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Development of productive capacities and trade: the key to inclusive and sustainable growth

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Note: The UN-CEB Cluster on Trade and Productive Capacity is an interagency mechanism designed to coordinate and implement joint initiatives. The Cluster is composed of 15 members: UNCTAD, the United Nations Industrial Development Organization, the United Nations Development Programme, the International Trade Centre, the World Trade Organization, the Food and Agriculture Organization of the United Nations, the United Nations Environment Programme, the International Labour Organization, the five United Nations regional commissions, the United Nations Office for Project Services and the United Nations Commission on International Trade Law (please see www.unctad.org).

Introduction

This note explains why trade and productive capacity need to be at the heart of any outcome of the Fourth United Nations Conference on the Least Developed Countries (LDC-IV) and highlights some key issues in this context. It discusses the main enabling policies, strategies and programmes needed for the development of trade and productive capacities.

The Programme of Action for the Least Developed Countries for the Decade 2001-2010, adopted in Brussels in 2001, provides for a set of development goals and policies for the least developed countries (LDCs). The purpose of the Conference is to review the Programme of Action and redesign new goals and instruments for the next decade. Socio-economic progress in LDCs has so far been hampered by insufficient attention to the production sectors as the basis of social and economic development. Ultimately, the Millennium Development Goals can be sustained only if they are supported by inclusive broad-based economic growth through the development of productive and trade capacities.

The economies of LDCs are characterized by multiple structural weaknesses due to the low level of development of productive and trade capacities, policy coherence and appropriate institutional arrangements. International trade and productive capacities are mutually reinforcing. Without trade, LDCs cannot earn foreign exchange to import products they need, obtain new technology and finance development, and will not be able to move up the development ladder.

The productive capacities of a country are essentially a matter of what a country is able to produce efficiently and competitively. This process occurs by expanding investment – in physical, human, social and environmental capital – acquiring technology and developing innovation. Capital accumulation and technological progress not only lead to the expansion of existing productive potential; they also facilitate a process of diversification and a shift in the form of integration of LDCs into the global economy. Substantial poverty reduction occurs as employment opportunities increase, along with the transformation of the productive base of the economy.

Further, LDCs need to diversify into a range of commodities, manufactures and services with a high potential for growth and employment creation, especially for the poor. Developing productive capacities and building international competitiveness in LDCs can be promoted through coherent trade and trade-related policies at the national, regional and international levels. However, an integrated and coherent strategy to build productive capacity needs to go further by incorporating adequate policies in three economic sectors – agriculture, industry and services – and other critical areas, such as energy, institutional and legislative framework for business, private-sector development, environmental policies and decent employment.

Economic growth alone does not guarantee inclusive development. The critical issue is whether the growth has been inclusive, bringing income gains, employment and access to essential services to the poorest segments of society. For example, growth based on the extractive industries could be less inclusive than growth based on agriculture or labour-intensive manufacturing or services. Cape Verde, Samoa, the Maldives and Botswana are examples of successful social and economic development. Further country-based evidence can be found in a report published in June 2010 by the United Nations

Development Programme (UNDP), *The Path to Achieving the Millennium Development Goals: a Synthesis Evidence from around the World*. It states that growth has been a primary driver in reducing poverty and hunger in countries where development has focused on agricultural productivity, employment intensity and the deliberately planned and gender-equitable distribution of income, assets and opportunities.

In contrast, countries that have not focused on inclusive growth and have relied heavily on targeted interventions financed by official development assistance have fared less well. Economic growth in most LDCs has been very fragile owing to the lack of diversified economic structure and extreme vulnerability of their economies. Moreover, it has not been inclusive. *The Least Developed Countries Report 2010* (UNCTAD) attributes this to countries' inability to generate sufficient productive employment and livelihoods for their rapidly increasing population – even during the boom years between 2002 and 2007.

Because of the diversity among LDCs, the heterogeneity of market conditions among countries at different levels of economic development and structural global asymmetries, there is a need for a trade and productive-capacities-led policy to achieve inclusive and sustainable development. It must also take into account differences in development and income levels, economic structures, institutional development and factor endowments.

1. The development of productive capacities is needed in all economic sectors

1.1. Agriculture

Agriculture constitutes the backbone of the economies of most LDCs. Agricultural commodities account for almost 50 per cent of gross domestic product (GDP) in countries such as the Lao People's Democratic Republic and Ethiopia, representing a major source of foreign exchange and revenues. This economic sector also employs more people than any other activity – as much as 60 per cent in most cases – supplies the bulk of basic food, and provides subsistence and income to more than half of the LDC population. For LDCs, improving agricultural productivity is a critical component of an inclusive growth strategy, and post-harvest activities focusing on the transformation, preservation and preparation of agricultural products for intermediate or final consumption are a major source of manufacturing employment and income in developing countries.

Experiences in Brazil, Chile, Kenya, Mexico, South Africa and Thailand have demonstrated the potential of agribusiness to generate employment, increase farm and rural non-farm incomes and raise the living standard of the rural poor. In this context, technology transfers are crucial; for example, Mali's success in rapidly increasing mango exports by about 60 per cent between 1993 and 2008 was aided by technology solutions. A landlocked country, Mali combined road, air, rail and sea transport with specialized containers and freezers to reach export markets. Technology upgrading in testing quality control is also essential for compliance with sanitary standards that can otherwise pose a significant obstacle to exports. Whether the agricultural and food industries in LDCs can respond to the predicted rise in demand for food and food products over the next 20 to 30 years will depend to a large extent on the increased application of existing technologies as well as the development and exploitation of new and innovative technologies.

1.2. Industry

Industrialization is integral to economic development. Very few countries have developed without adding value to their products and industrializing, and rapidly growing economies tend to have rapidly growing manufacturing sectors. Research by the United Nations Industrial Development Organization (UNIDO) shows that differences in levels of total factor productivity are the principal determinants of differences in levels of development. Industry is often the leading high-productivity sector, and growth has lagged where countries have failed to shift capital and labour from low- to high-productivity sectors. In short, what countries make matters for growth and for inclusive and sustainable development. The dramatic shift in international trade and production from end products to tasks is an important opportunity for LDCs to integrate into global value chains and exploit new niches that are created in the trade flows of tasks or components. Manufacturing activities also generate significant forward and backward linkages to services and primary sectors, promote industrial innovation and contribute to gender equality in developing countries, as labour-intensive manufacturing constitutes the key source of wage employment for women.

Industrial development thus has a tremendous transformative potential. According to the *Industrial Development Report 2009* by UNIDO, exports of manufactures have for many years been growing much more rapidly than the production of manufactures and that developing countries are gaining global market share. Yet the pattern of industrial development in developing countries has been highly uneven. Industrialization can be said to be “lumpy” in space, production and time. The challenge for LDCs is therefore to reach the threshold of competitiveness and to upgrade continually their ability to compete. Once an economy crosses over the competitive threshold, its industrial expansion and employment generation can be explosive, as demonstrated by the spectacular rise of the emerging economies, especially in East and South Asia.

1.3. Services

Developing the productive capacity of LDCs in the area of services, particularly tourism and infrastructure-related ones, such as energy, communications, transport, and financial services, will be an essential means to both improve and diversify their production of goods and services. It will also contribute to building their resilience to external shocks and limit their dependence on commodities. Various services are found at each link of the value chain; therefore, increasing their availability and quality will have a large impact on the end products. Infrastructure services will also facilitate the exchange of goods and services at the national, regional and international levels. Moreover, services such as health and education will directly contribute to the upgrading of human resources, skills and managerial capabilities that are essential for improving the productive capabilities of countries.

The potential for tourism to play a significant role in the socio-economic development of LDCs is being widely recognized. In recent decades, tourism development has witnessed a substantial diversification of destinations and several LDCs have registered massive growth in tourist arrivals and expenditure. This trend is likely to continue, which clearly indicates that LDCs will be among the major playing fields for international tourism in the years to come.

The involvement of LDCs in world services trade remains extremely limited, representing only 0.5 per cent in 2008. The latest economic and financial crisis has shown that services exports tend to be more resilient than merchandise trade. Developing the services sectors of LDCs can make them more robust and promote economic growth, competitiveness and welfare improvement, particularly in landlocked countries where transborder transport and logistics issues can be major deterrents to goods trade.

2. Productive capacity for trade-led growth: the role of trade policies

Trade policies and measures and the development of productive capacities mutually reinforce each other and as such are indispensable for the development of LDCs. National and international policies that can facilitate this should be rooted in an approach to trade with development at its core. Policy should focus on production and trade in tandem, and from this perspective identify how international trade can support capital accumulation, technological change, structural change, employment creation, poverty reduction and the integration of LDCs in the global supply chains. It is important to maximize these beneficial effects of trade. To this end, developing countries, especially the most vulnerable, need to be given the flexibility and support to strengthen their production and trading capacities as part of broader development strategies. Trade and the necessary accompanying productive capacity-building are, and will continue to play, a central role in the efforts of LDCs to lift themselves out of poverty. International and national policies should be mutually supportive. Enhanced policy coherence between trade-related policies – and this would include competition policy and other macro-economic policies and strategies, such as industrial development policies and national export strategies – is needed to strengthen the competitiveness of LDCs and establish an enabling policy environment to stimulate export-led production, trade and development.

LDCs are seeking an early, ambitious, balanced and development oriented conclusion of the Doha Development Agenda, as it will provide the necessary stimulus for the growth and development of their economies. An important element is the provision of commercially meaningful duty-free and quota-free market access for products of LDCs by developed countries and those developing countries declaring themselves in a position to do so, with pragmatic, user-friendly, transparent, simplified and easily administered rules of origin as set out in annex F of the WTO Hong Kong Ministerial Declaration (2005). LDCs are also seeking effective and commercially meaningful market access improvements that will have an impact on manufactures, agricultural products and services, and cover products with export potential. Improved market access in the area of services, for example in Mode 4, and a services waiver enabling the extension of preferential market access for the services and service providers of LDCs, complemented with meaningful services commitments, are key. An ambitious, expeditious and specific outcome on cotton is also an important development deliverable. Other priorities include addressing non-tariff barriers, especially with respect to product standards, enhancing trade facilitation and improving and making more precise, tangible and operational special and differential treatment provisions.

Duty-free, quota-free treatment to LDCs by other developing countries in a position to do so should be made more generous by making limited or no exceptions to product coverage and flexible rules of origin requirements, accompanied by direct Aid-for-Trade assistance, investment and technology transfer from these developing countries to LDCs to build up their productive and supply capacities so they can take advantage of preferential market access.

Accession to the WTO of LDCs currently in this process should be expedited and the terms of accession made consistent and commensurate with their levels of development and be done in conformity with the guidelines for accession of LDCs adopted by WTO members in 2002.

South–South trade should be given additional support. South–South trade initiatives provide LDCs with new opportunities to export goods and services. These initiatives at the subregional, regional and interregional levels need to provide LDCs with more favourable market access conditions, simplified rules of origin matching productive capacities of LDCs and productive capacity-building support. In this regard, the Global System of Trade Preferences among Developing Countries offers an important mechanism to advance trade opportunities of LDCs.

3. Key enabling elements for trade and productive capacities development

3.1. Accessing energy

The lack of energy for productive use – especially in rural areas – high costs and unreliable energy services constrain economic activity in many countries and significantly hinder business operation and growth. A World Bank study indicates that countries with underperforming energy systems may lose up to 1–2 per cent of growth potential annually as a result of electric power outages, over-investment in backup electricity generators, energy subsidies and losses, and inefficient use of energy resources. Globally, around 3 billion people rely on traditional biomass and coal as their primary source of energy, and in sub-Saharan Africa, only about 10 per cent of the population currently benefits from access to electricity. Developing countries, LDCs in particular, need to expand access to reliable and modern energy services if they are to reduce poverty and improve the health of their citizens, while at the same time increasing productivity, enhancing competitiveness and promoting economic growth. A wide range of energy services can enhance the productive capacity in a number of areas, including agricultural production (e.g. water pumping for irrigation, mechanized tilling) and processing, better lighting to extend the working day and mechanical power to drive motors for manufacturing (e.g. textiles and garments, canning, bottling and printing). An example of the successful improvement of electricity infrastructure is Ethiopia’s Electricity Access Programme, which is highlighted in the UNDP report, *The Path to Achieving the Millennium Development Goals: a Synthesis of Evidence from around the World* (2010). Five main hydroelectric power plants are being constructed, potentially increasing nationwide coverage by 22 per cent and connecting 758 towns and villages. In Burkina Faso, Ghana, Mali, and Senegal, the adoption and provision of access to cleaner, more reliable fuels have also created income-generating opportunities, particularly for women. In Bangladesh, microcredit schemes have made solar home systems affordable, helping reduce energy poverty in rural communities.

3.2. Institutional and legislative framework needed for business

While developing countries, including LDCs, may have material or human resources to contribute to their own development, weak legal and institutional machinery often makes it extremely difficult to put this capital to good use. To broaden entrepreneurial opportunities and human and social capital, as well as to increase the effective use of productive resources, it is necessary to have an appropriate legal and judicial framework. When this is lacking, resources are wasted and effective investments are impeded. Investors are unwilling to invest because of the concern that their counterparts, whether public or private partners, will breach their promises without having to face legal consequences. Lenders are unwilling to lend because of the risk of not recovering their loans in the event of non-performance by borrowers. Microentrepreneurs and small and medium-sized enterprises (SMEs) have very little access to financial services and lack effective tools to contract and make deals.

The development of markets requires a predictable and stable legislative environment. Laws should foster contract enforcement and protect property rights, and prevent arbitrary government actions, such as non-competitive and non-transparent procurement methods. In addition, a fair judiciary that can enforce contracts and speedily resolve disputes should be in place. Protection and promotion should be afforded not only to large enterprises, as is often the case in developing countries, but also to microenterprises and SMEs. This would help informal business expand into the formal economy.

Further, legislation should promote transparent and accountable governance in public procurement, private-public partnerships in basic public infrastructure, enhanced access to credit for microentrepreneurs and SMEs, effective means of settling commercial disputes quickly and inexpensively, and an international sale of goods regime that is transparent and easily understandable. This would help LDCs open up to new markets and commercial partners, and improve the economies of scale of developing countries.

Harmonization, based on the adoption of international legal standards prepared in neutral and balanced forums such as the United Nations Commission on International Trade Law can help countries – including developing countries and LDCs – develop or modernize their legal framework. By reducing legal obstacles to the flow of international trade, harmonization can contribute to creating a legal regime that is efficient, accessible and compatible with those of its trading partners, thus enabling its use by all those parties relatively new to the business of international trade.

3.3. Private sector-development

Dynamic entrepreneurship and enabling administrative environment are necessary conditions for the bottom-up development of competitive and productive SMEs. Many LDCs are characterized by subsistent agrarian societies, a lack of growth-oriented capable entrepreneurial human resources and an inefficient administrative business environment. The result is a large number of small-scale enterprises in the informal sector that find it difficult to take advantage of opportunities and to access capital, subcontracts and larger domestic and foreign markets. Individually, SMEs are often unable to seize international market opportunities that require large production quantities, high quality standards and regular supply. Further, their small size makes it difficult to access effectively business services, such as training, market intelligence, logistics and technology innovation. A cluster and network approach aimed at creating synergy among business entities can play a key role in overcoming these difficulties. A focus on human resource development for entrepreneurship and skills development is essential to build a nationwide foundation for competitive private-sector development and productive activities. Streamlining and building capabilities to implement business-related laws and administrative processes, for example, for licensing, are basic measures that can be taken to improve public-service capacity and cut transaction costs for entrepreneurs wishing to start up a new business and expand.

Evidence shows that SMEs are more constrained by financing and other institutional obstacles than large enterprises. Access to seed-, start-up- and early-stage financing remains a major challenge for many entrepreneurs, and this is exacerbated by the weaknesses in the financial systems of many developing countries. Policy measures that seek to increase access to finance may include facilitation of access to loans, credit guarantees, venture capital and equity funds. However, these instruments should be provided in partnership with the private sector, as there can be pitfalls in government involvement in SME financing. The past few years have seen the emergence of networks of angel investors, or business angels, through whom start-ups can apply for funding. The creation of business linkages between large firms and SMEs can lead to the establishment of special funds to facilitate small-scale start-up supplier financing. Many SMEs in LDCs do not have the possibility of offering collateral to access finance. It is, therefore, necessary to seek innovative financing mechanisms such as the use of entrepreneurship as a form of collateral.

3.4. The role of environmental policy

Although the LDCs as a group contribute relatively little to global warming, they will be disproportionally affected by changing climate conditions. This concern is already acute in continental LDCs that are frequently affected by drought and desertification, and in small-island LDCs, where threats to coastal areas affect productive capacities as seriously as they affect households.

Moreover, soil, forests, fish, water and other forms of natural capital constitute a major portion of the productive assets of the poor and of total wealth in low-income countries. These natural resources provide the basis for livelihoods, offering employment and income, business development and trade opportunities, as well as insurance or fallback options in times of economic hardship. Many LDCs maintain a heavy reliance on the agricultural sector, with approximately 70 per cent of the LDC labour force deriving its income from that sector, as noted in UNCTAD's *Trade and Environment Review 2009/2010*. Ecological deficit can thus affect the livelihoods, productive capacity and trade opportunities of the populations of LDCs disproportionately.

A policy framework that promotes the sustainable management of natural capital and ecosystems and helps adapt to and mitigate the effects of climate change should be a key element in the development strategies of LDCs. It is essential that such policies also aim to ensure food security. Environment-related concerns should be at the heart of all strategies to develop productive capacities along these lines, and growth should not be decoupled from high and increasing levels of carbon emissions.

Policies that promote rational public expenditure and investment, including private investment, in sustainable economic activity and infrastructure, such as energy access, water and roads, are essential. Improving the physical and telecommunications infrastructure of agricultural communities, for example, has the potential to stimulate sustainable agricultural production and related trade and thereby provide employment and development opportunities in rural areas. It is also important to reform subsidies that encourage poor environmental and resource management. A recent report, *Towards a*

Green Economy: Pathways to Sustainable Development and Poverty Eradication – a Synthesis for Policy Makers (UNEP, 2011) identifies a number of cases in which developing countries have been able to allocate savings from subsidy reform to education, primary health care and microcredit schemes for vulnerable groups. Environmentally related taxes and payments for ecosystem services schemes can also be used to promote productive capacity that is sustainable.

At the national level, regulatory reforms, such as those regarding property, land-use rights and standards, can be important to establish a regulatory framework that promotes fair and sustainable production and trade. At the international level, an equitable multilateral trading system can facilitate trade in, for instance, environmentally enhanced goods and services, and open up opportunities for LDCs to take advantage of the growing markets for such products and services.

Finally, it is important that the international community support the strengthening of institutional capacity in LDCs so that these countries can manage their natural resources better, and design, implement, monitor and enforce the policies that contribute to social and economic development and at the same time tackle climate change and the degradation of ecosystems.

3.5. Generating decent employment

Employment constitutes the most important link between growth and poverty reduction. The creation of decent employment should, therefore, be at the centre of a holistic and coherent strategy for trade and the development of productive capacity. The concept of decent work has been defined by the International Labour Organization and endorsed by the international community as opportunities for women and men to obtain productive work that delivers a fair income in conditions of freedom, equity, security and human dignity. For LDCs, this means a twin challenge of creating more employment and increasing labour productivity. Policies to support a structural transformation and productivity growth, as outlined previously, are key to achieving this aim. However, they must be complemented with policies on the supply side of labour, in particular the development of education and skills for workers in LDCs, which is essential if they are to benefit from trade. At the same time, these policies are indispensable for LDCs as they strive to adapt to more advanced technology and build up productive capacity. Labour productivity can also be enhanced through “high-road” business practices that enhance labour productivity through better management and investment in workers while respecting labour standards.

Despite its importance for growth and structural transformation, trade can also have negative effects on workers in developing countries. Given the high dependence of most LDCs on very few export products, an increase in trade openness is likely to lead to even higher vulnerability to external shocks, at least in the short run until a more diversified export base has been built up. Opening up to trade can also have serious adjustment implications that typically create both winners and losers among workers. Furthermore, trade is often found to contribute to income inequality by raising the relative income of skilled over unskilled workers (the “skill premium”) and by weakening the position of workers compared with capital owners. Therefore, trade openness should be accompanied by appropriate policy measures for social protection that protect those affected by negative shocks and possibly additional measures to ensure that the gains from trade are distributed equitably.

4. How to finance the development of productive and trade capacity of the least developed countries

4.1. The role of official development assistance

Official development assistance provides an important source of financing for LDCs. These countries, particularly subsistence or commodity-dependent economies, often lack the ability to broaden their tax base, while facing high GDP growth volatility and hence fragile revenue bases, which may be further constrained by multilateral commitments and policy conditionalities linked to official development assistance. A considerable number of LDCs do not have access to capital from international financial markets, making concessional loans and grants crucial forms of financing for development. Repeated calls have been made for donors to boost official development assistance contributions to 0.7 per cent of the gross national income target, most recently reaffirmed at the United Nations Summit on the Millennium Development Goals. The question remains as to whether the increases in official development assistance have kept pace with the increases in donor commitments and with the requirements for addressing the core challenges of the Goals, not to mention the added requirements for addressing emerging new global concerns, such as climate change and food security.[1]

However, heavy reliance on official development assistance-supported investments for the provision of social services is particularly risky in LDCs, where the predictability and stability of official development assistance flows is not certain. The needs addressed by the internationally agreed development goals often affect 80 per cent of the population, and are thus unlikely to be met solely through project-based actions. Even more importantly, there is a danger that an approach purely based on official development assistance lacks national ownership and sustainability, once external financing dries up. A more sustainable and durable solution for the provision of social services must be driven and supported by dynamic economic growth.

Trade and official development assistance can support efforts to develop productive capacities and generate inclusive growth. For trade policy and official development assistance to serve development, they must be targeted towards the creation of employment, the building of infrastructure, the transfer of technology and the generation of domestic resources. Thus, official development assistance should not be focused exclusively on the social sectors, but should also support the rest of the economy, for example, by building key support infrastructure, supporting technology transfer and providing subsidized credit to entrepreneurs.

To date, official development assistance strategies have remained poverty-reduction strategies, placing strong emphasis on social concerns. As a result, the share of official development assistance allocated to social uses increased, in relative terms, from 40 per cent in 1990 to 60 per cent in 2008.[2] However, the share allocated to production sectors, economic infrastructure and the local development of SMEs has fallen significantly, and LDCs and other developing countries have been urged to attain higher social development without having laid a solid economic foundation for such progress

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[1] See UNCTAD, *Trade and Development Report, 2008,* chapter V.

[2] UNCTAD, *The Least Developed Countries Report 2010,* p. 89.

Genuine national development strategies are an important cornerstone in achieving long-run growth, broad-based poverty reduction, and ultimately achieving the Goals in LDCs. While national ownership is essential for growth strategies, donors must remain strong partners in the development processes. Increasing the reliability of aid flows and turning the fragmented aid system into a truly global partnership for development is as important as a redirection of official development assistance flows towards growth sectors.

Finally, official development assistance is often delivered in a way that differs substantially from the priorities identified in national development strategies. In addition, the aid is conditioned on criteria that are not necessarily aligned with the interests of the recipient country. This has resulted in a reduced national ownership of the process of design, delivery and allocation of official development assistance and has diminished its effectiveness. There is a need to reform and reduce conditionalities attached to aid in order to promote country ownership of the process and ensure its alignment with national development strategies. Providing more aid for the development of productive capacities will result in a closer alignment of official development assistance with the development priorities of LDCs as expressed in their national development strategies and poverty reduction strategies.

Further, remittances to LDCs have grown four fold during the last 10 years, reaching about $25.9 billion in 2010; they represent the third largest source of capital inflows into LDCs after official development assistance and foreign direct investment. They constitute an important source of development financing that can be harnessed to develop productive capacities and enhance trade. However, remittances do not replace official development assistance or foreign direct investment, which remain important for LDCs.

The Millennium Development Goal 8: The Global Partnership for Development at a Critical Juncture – MDG Gap Task Force Report 2010 emphasizes the importance of donors accelerating delivery on existing aid commitments, including through renewed technical, financial and political support to the Aid-for-Trade initiative, as well as through increased support to the Enhanced Integrated Framework, which is the entry point for LDCs in accessing aid for trade. According to estimates made by the Organisation for Economic Co-operation and Development, official development assistance commitments in Aid for Trade reached $41.7 billion in 2009**.** Figures are forecasted to remain constant in 2010 and 2011.

The role of Aid for Trade

Aid for Trade, as the trade-related capacity-building component of official development assistance, continues to serve as an integral link between trade and development for LDCs. In addition to facilitating the mobilization of resources to LDCs to allow them to enhance their supply-side productive capacities, Aid for Trade has supported more effective mainstreaming of trade within LDC national and sectoral development plans. Aid for Trade provides an enabling environment to make trade work for development and promote economic growth through trade. It is acknowledged that the enhanced market access opportunities foreseen for LDCs under the Doha Development Agenda alone will be most effectively utilized when coupled with assistance to build up productive capacities. Aid for Trade is demand driven; by providing the necessary financial and technical assistance support, LDCs build up this supply-side capacity and strengthen their trade-related infrastructure to enable them to produce and trade more.

Enhanced Integrated Framework

The Enhanced Integrated Framework is an Aid-for-Trade partnership for LDCs that lays the foundation for promoting productive capacity-building through its focus on mainstreaming trade, strengthening trade institutions and building capacity needed to roll out coordinated trade and development assistance. An Enhanced Integrated Framework multi-donor trust fund is available to support these efforts. The Diagnostic Trade Integration Studies Action Matrix sets out a country's nationally agreed priority areas and provides a common platform for stakeholders from government, civil society, the private-sector and development partners to acquire ownership of a country's trade-and-development path. The Enhanced Integrated Framework also supports the sustainability of building productive capacities to help countries move up the value chain and expand their capacity to trade competitively and diversify. In addition, the Framework also helps graduating LDCs maintain momentum to promote a longer-term approach to productive capacity-building by providing transitional support.

4.2. Domestic resource mobilization

While in the short- to medium-term there is a need for more official development assistance, greater mobilization of domestic financial resources is key to reducing aid dependence in the long term. Data from *The Least Developed Countries Report 2010* suggest that official development assistance accounted on average for about 39 per cent of total public expenditure in 44 LDCs during the period 2006–2008. Building capacity, as well as true democratic foundations of developmental States in LDCs, requires increased domestic tax and revenue generation. National policies in this regard should involve efforts to build competent and effective tax administrations, and better management of natural-resource rents that broaden the tax base, especially through measures to bring untaxed informal activities into the formal economy. These national efforts should be supported by a number of international measures such as (a) helping LDCs build capacity for tax mobilization; (b) promoting financial and tax cooperation to reduce capital flight and harmful tax competition; and (c) supporting development of the financial sector in LDCs. Enhanced domestic resource mobilization would not only reduce the need for aid, but would also increase the policy space of LDCs to pursue the development of productive capacities in accordance with their own priorities.

4.3. The role of foreign direct investment

Since domestic investment levels are low in LDCs, foreign direct investment and other forms of activity relating to transnational corporations can contribute to the capital stock, as well as to the introduction of new technology and management know-how that can benefit their long-term and strategic development objectives. Indeed, the share of foreign direct investment flows in gross fixed capital formation has grown steadily over the past decade. Developed countries were the main source of foreign direct investment for LDCs during the 2000s and the presence of transnational corporations from industrialized countries remains dominant. However, LDCs are also increasingly attracting foreign direct investment from developing and transition economies, such as Brazil, China, India, Malaysia, South Africa and the Russian Federation. In addition, investments by member States of the Gulf Cooperation Council in sub-Saharan African LDCs have also been on the rise in sectors such as telecommunications, tourism, finance, infrastructure, mining, agriculture and oil and gas.

Most LDCs make significant efforts to improve their investment environment in order to attract foreign direct investment, including by the establishment of dedicated investment promotion agencies to better assist foreign investors. Today, the regulatory conditions established in many LDCs are on par with those in other developing countries. Furthermore, increased attention has been paid by many LDCs to policy initiatives at bilateral, regional and multilateral levels in order to enhance their international integration and, among others, establish a larger market for investors. Some of the larger LDCs also offer similar opportunities for investors arising from significant domestic markets. However, when it comes to conventional risk ratings, LDCs tend to suffer from image problems and a simple lack of information; therefore, additional efforts are needed to market their improved investment environments and opportunities. Investment promotion needs to be grounded on the interests and development priorities of LDCs. Not all types of foreign direct investment are likely to lead to positive knowledge and technology spillover. Preferential treatment – for example, tax privileges – granted to foreign investors should be approached with caution.

4.4. External debt

The group of 49 LDCs has average debt ratios that are about 50 per cent higher than the overall developing country average.[3] Despite improved debt indicators for the LDCs as a group over the 2000–2008 period, the global financial and economic crisis has had a considerably negative impact on LDCs because of contractions in economic growth, export earnings, remittances and investment. Debt service burdens, both as a share of exports and as a percentage of government revenues, remained heavier during 2010, compared with the pre-crisis years. To mitigate the negative impact of the financial crisis, many LDCs have increased public spending by digging into the fiscal cushion built up during previous years. However, if the economic recovery were delayed further, their fiscal space would be quickly exhausted. The international community must avoid complacency and remain vigilant in monitoring the debt situation of LDCs and take steps to ensure that grant and concessional financing is readily available and directed to productive sectors of the economy.

Many LDCs have very small domestic financial sectors and often depend on external resources to finance not only projects in the production sectors of their economies and large infrastructure projects, but also the development of their health and education sectors. Borrowing from external resources to finance these sectors could result in an unsustainable debt situation. This suggests that any effort aimed at improving debt sustainability in LDCs should start by recognizing that these countries have enormous needs for investment in social and physical infrastructure, but a limited ability to sustain the external debt needed to finance these investments. Debt cancellation and a surge in official development assistance are thus necessary in order to promote economic and social development without creating the conditions for devastating debt crises.

[3] UNCTAD, *The Least Developed Countries Report 2010*, p. 31.

Agenda for action

There is clearly a case to be made for substantially building up productive capacities and trade in LDCs as major drivers of economic growth, increased public revenue and job creation. In order to help speed up progress of LDCs towards achieving their national development goals, the following steps should be taken:

1. Orient development policies aimed at stimulating sustained productive investment, creating decent employment, developing workers' technological capabilities and skills, expanding access to reliable and modern energy services for productive use, strengthening linkages within and across regions, sectors and between enterprises, and promoting sustainable management of natural capital.

2. Enhance the economic diversification of LDCs by promoting domestic value-added processes as a core element of the manufacturing and services sectors.

3. Foster at all levels a strong enabling environment to enhance long-term agricultural production and productivity in LDCs based on public and private investment, adequate rural infrastructure and the development of strong and sustainable agricultural value chains, including through the promotion of agro-industries and agribusiness, and improving access of farmers to markets.

4. Adopt a more strategic approach to trade policy and legal standard-setting that views trade as a means to achieve inclusive and sustainable growth and development, rather than being an end in itself.

5. Grant preferential market access and reduce tariff peaks and tariff escalation in order to make LDC exports commercially meaningful and beneficial for the development of productive capacities and growth in general.

6. Ensure that Aid for Trade will continue to serve as a sustainable integral link between trade and development for LDCs by generating the resources to support the building of productive capacities, trade-related infrastructure, institutions and regulatory regimes.

7. Unlock the full potential of the Enhanced Integrated Framework for LDCs as the vehicle available to LDCs to access Aid for Trade by mainstreaming trade into their national development strategies and articulating their demand for support, leading to delivery by their development partners.

8. Deliver on existing commitments and increase the allocation of official development assistance to ensure more support to the production and trading sectors and develop new financing mechanisms, including through domestic resource mobilization to back the development of productive capacities and business opportunities.

9. Refocus economic and finance policies aimed at promoting both domestic and foreign investment that enhances the productive, technological and trading capacity of developing countries, in particular LDCs.

10. Improve debt sustainability so as to free financial resources for developing productive and trade capacities.