

5. A DEVELOPMENT PARADIGM SHIFT: POVERTY REDUCTION THROUGH PRODUCTIVE EMPLOYMENT GROWTH

“The only way to reduce poverty in the LDCs without resort to international welfarism or international migration is through the development of productive capacities of the LDCs and the concomitant expansion of productive employment opportunities within them” (UNCTAD 2006).

This chapter is based heavily on the innovative work undertaken by UNCTAD⁴⁰ (drawing on research from other sources, including ILO, FAO, UNDP, UNIDO, UNRISD and DESA) to promote a paradigm shift in international and national strategies towards poverty eradication in least-developed countries (LDCs). Many of the lessons are valid for other developing countries that do not fall under the UN technical definition of an LDC.

The paradigm shift involves placing at the heart of policies the development of productive capacities in a way that expands productive employment opportunities to reduce poverty. It means shifting from an approach that targets social policy but takes a universally non-interventionist approach to the economy, to a more *targeted economic policy approach* (that supports both production and employment) and a progressively universal coverage of social policy. It means also a shift from a “trade-driven approach to development” to a “*development-driven approach to trade*.”

Understanding this paradigm shift is essential for the donor community as well. Doubling or re-doubling of external development finance will not be effective if it continues to be linked to the wrong development model.

WHAT IS PRO-POOR GROWTH?

The starting point is a better understanding of what we mean by “*pro-poor growth*.” It means transcending two tendencies in analysing the causes of poverty. At one end of the spectrum, microeconomic analyses of the causes of poverty focus on characteristics of the poor (such as illiteracy, living in remote areas, working in subsistence agriculture, etc.) and directing policies to address these in a way that is divorced from the broader macroeconomic context. At the other extreme, linking diagnoses of poverty to the macro-context lead to simplistic and misleading assertions that “economic growth is good for the poor.” In between, there are studies that try to show that growth is pro-poor if the income share of the poor increases, or accelerates. But empirical work on pro-poor growth shows that to

⁴⁰. Unless otherwise stated, most of the analysis and evidence presented in this chapter are drawn from UNCTAD’s *Least Developed Countries Report 2006*, which focused on developing productive capacities for productive employment.

get behind these vague statistical relationships, it is necessary *to start with the view that household living standards are primarily based on the generation and sustainability of jobs and livelihoods.*

The starting point of poverty analysis should be how people make a living, which in turn is determined by whether there is a virtuous circle of expanding both production and quality jobs (that is, expanding productive capacities *and* inclusive productive employment opportunities) – and whether the international economic system is supporting or undermining this process.

The decent work challenge in developing countries is not just unemployment. Most poor people work: in the absence of social security they simply cannot afford to be completely unemployed. The overwhelming majority of the active population in low-income countries is employed or self-employed in the informal economy, earning very low income without rights and protection. The basic cause of poverty is that *there are simply not enough productive employment opportunities in the formal sector for a growing labour force.*

Part of the challenge is to better utilize existing capacities: existing productive resources and entrepreneurial capabilities in low-income countries are typically underutilized, notably because of lack of demand and other structural weaknesses. But beyond that, the challenge is to set in motion a concerted effort to catalyse and sustain a virtuous circle in which the *further development of productive capacities and the growth of demand mutually reinforce each other.* This means investing not only in the more productive and dynamic sectors of the economy but also in building capabilities *in the sectors where the majority of population (and the poor) are working.* Without that, there can be high growth, but at best low-job-intensity growth, and certainly not pro-poor growth.

THE NEGLECTED IMPORTANCE OF LOCAL DEMAND

Productive capacities (which condition the scope for generating more productive employment) develop through the inter-related processes of:

- **capital accumulation** (investments not just to increase machinery and equipment, but also supporting economic and social infrastructure and human capital);
- **technological progress** (new technologies, know-how and innovation); and
- **structural change** (more productive synergies within and between sectors of the economy).

However, these processes will not occur automatically by themselves or continue in some mechanical fashion forever. As we have seen in the previous chapter, what mainstream economic policy frameworks have missed is the **essential role of demand.** Demand is firstly what determines whether productive capacities are fully utilized or not. But even more important, the expectation of whether or not demand will grow is what conditions profit expectations and hence decisions to invest to expand productive capacities.

Domestic demand makes the largest contribution to economic growth in most low-income countries, yet its growth is also very weak as it has been neglected. This contributes to holding back investments in productive capacities, which in turn limit the scope for productive employment opportunities that could raise domestic demand. In order to break this vicious cycle, a key challenge is to boost local demand in the sectors where its potential is the highest. In the majority of low-income countries, *trends in domestic demand are closely related to what happens within the agricultural sector.*

AGRICULTURAL GROWTH LINKAGES, EMPLOYMENT AND POVERTY REDUCTION

Historically, the majority of the poor in low-income countries have been employed in agriculture. However, decades of structural adjustment policies that rolled back investments in agriculture (which was further undermined by unilateral agricultural trade liberalization) have seriously contributed to weakening the capacity of agriculture to productively absorb a growing labour force. Other factors, such as limits to arable land and environmental degradation have also contributed to this trend. We might be at a tipping point where more people will be seeking work outside agriculture for the first time in the history of LDCs. Yet non-farm productive employment opportunities are also growing too slowly.

To reverse this trend, it is essential to *capitalize on the linkages between agriculture and the rest of the economy*. On the supply side, concerted efforts to raise agricultural productivity is particularly important for increasing domestic savings in very poor countries and also for ensuring food security through an adequate supply of locally-produced foodstuffs. But demand-side linkages that result from agricultural growth are also an important mechanism to stimulate the development of local manufacturing industries and local services. These inter-sectoral linkages can serve as a catalytic incentive for productive investment decisions, mobilization of latent entrepreneurial capabilities and to ensure that economic growth is more broad-based and inclusive.

Research on agricultural demand-led industrialization in countries at different levels of development has found that in low-income countries, every US\$1 of expenditure by agriculture generates US\$2.75 of induced demand for non-agricultural inputs and services, and 70 percent of this backward linkage effect is attributed to rural household demand for consumer goods and services. Research in Africa has also found that growth in household incomes that comes from increases in agricultural production and incomes (due to technological changes, better prices or lower input costs) is largely spent on farm and non-farm items that are locally-produced. Adding US\$1 of new farm income potentially increases total income in the local economy – beyond the initial US\$1 – by an additional US\$1.88 in Burkina Faso, US\$1.48 in Zambia and US\$1.48 in Senegal.

Viet Nam's relative success in terms of growth and poverty reduction during the period 1993-1998 provides a good example of how investments in agriculture have positive growth spill-overs in other sectors. Broad-based increases in agricultural labour productivity increased earnings for the majority of the poor and stimulated domestic demand for non-agricultural goods that were also produced by the poor in small and medium-sized enterprises (SMEs). This in turn led to higher earning opportunities for agricultural goods and services thereby creating virtuous circle of growth and poverty reduction.

The same kinds of synergies can be observed while promoting labour-intensive infrastructure projects as part of local development programmes that simultaneously support neighbouring micro- and small enterprises by using local materials and maintenance, and rely less on foreign inputs.

An important part of the process is to ensure that gains in productivity serve both for reinvestments and to improve incomes of small farmers as well as agricultural and non-agricultural wage earners. This requires institutions that notably support income redistribution, rights to bargain for better wages or farm incomes that must be adapted to the special conditions of the informal economy.

RESOURCE MOBILIZATION AND STATE CAPACITIES

These examples of bottom-up employment-led growth strategies that complement investments in more dynamic sectors require sufficient finance and State capacities. According to UNCTAD, domestic gross savings rates in LDCs are currently too low to achieve the investment rates needed to make a significant impact on poverty reduction (albeit a significant proportion may be leaking out through capital flight). But the potential savings that could result from better utilizing underemployed labour and latent entrepreneurship through the types of initiatives mentioned above could be very significant.

A defining feature of the most successful East Asian developing economies has been their ability to raise their domestic savings ratios by increasing business savings (not simply household savings). After the initial stages of the development process, the engine for developing productive capacities was the creation of a strong “*investment-profit nexus*.” Through this nexus, expected profits provided the incentive for investment; and realized profits were both an outcome of investments and a source for further investment. This did not happen automatically. It required the use of the heterodox policy instruments described in the previous chapter; and was backed in the early stages by equitable land distribution and very large amounts of foreign aid.

External finance can play an important catalytic role in kick-starting and supporting a virtuous cycle of domestic resource mobilization and investment. Low-income countries have been by and large left out of international capital markets. As for longer-term foreign direct investment (FDI), its effectiveness depends on whether domestic policies manage to integrate FDI into domestic development strategies. Empirical studies show that FDI displaces (or “crowds out”) domestic investments at least as frequently as it promotes (“crowds in”) domestic investments. The data on LDCs suggests that foreign investment has not brought strong positive linkages to generate higher levels of private domestic investment. FDI-dependent growth based on exports of oil, minerals, or manufactures produced in export processing zones (EPZs), has often led “*enclave economies*” with little employment generation outside these enclaves. Elaborating policies that can foster positive linkages between FDI and domestic private entrepreneurship is a major challenge.

Low-income countries have thus been relying heavily on official development assistance (ODA) as a source of external finance. However, the potential of ODA to expand their fiscal space has been reduced by a number of shortcomings including: unpredictability and volatility of aid which tends to be pro-cyclical; lack of coordination of the aid system; high transaction costs of multiple donors; internal brain drain from the public sector to donor projects; and a fiscal squeeze on current expenditures due to conditionality and increased debt service payments from aid loans.

As low-income country governments are improving their financial management capabilities, they have repeatedly called for a much greater proportion of ODA to be channelled directly into their national budget (**budget support**). This call was echoed in the conclusions of the first Development Cooperation Forum (DCF) of the United Nations Economic and Social Council (ECOSOC) in June 2008, which states that: “*Budget support should be increasingly*

41. Official summary of the ECOSOC Development Cooperation Forum 2008: http://www.un.org/ecosoc/newfunct/Summary_of_the_President.pdf.

*used as a preferred modality for delivering development aid due to its positive effects on national ownership, disbursement speed and use of national systems.”*⁴¹

If ODA is to support national ownership of policies, it should mean that developing countries should have the *democratically-accountable* policy space to experiment with heterodox economic policies in support of expanding productive employment. This right is often denied by the donor community and IFIs on grounds that these policies do not work; but when provided with evidence that they can be successful if well managed, the argument shifts to saying that State capacities do not exist. Former UNRISD Director Thandika Mkandawire (2001) has identified a series of “impossibility theses” that are often put forward to argue that the State cannot play a developmental role in Africa.

Weak State capacities are sometimes the result of long periods of civil conflict, but they are also often the result of external conditionalities that imposed severe cutbacks on State administrative services since the 1980s. If State capacities are indeed still weak, this does not mean that the State is irrevocably incapable. Direct budget support is often denied because more progress is needed for good governance. But lack of financial resources is a key source of inadequate governance. *Good governance requires an adequately paid civil service* (UNCTAD 2006).

Governance-related conditionalities can also undermine the effectiveness of aid if they insist on the doctrine that “less government intervention is good to promote a better investment climate.” In successful developing countries, a better investment climate meant something quite different: it entailed public action that recognized the diversity of enterprise-level capabilities and proactive efforts to upgrade them; it entailed a macroeconomic framework that was geared to promoting rapid capital accumulation by providing investment incentives.⁴²

In addition to fiscal constraints and donor-led conditionalities, other policy space limitations are related to provisions in various multilateral and bilateral trade agreements (see next chapter), but also to what is known as the “balance-of-payments constraint.”

THE BALANCE-OF-PAYMENTS CONSTRAINT (PART 1)

The conventional approach to the **balance-of-payments constraint** stipulates that no country can grow faster in the long run than the rate consistent with “balance-of-payments equilibrium” which implies that there should be a balance between the value of exports and the value of imports, unless higher import costs vis-à-vis export revenues (trade deficits) can be financed through sufficient capital inflows.

Each component of demand in the broad sense of the term has some degree of import content (whether private consumption, investment, government expenditure, exports and of course imports). This import content is essential for the continuation of ongoing economic activities and development, so countries need foreign exchange to pay for these imports.

⁴². As UNCTAD (2006:300) argues in this regard: “The government capacities required in order to formulate and implement a strategy to develop productive capacities and expand productive employment opportunities are no more exacting than those required for formulating and implementing a poverty reduction strategy [PRSP]. Indeed, there are probably more *working* models to turn to with regard to the former than the latter [emphasis added].”

Export earnings are usually the most important source of foreign exchange. But if the rate of growth of exports is not enough, countries are obliged to attract external capital to finance the difference between the value of imports and the foreign exchange provided by exports. If this does not happen, it is said that the components of demand have to be constrained in the long term in order for the balance of payments to be in equilibrium.

Growth in the LDCs has been constrained by their balance-of-payments position. Most have experienced current account deficits, which have been financed by capital flows and transfers. But when the latter are not sufficient or unreliably volatile, measures are taken to cut back on imports, which implies cutting back on demand generally, since all elements of demand have an import content. Constraints on the balance-of-payments can have several external sources, such as :

- declining terms of trade ;
- externally-imposed unilateral trade liberalization (often letting in heavily subsidized imports) ;
- protectionism in rich countries ; and
- misaligned currency values.

In the wake of the global economic crisis, these constraints have taken catastrophic proportions for the many developing countries that do not have sufficient foreign currency reserves to buffer the shocks of collapsing export revenues, migrant remittances and capital flight.

The balance-of-payments constraint is a perennial problem, but the conventional approach outlined above ignores its deeper roots. This constraint represents one of the most deficient and inequitable features of the current international financial architecture : it places the onus of adjustment on deficit countries with weak currencies. Chapter 7 examines some of the systemic remedies to this problem put forward in the wake of the global financial and economic crisis. Suffice it to mention here that past responses to the balance-of-payments constraint have often translated into “engineered recessions” (“stabilization programmes”) to curb import demand ; and an excessive focus on unsustainable “trade-led approaches to development.”

A DEVELOPMENT-LED APPROACH TO TRADE

The global economic crisis has given more momentum to calls for a reorientation of development approaches that rely less on export-based demand and more on domestic consumption-led demand growth. The current imbalance focusing primarily on trade-led growth has a long history: UNCTAD has noted how free trade theory has come to dominate the understanding of development processes since the 1980s. This was reinforced in the 1990s through arguments to the effect that “fast and full integration with the world economy was the key to seizing the opportunities of globalization and minimizing the chances of being left behind.” From this perspective, UNCTAD noted, “global integration began to replace national development as major policy objective of governments” (UNCTAD 2006:293).

The paradigm shift discussed in this chapter involves a different approach to trade. It means pursuing a strategy that does not simply focus on developing productive capacities in the more dynamic sectors with export potential (tradable sectors) but that also supports

productive capacities within non-tradable activities (products that are sold locally) and seeks dynamic linkages between the two. Especially in low-income countries, it is in the non-tradable sectors that the majority of the population (and the poor) tend to be employed. They represent a vast pool of underemployed labour and entrepreneurial potential and source of domestic demand for more balanced growth. Obviously, the strategy has to be complemented with regional trade linkages (essential for very small national economies) as a stepping stone or alternative to global integration.

Under this paradigm, the policy approach “...first focuses on production, and then from this perspective identifies how international trade can support capital accumulation, technological change, structural change, employment creation and poverty reduction. What matters is not to maximize trade, but to maximize the beneficial effects of trade” (UNCTAD 2006:293-294).

The next question is whether trade rules support or hinder this process.

