1.1 | 1.2 | 0.0 |
| Martins (2015) | 2002-2013 | Africa | 1.9 | 1.1 | 0.8 |
| | | Asia | 5.8 | 4.1 | 1.6 |
| | | Latin America | 1.2 | 0.7 | 0.5 |
| | | Developed | 0.9 | 0.7 | 0.2 |

Source: McMillan et al. (2017)

# The political economy of economic transformation

The economic transformation agenda makes greater demands on policy-making and implementation than simply to sustain growth. Therefore, it is important to take due account of the various factors that may hinder the needed adjustments to the policy process, including the distinctive configuration of public and private interests and incentives in **the country's political economy**.

Policy suggestions should be realistic about the disincentive effects on investment patterns of politics and interest representation generate. They should also be aware of the scope for **stepwise, cumulative change and politically smart interventions** to address particular blockages (Box 1).

## Box 1: Country variations in political economy

**Nigeria:** Inward-looking policy orientations are bound up with a political economy that, since at least the end of the Biafra war in 1970, has reduced both politics and business to a struggle for control of oil rents.

**Rwanda:** The political settlement removes or substantially weakens two of the features that, in most contemporary African political systems, work to undermine policy-making in the national interest: winner-takes-all electoral competition and the use of economic rents and political appointments to reward members and supporters of a winning coalition.

**Mauritius:** The island state was not obviously well placed to emerge as a high-performing economy, and rather shared with continental members of the Africa region several structural features that have often been seen as predestining countries to irregular economic growth and limited structural change.

**Bangladesh:** In conventional terms, it is a paradox that the country has experienced substantial success in export manufacturing and a number of other fields of economic and social development despite scoring poorly on most indicators of quality of governance.

**Indonesia:** The reasons for Indonesia's success in economic transformation need to be looked for in areas other than those emphasised in theories about the institutional drivers and inhibitors of development progress that remain influential in international quarters, especially in relation to Africa.

# Choosing and combining policies for economic transformation

Table 2 offers **a typology of policy approaches** to supporting economic transformation.

The types of public actions proposed in the literature divide into those intended to accelerate the relative growth of higher value-added sectors in the economy – in other words policies to support structural change – and those intended to accelerate the pace of within-sector productivity growth. Within each of these policy sets the literature further distinguishes between 'horizontal' or enabling interventions and targeted interventions. This produces a two-by-two classification matrix.

## Table 2: A typology of public actions to promote economic transformation

| | General enabling interventions | Targeted interventions |
|---|---|---|
| Public actions to support structural change | Investment climate reforms<br><br>Financial sector development<br><br>Strengthening state–business relations | Export push policies<br><br>Exchange rate protection<br><br>Selective industrial policies<br><br>Spatial industrial policies<br><br>National development banks |
| Public actions to support within-sector productivity growth | Building fundamentals<br><br>Investments in basic production knowledge:<br>• Managerial good practices as public goods<br>• Agricultural innovations<br><br>Promoting competition | Management training<br><br>Attracting foreign direct investment<br><br>Export diversification<br><br>Developing global value chains<br><br>Increasing agricultural productivity |

While a combination of policy types is likely to be necessary, **the choice should be influenced by a judgement about the feasibility of making headway in spite of the identified political-economy constraints**. Domestic action is in the driving seat but the international community can contribute in several ways, including by influencing international policy (e.g. trade agreements that lower costs, or more stable and efficient banking rules) and with well-designed aid programmes.

### Box 2: Policy choice – country options

**Nigeria:** There is no shortage, in strictly economic terms, of good entry points for upgrading the quality of growth. A range of sectors and products appear promising on the basis of one or more type of rigorous assessment.

**Rwanda:** Until recently, targeted initiatives have not paid serious attention to export manufacturing or processing. The Kigali Special Economic Zone, a strong step in the right direction, has been operational for a relatively short time, with a number of pilot investments showing promise.

**Mauritius:** From the 1970s consensus was built across the public and private sectors around a strategic direction for the economy, based on structural transformation away from sugar and towards garments, tourism, financial services and finally an integrated services platform.

**Bangladesh:** While there has been transformation, much still needs to be done. Political uncertainty, weak institutions, lack of skilled workers, unreliable energy, limited suitable land and a cumbersome and opaque regulatory framework have held back investment.

**Indonesia:** During the oil price slump of 1980–86, income per head continued to grow, whereas in Nigeria it fell sharply. The immediate reason was that the collapse in foreign exchange earnings prompted economic liberalisation and opening to foreign investment, which paved the way for rapid growth in export-oriented manufacturing. In Nigeria similar moves were rejected.

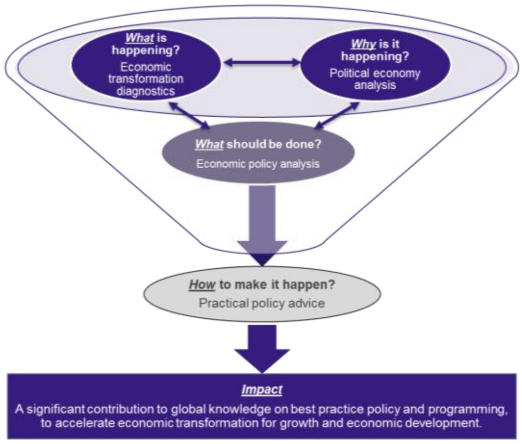
## Country experiences

**Nigeria**'s large transformation deficit is traced to policies and interest configurations that generated overreliance on oil wealth. **Rwanda** has committed to an ambitious catch-up strategy, now firmly based in agricultural transformation and more tentatively in services and export manufacturing. In **Mauritius**, a well-designed combination of enabling and targeted policies was supported by a remarkable political consensus, enabling a successful transition from plantations to manufacturing and then high-value services. **Bangladesh**, too, has experienced significant transformation, based on somewhat lopsided advances in manufacturing and in spite of a generally unfavourable political economy. **Indonesia** illustrates that large, oil-rich countries do not automatically experience the negative economic and political effects of the 'resource curse'. Taken together, this illustrates that there are **different pathways to economic transformation**, which rely on varied policy combinations and ways of addressing political-economic obstacles.

## Towards a guided enquiry into economic transformation

We offer a multi-disciplinary approach to identifying opportunities, diagnosing constraints and mapping out realistic policy options that can help countries put their growth paths onto a more transformational footing. As Figure 2 shows, this covers questions around four dimensions of a country's experience in economic transformation.

### Figure 2: The four steps in the guided enquiry into economic transformation




### What is happening?

The first step describes the current transformation experience, answering such questions as: How has the production structure evolved historically to where the country is now? How large are the productivity differences across sectors and among firms? What is the 'productive knowledge' in the economy?

Diagnostic tools include sectoral productivity decompositions, firm-level productivity analysis, trade in value added, Hausmann product space analysis and analysis of employment, trade, foreign direct investment, gender and spatial data.

Our analytical work so far finds that **many countries have severe transformation deficits**, indicated by:

- Growth without structural change
- Lack of productivity change at firm and sector level and large productivity differentials across sectors and firms
- Absent diversification: little industrialisation, too many low-productivity services
- Lack of resilience and quality growth

Of course, each country is different and the diagnostics bring out country specifics.

### Why is it happening?

The second step is to understand why there has been so little transformation, considering both economic and political economy explanations.

Tools include reviews of economic constraints based on firm surveys and consultations, existing studies, e.g. Sutton enterprise maps, and application of the growth diagnostic approach (Hausmann et al., 2008). Political economy constraints are understood through study of political incentives, policy-making processes, leadership, policy consistency, coordinating capacity and state–business relations.

Ansu et al. (2016b) offer a number of propositions as to why economic transformation has rarely happened. Many economic constraints to economic transformation are well known, even though exact patterns are country-specific. However, addressing them is hard, as there are often **deep-rooted (political) constraints to technically feasible policies**. Moreover, **processes of policy change are often complex,** without obvious entry points.

## What needs to be done?

Bearing in mind the political economy, the third step is to understand what needs to be done to support economic transformation.

Promising sectors are associated with high levels and growth rates of productivity (McMillan/Rodrik productivity decomposition); comparative advantage (revealed comparative advantage analysis) and growing world demand; GDP and employment effects (multiplier analysis using input-output models); diversification and growth benefits (Hausmann product space analysis); and private sector interests (firm-level consultations and surveys)

Policy analysis identifies appropriate policies, in terms of economy-wide, broad-based policies and targeted interventions (e.g. special economic zones, value chain analysis). Prioritisation of policies needs to take into account first- and second-best options as well as political economy constraints.

By applying these techniques in a variety of settings, it is possible to **identify objectively promising sectors** in manufacturing and services that can promote economic transformation and quality jobs, not wasting resources on sectors without promise.

A range of policies (broad-based and targeted) can be identified to promote such sectors; some are common across sectors. Te Velde et al. (2015) on Nigeria suggest quite a number of policies need to be coordinated at the same time. Reviews of large developing countries (Leipziger, 2015) and of promising transformation policies in Africa (Ansu et al., 2016) suggest **transformation is associated with openness and exporting** and that **some level of targeting is required; general 'investment climate' support is not sufficient.**

## How to make it happen?

A very important step is to focus on the implementation of suggested policies.

Techniques and activities include in-depth stakeholder engagement (including policy-makers, donors and private sector firms); identifying politically smart interventions (using political economy analysis), linking country policy-makers' programmes with feasible policies and government planning, building in monitoring, learning and adjustment; and linking donor programmes with feasible policies.

Donors can assess the transformational potential of combinations of programmes. For Nigeria, Booth (2015) distinguishes between options focused on sectors (targeted) and on context (enabling) on one dimension, and options that focus on transformative growth and on 'holding pattern' growth on the other. At one extreme, donors may facilitate demonstration projects that show how transformative growth works in practice in a specific context. At the other, donors may continue to alleviate general constraints to small and medium-sized enterprise development.

Applying these techniques, the following lessons can be identified:

- A targeted set of actors (donors, country governments and private actors) can help get a country onto a more transformational path and the steps above can help in navigating these complex policy processes.
- Implementation matters. **Getting it all right at once is a tall order:** instead, it is important to target politically feasible projects and demonstration projects. **A process with feedback and learning is needed.**
- Transformation deficits are the result of unfavourable political economies (vested interests in the *status quo*), but false economic thinking (e.g. about industrial development based on import barriers rather than raising productive capabilities) is also a factor. **Policy ideas are worth tackling too**.

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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