DIIS POLICY BRIEF

ELITES, PRODUCTION AND POVERTY: A COMPARATIVE STUDY

What aid should and shouldn't do in order to support private sector development

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If foreign aid is to have a greater impact on reducing poverty in poor countries in a sustainable manner, then it needs to focus more on economic cooperation and changing productive structures, and to move away from a focus on social sectors and subsidizing the consumption of poor people.

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How can foreign aid support the process of economic development so that aid will make a significant, sustainable impact? The short answer is that 'business as usual' will not do. But the more complex answer is that we must first understand how economic development and sustainable poverty reduction occur. We know that they are driven by private sector development, but current understandings of such development can be too simplistic and even naïve about how companies and industries emerge and about the necessary relations between government and business.

POLICY RECOMMENDATIONS

1. Donor agencies need to create new mechanisms for delivering aid to support productive sectors that are flexible, allow risk taking, and rapidly disperse funding.
2. Donor agencies' support for private-sector development should be industry-specific and part of a coherent approach to support that industry.
3. Donor agencies need to broaden their conventional understanding of what is an 'enabling environment' to include what enables particular industries to succeed.
4. A donor agency could support government bureaucrats to gain knowledge about new industries or upgrading old ones.
5. A donor agency could focus on an industry that a recipient government is already interested in supporting, and on an industry in which donors have technology and expertise to offer.
6. In the case of a lack of clear political support, a donor agency could help industry actors in an emerging industry driven by private investment to get organized and coordinated, and eventually lobby the government for what they need.

Economic development and Africa

What makes most African countries poor is their lack of economic transformation. Widespread poverty is the result of having an economy that is predominantly agrarian and where agriculture is characterized by low productivity. Changing the structure of the economy is the key to long-term, sustainable poverty reduction. Countries that have grown rich and reduced poverty have necessarily moved away from agricultural production into economic activities with higher productivity which generate more employment. This requires simultaneously increasing agricultural productivity and moving into manufacturing.

Why do poor countries need to industrialize? The answer is that increasing agriculture productivity in food crop production is not enough. As agriculture production and productivity increases, it will need to employ less labor and it will drive down the prices of food crops. People previously (under)employed in smallholder agriculture, who are often farmers by default, will need to move into economic activities characterized by higher productivity, otherwise large pockets of poverty will remain because people will move into informal sector activities in the cities characterized by low productivity. Countries must build manufacturing and agro-processing industries, because these industries create jobs and impart new skills to the labor force.

In short, agriculture alone cannot make a country wealthy, and extractive industries do not necessarily create many jobs and the kind of skills that can be used in other industries. Relying on agricultural commodity production and natural resources is a risky strategy that can easily shift from producing wealth to producing poverty when commodity prices drop or production runs into diminishing returns. A wealthy country is a country whose economy is based on knowledge-assets, not natural resource endowments.

This kind of structural change in the economy requires building technological capabilities: the technical, managerial and institutional skills that allow enterprises to utilize equipment and technical information efficiently. Such capabilities are the invisible glue that make industries competitive. Technological capabilities involve tacit knowledge that cannot be easily transferred and does not appear spontaneously, but is rather acquired through learning by doing and investing in learning new things. Following on from this, structural change does not happen spontaneously, but requires directed effort and collective action among many actors. In particular, in less developed countries, structural change requires support from governments in partnership with productive firms.

Here I present five propositions regarding how aid can contribute to economic development. I will provide a quick summary of how I understand economic development, as this is important in comprehending my suggestions for how foreign aid should support it.

1

The everyday practices of aid agencies and the manner in which aid is given partly explain why aid has such a limited impact on economic development. New approaches and aid mechanisms are needed.

A donor agency should not agree on a generic intervention or program and then try to roll it out across its recipient countries, or even variations of it. The industry approach advocated here requires that donor support is based on an analysis of the needs of a specific industry in a particular recipient country, and that recipient governments design their own projects in collaboration with the beneficiary firms and their industry organizations. In devising solutions to an industry's specific problems, recipient governments can learn from other countries' experiences and the solutions they used, but not transfer them wholesale. These experiences and solutions must be adapted to the country's context based on local expertise, both inside and outside government.

Furthermore, donors need to change their administrative procedures and create new mechanisms for delivering aid that aims to support productive sectors in ways that:

- Allow projects to be designed quickly and make funds and assistance available quickly, especially when targeting export-oriented industries because global markets are always changing.
- Enable project implementation to be flexible, responding to unforeseen needs or changes in the domestic or global context.
- Encourage taking risks and supporting innovative ideas in developing productive sectors.

2

For foreign aid to make a significant impact on private-sector development, it must target specific industries

Donors want to support private-sector development as a way to promote market-led growth. But the concept of private-sector development needs to fit the realities of existing economies and to be linked to the objective of promoting economic transformation. One can do this by taking an industry approach.

An 'industry' simply means the commercial production and sale of a particular product or a range of related products. It can be an agro-industry, manufacturing industry, or service-based industry.

Donor and government activities should be industry-specific and part of a coherent approach to support that industry. Private sector oriented programs should not aim generally at facilitating SME development, improved infrastructure, access to credit, vocational education, regional integration, standards and accessing export markets. Rather a program should focus on addressing these issues, where relevant, within the context of the targeted industry and a coherent strategy based on an assessment of constraints on the industry and solutions to address them.

This even applies to supporting staple food crops. Rather than focusing on general reforms in agriculture and increasing agricultural productivity, an agricultural program should be tailored around a particular staple food crop in the country. Each product and crop has a different organization of production and marketing chain, and this should shape how it is supported.

Foreign aid projects that are not targeted end up having little impact. An industry approach is about finding solutions to problems that particular industries face. It is about donors narrowing the scope for action, and being creative but also pragmatic.

3 Private-sector development requires more than a good business environment, and indicators of 'good investment climate' are not a prerequisite for industry growth

Parts of the 'good governance' approach to private-sector development are important, but other parts are not necessary and some even conflict with an industry approach. An enabling environment is necessary, but the conventional understanding needs to be broadened to include what enables particular industries to succeed.

Harvard economists Dani Rodrik and Ricardo Hausmann have used the phrase 'doomed to choose' in relation to the imperative of industrial policy: 'The idea that the government can disengage from specific policies and just focus on providing broad-based support to all activities in a sector-neutral way is an illusion based on the disregard for the specificity and complexity of the requisite publicly provided inputs or capabilities ...'

There are constraints on industries that apply across the whole economy, such as the high cost of finance, inadequate supply of electricity and water, poor roads, and lack of semi-skilled labor. However, providing solutions to these problems for all existing economic activities is not feasible for governments with limited budgets, and their provision often needs to be tailored to meet individual industry needs.

Other constraints on industries are industry-specific: specific to the organization of production, global value chains, and the coordination and competition of a particular industry. For example, some industries may require the creation of an internally secure market through preferential tariffs in order to build up an industry that can compete with imports from advanced countries in goods such as sugar, rice or poultry.

Investment climate assessments and doing business surveys do not recognize the specificity of the inputs required for each business activity. Rodrik and Hausmann argue that these kinds of surveys are not the right way to identify the critical improvements each activity needs.

The case of the emergence of horticulture exports in Ghana, which is a non-traditional export, also indicates that new industries can emerge in very hostile economic environments. In fact, it was economic crisis that lead Ghanaians to invest in a new export product because they needed foreign exchange and there were no other 'easy' opportunities for making money. What is needed is to look at the incentives for entrepreneurs with limited capabilities and finance to invest in productive sectors, vis-à-vis easier alternatives to making quick profits.

4 Building competitive industries must be led by industry actors working with government bureaucrats

For the targeted industry support to have credibility in the eyes of industry actors and their buy-in, industry actors must play a substantial role in devising the support.

In order to build effective relations between industry actors and state bureaucrats, state bureaucrats must begin working directly with industry actors and gaining industry knowledge.

Today, too often it is donor-paid consultants who not only devise productive sector interventions, but are also the main ones engaging with industry actors. Consultants have become interlocutors for the state bureaucrats. But the evidence shows that it is important for bureaucracies to play this mediating role.

State bureaucrats must have knowledge of the industry and share a certain vision of where it is going with industry actors. For bureaucrats to work, they must also have critical political backing in order to acquire the resources and skills they need.

Building competitive industries in countries with generally low capabilities, and even upgrading industries in countries with moderate capabilities, often requires importing foreign expertise. But the expertise of foreign consultants must be transferred to local technocrats, within and outside government, so that they can provide the necessary supporting services which industries require.

Donors should support state bureaucrats in gaining knowledge about new industries or upgrading old ones. More specifically, aid could subsidize the cost of:

- importing foreign expertise
- sending state bureaucrats abroad to gain expertise in a new industry, or
- launching exchange programs targeted at helping bureaucrats, industry actors and universities gain new expertise from countries which have it.

5

Donors can only play a backseat role in this process, but can use aid in creative ways

Donors could help fund the targeted industry strategies of recipient governments. When I make this suggestion, the response I often receive is 'which industries?' There are two criteria for selecting industries that are important in winning sustained political support from the donor and recipient side, which is necessary if aid is to be effective in building competitive industries:

1. Select industries which ruling elites in the recipient country are interested in supporting. The interest of the ruling elites will be indicated by the fact that they are already talking about doing something in the industry, or are actually implementing something on their own.
2. Select industries in which the donor country has technology, expertise and experience to offer the recipient country.

In the case of a lack of political support from the ruling elites, donors could look for nascent industries driven by private investment, and help the actors in these industries to get organized, cooperate and over come collective action problems that inhibit the growth of industries in less developed countries. Donors can also help strengthen the industry associations, which in turn can lobby their government for what they need and perhaps create interest among ruling elites.

The most important aspect of foreign direct investment is the technological capabilities and market connections that it brings, not necessarily the capital. But conditions must be placed on foreign direct investment so that skills and technology are 'transferred' to local entrepreneurs and firms through learning by doing.

Aid can be used to create incentives for companies from donor countries to invest in certain productive industries in recipient countries, with conditions on building local technological capabilities or on helping to create forward/backward linkages around that industry.

Here the key point is not being afraid to link donor domestic commercial interests and aid; employ more of a 'mutual benefit' approach to aid

FURTHER READING:

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