UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT
UNCTAD

No.88
AUGUST 2021

POLICY BRIEF

Enhancing productive capacities and transforming least developed country economies through institution-building: Upcoming United Nations conferences and the way forward

The least developed countries (LDCs) are vulnerable to exogenous economic, environmental and health-related shocks, such as the coronavirus 2019 (COVID-19) pandemic, due to the low level of development of their productive capacities. The fifteenth session of the United Nations Conference on Trade and Development (UNCTAD XV) will be held in October 2021 and the fifth United Nations Conference on the Least Developed Countries (LDC5) will be held in January 2022; both conferences will aim to seek ways and means of expanding productive capacities, critical to building socioeconomic resilience and enabling LDCs to achieve structural transformation and sustainable economic growth. In this policy brief, UNCTAD intends to shed light on the role of institutions in fostering productive capacities, and examines Institutions as one of the eight categories of the UNCTAD Productive Capacities Index.[1] In the context of the formulation and implementation of policies and strategies in support of LDCs, recommendations are provided to support the building of stronger and more effective institutions, a prerequisite for fostering productive capacities.

Key points

- Expanding and upgrading productive capacities in LDCs is critical to building economic resilience and supporting structural transformation.
- Functional institutions are drivers of productive capacities and economic growth when they formulate and implement effective development policies.
- Strong institutions are needed to facilitate an integrated and inclusive approach to policymaking.
- Use of the Productive Capacities Index can play a critical role in helping LDCs to identify and understand key issues that affect the functioning of institutions.

The key role of institutions in building productive capacities

In the development economics discourse, institutions comprise organizational structures, procedures and established practices.[2] They include, for example, public entities, policies, contracts and rights, the rule of law and enforcement and various governmental forms and functions. In addition, institutions may also refer to cultural habits and practices, including beliefs, traditions and norms adhered to and perpetuated through behavioural patterns and societal assumptions. Through institutional implementation, oversight and regulation,

[1] The Index assesses and measures the performance of productive capacities in countries. The eight categories are energy, human capital, information and communications technologies, institutions, natural capital, the private sector, structural change and transport (see https://unctad.org/topic/least-developed-countries/productive-capacities-index).

[2] D North, 1991, Institutions, *The Journal of Economic Perspectives*, 5(1):97-112.

UNITED NATIONS
UNCTAD

Governments can build and improve energy and transport infrastructure; foster human capital development, including in education, skills and health; develop information and communications technologies; promote private sector development and competitiveness; and advance structural change.

The Productive Capacities Index shows that LDCs lag behind other developing countries and developed countries in the following categories in particular: human capital, information and communications technologies, institutions, the private sector and structural change.[3] In addition, the Index indicates that developed countries and developing countries with a relatively high overall Index score consistently score highest in the institutions and private sector categories and that LDCs appear to struggle in these categories.[4] There are significant gaps between LDCs, other developing countries and developed countries (figure 1). This suggests that the overall Index scores of LDCs are significantly dragged down by the quality of their institutions, which often lack the capacity to formulate and implement effective policies.

Figure 1
Productive Capacities Index scores, institutions category, by country groups

Source: UNCTAD, 2020, *UNCTAD Productive Capacities Index: Methodological Approach and Results* (United Nations publication, Geneva).

Implementing effective policies

Central to strong institutional frameworks is the capacity of national institutions to implement, monitor and enforce effective policies that contribute to economic and social development. Even if policies are properly formulated, and developed through inclusive and well-functioning processes, weak implementation and application can undermine their effectiveness.

Many of the difficulties in policy formulation and implementation in LDCs stem from fragmented governance and regulation, poor institutional coordination, a lack of adequate financing and a lack of inclusiveness in the policymaking process.[5] Fragmented governance and regulation may lead to a lack of consistency between policies formulated at the national level and implementation at subnational levels. Moreover, uncoordinated governance can produce dysfunctional information systems that focus on parts of the economy rather than the whole, leading to a misallocation of resources. Finally, regulatory fragmentation leads to complexity, increased transaction costs and reduced economies of scale.

[3] Structural change refers to the movement of labour and other productive resources from low-productivity to high-productivity economic activities. This shift is currently captured by the sophistication and variety of exports, the intensity of fixed capital and the weight of industry and services in total gross domestic product. Structural change can also take place within a given sector provided that binding constraints in the sector are identified and effectively addressed.

[4] UNCTAD, 2020, *UNCTAD Productive Capacities Index: Focus on Landlocked Developing Countries* (United Nations publication, Geneva).

[5] With regard to necessary features of efficient institutions, see G Banks, 2015. Institutions to promote pro-productivity policies: Logic and lessons, Productivity working papers No. 1, Organisation for Economic Co-operation and Development (OECD).

Another sensitive issue is coordination among various institutions and the participation of stakeholders in policy formulation and implementation. Policies developed in administrative silos are unlikely to be implemented effectively or produce expected outcomes. Instead, policies should be designed through coordinated and participatory processes that rely on the collaboration and coordination of a range of stakeholders at multiple levels.[6] Such processes also need to include a diverse number of voices and public views, including those of the private sector and civil society.[7] Inclusive development strategies are critical in achieving concrete policy outcomes. There may be merit in establishing institutions to independently oversee the policymaking process and ensure that it follows a harmonized and inclusive approach.

The challenges in policy formulation and implementation highlighted above are often compounded by a lack of policy coherence that reduces the potential to improve productive capacities. In particular in LDCs, coherent macroeconomic, fiscal, industrial, sectoral and investment and trade-related policies at the national, regional and international levels, which target and prioritize strategic sectors that offer comparative advantages and greater value added potential, are therefore necessary. Policies should also focus on critical areas, such as energy supply, regulatory frameworks and private sector development. This may require identifying cross-cutting policy areas in which coordinated actions will be crucial.

Building an enabling environment

In the economic sphere, one of the main purposes of institutions is to reduce uncertainty by establishing a stable and predictable environment that is conducive to economic growth.[8] This can be achieved primarily by implementing laws, rules and regulations that instil transparency and accountability and influence the decision-making processes of both individuals and firms by signalling the types of conduct that are legitimate and acceptable and the types that are not. By setting established practices and procedures, including through pro-poor and more equitable laws and regulations, institutions can help lower transaction costs for economic actors and reduce the potential for illicit activities to proceed unchecked.

Institutions that fail to enforce rules or create an enabling environment increase transaction costs and the risks of economic loss. In addition, lack of a legal and judicial framework impedes effective domestic and international investment, as investors are not appropriately protected by legal provisions and face a greater risk of financial loss.

However, strong institutions and effective legal frameworks can help attract quality investment and foster business transactions by anchoring expectations. In addition, they help ensure that markets and the economic system function properly. A coherent enabling environment is characterized by the following, as shown in figure 2:

(a) Transparent institutions, which are open about their revenues, activities and budget allocations. This makes it more likely that resources will be allocated and used efficiently, to avoid corruption and resource mismanagement;

(b) Accountable institutions, which serve the population as a whole and not specific interests. They must be held accountable for maintaining the rule of law, providing quality services and ensuring effective and sustainable development in an equitable manner;

(c) Efficient institutions, which need to put in place mechanisms, processes and tools to formulate, implement and enforce effective, sustainable and coherent policies in all sectors;[9]

---

[6] C Ansell, E Sørensen and J Torfing, 2017, Improving policy implementation through collaborative policymaking, *Policy and Politics*, 45(3):467–486.

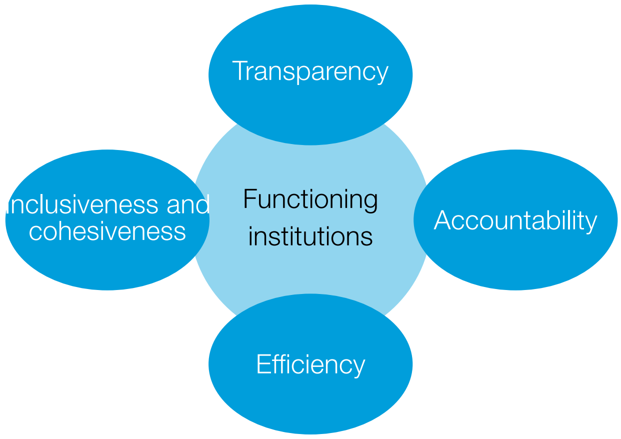
[7] OECD, 2013, *Government at a Glance 2013*, OECD Publishing, Paris.

[8] D North, 2003, The role of institutions in economic development, Discussion papers series No. 2, Economic Commission for Europe.

[9] OECD, 2015, Post-2015 reflection series, element 8: Policy coherence for inclusive and sustainable development.

(d) Inclusiveness and cohesiveness, which includes consultation, collaboration and coordination with the private sector and civil society and is critical in designing and implementing coherent policies and ensuring successful outcomes.

Figure 2
Elements of a coherent enabling environment



Source: UNCTAD.

LDCs need to build strong institutions, capable of creating an environment of trust by formulating, implementing and enforcing policies that reduce the impact of uncertainty and promote economic activity, not only to generate productivity and economic growth but also to ensure inclusive and sustainable growth.

Managing natural resource rents

Most LDCs rely heavily on the exploitation of natural resources for economic growth. This is evidenced by the Productive Capacities Index, which shows that these countries lag behind developed countries and other developing countries in all categories except natural capital. Moreover, the Index shows an inverse relationship between the level of economic development and natural capital, and between the latter and human capital. This highlights the difficulty in LDCs of capturing rents from natural resources to advance human capital development and structural transformation. Dependence on natural resources is detrimental to diversification and results in higher levels of export concentration and lower levels of export complexity, which hinders structural transformation and leaves large parts of the population in poverty.[10]

A lack of strong and vibrant institutions is the primary barrier in LDCs to channelling natural resource revenues into higher value added and social sectors and thereby advancing sustainable development and structural transformation.[11] This stems from a lack of transparency and accountability in the management of natural resource rents, which often results in the misallocation of public spending.