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**Special Body on the Least Developed, Landlocked
Developing and Pacific Island Developing Countries****Executive summary of the Asia-Pacific Countries with
Special Needs Development Report 2019: Structural
Transformation and its Role in Reducing Poverty****Note by the secretariat***Summary*

Countries with special needs in Asia and the Pacific have made considerable development gains in recent decades. Nevertheless, further progress is needed in several areas. While these economies have been successful in reducing rates of poverty, two in five people still live on incomes below \$3.20 a day, which is the standard poverty line for lower-middle income countries. In many countries, especially the least developed countries, extreme income poverty, that is measured at \$1.90 a day, also remains persistent.

In most countries with special needs, the agriculture sector remains the largest employer, despite witnessing a significant decline in its contribution to overall output. While large proportions of the labour force have moved to services, this transition has mostly been to low productivity informal services rather than to high value-added activities. Importantly, the transition to services has bypassed the relatively higher-productive, employment-generating dynamism of the manufacturing sector in many countries. At the same time, little progress has taken place in within-sector upgrading in the agriculture sector, failing to facilitate value added activities in rural areas.

Poverty is high in many countries as real wages remain low. This reflects low overall levels of productivity. Increasing productive employment is therefore critical to increase real wages and thus facilitate reduction in levels of poverty. Indeed, realizing the socioeconomic-related aspects of the Sustainable Development Goals is dependent on the ability of countries with special needs to provide decent employment through structural transformation. The *Asia-Pacific Countries with Special Needs Development Report 2019: Structural Transformation and its Role in Reducing Poverty* examines the link between structural transformation and poverty reduction and puts forward relevant policy considerations to align structural transformation and poverty reduction, highlighting the importance of targeted industrial policies and rural development.

The Economic and Social Commission for Asia and the Pacific is invited to discuss aspects of suggested policies and provide guidance to the secretariat on the kind of targeted interventions that could be provided to support implementation of these policies, keeping in view differential circumstances and experiences of countries with special needs.

* ESCAP/75/L.1.

I. Structural transformation in countries with special needs

1. The Asia-Pacific least developed countries, landlocked developing countries and small island developing States, which collectively are referred to as “countries with special needs”, are a heterogeneous group of countries that vary significantly in their economic size, population size and geographic features. Notwithstanding their differences, these economies face deep structural impediments in their pursuit of sustainable development. Thus, while landlocked developing countries suffer from high transport costs to world markets owing to their lack of access to the sea, small island developing States are particularly constrained by their geographic isolation and their smallness, which translates into lack of economies of scale. Least developed economies face the challenge of overcoming low levels of human development and are confronted with high levels of economic vulnerability.

2. The diversity of the countries with special needs is also reflected in the structural composition of their economies. Indeed, agriculture, which contributes an average of 17.3 per cent of output in countries with special needs, is today no longer the largest sector in terms of output share. This reflects structural transformation, which broadly refers to the process of continuously redeploing factors of production to higher value activities. Traditionally, this has involved a change in the composition and distribution of economic activities from agriculture to industry and then services. Recently, several countries have experienced a switch from agriculture to services, bypassing the transition to industrial development. Structural transformation helps to enhance an economy’s productive capacity, and thus is fundamental to ensuring and sustaining long-term economic growth, which in turn facilitates employment generation and a reduction in poverty.

3. Based upon employment shares in agriculture, industry and services, one can classify countries in different structural transformation pathways and distinguish between “structurally underdeveloped” economies (where the share of employment in agriculture is higher than in industry and services), “structurally developing” economies (where the share of employment in services is highest, followed by agriculture and industry) and “structurally developed” economies (where the share of employment in services is highest, followed by industry and agriculture). While this approach can lead to the counterintuitive situation in which some least developed countries (such as Cambodia) and small island developing States (such as Maldives) are technically classified as structurally developed, using additional parameters such as aggregate productivity provides a more complete assessment.

4. According to this classification, most least developed countries are categorized as “structurally under-developed”, most landlocked developing countries are “structurally developing”, and many small island developing States are classified as “structurally developed”. For instance, in Nepal (a least developed, landlocked country), almost 72 per cent of the population depends upon agriculture, which contributed 34 per cent to output. Indeed, agriculture accounts for an average of 53 per cent of employment in least developed countries and 37 per cent across countries with special needs. In Maldives, however, only 8 per cent of labour is employed in agriculture and 68 per cent is employed in the service sector.

5. Despite these differences in classification, a general defining feature of the countries with special needs is that levels of productivity are generally low. For instance, in 2016 averages of gross value added per employee in least developed countries, landlocked developing countries and small island developing States were only 20 per cent, 48 per cent and 50 per cent,

respectively, of that in other developing Asian countries. Moreover, levels of productivity have only evolved incrementally, particularly in the services sector. In some countries, productivity has stagnated or even regressed since 1991.

6. One reason is that the pace of structural transformation in the countries with special needs has been relatively slower than those of other Asia-Pacific countries. Also, their structural transformation has followed a different pattern to that of the East Asian “miracle economies”. This is in part due to today’s significantly altered economic and political landscape, which is marked by a greater degree of globalization and a different set of rules by which the countries with special needs are governed, as well as the emergence of regional and global value chains.

7. Typically, employment shares in industry (which comprises manufacturing and construction) broadly follow an inverted U shape, that is to say, reflecting an increase for lower levels of development and a decrease for higher levels of development owing to the productivity differentials between sectors. However, in countries with special needs the share of employment in industry, particularly in manufacturing, has stagnated or even regressed (“deindustrialization”) while the share of services in output has increased significantly since 1991. Many countries with special needs are bypassing the dynamism of the manufacturing sector. This is a cause for concern and needs the attention of policymakers. Specifically, the average share of employment in manufacturing has not progressed beyond 7.8 per cent in countries with special needs, in contrast to the 18 per cent share of manufacturing in total employment that today’s high-income countries averaged during their ascent.

8. The manufacturing sector is fundamental to capital accumulation, technological progress and job creation. However, the changing nature of manufacturing, which is most prominently reflected by increasing labour-saving automation, raises the question of its ability to absorb large increases in labour supply. This is particularly true for least developed countries where large proportions of the labour force currently in the agriculture sector could potentially be absorbed in manufacturing.

9. Moreover, although the role of the services sector has increased in terms of the contribution to output in most countries with special needs, worryingly, this increase has mostly been in low productivity informal services, especially in the least developed countries and small island developing States. As a result, labour productivity in services has also remained stagnant or increased only marginally at best. The role of the service sector and productivity enhancements within the sector must therefore be examined in greater detail, with a view to expanding high-productivity services. This is especially relevant in small island developing States, where immutable factors such as distance and lack of economies of scale are likely to limit the potential of manufacturing to serve as the backbone of economic development.

10. Finally, the highest productivity growth in countries with special needs has often been in the extractive industries sector. This sector, however, tends to be capital intensive and bears only limited potential for employment. At the same time, it has weak backward and forward linkages with the rest of the economy such that spillovers from growth in the extractive sector to the rest of the economy tend to be limited. Moreover, greater activity in this sector often goes hand in hand with significant negative environmental spillovers.

11. In sum, despite evidence of structural transformation unfolding in countries with special needs, with only a gradual increase in levels of productivity taking place, the expansion of the productive capacities, that is, moving up the value added ladder, has not taken place. Rather, these countries have expanded the production of their current set of products and those of the extractive sectors. Successful structural transformation must include two interrelated outcomes: in addition to a reallocation of labour to more productive existing activities, new and more advanced activities must also emerge. Such structural transformation tends to be more conducive for employment generation and poverty reduction.

12. Structural transformation must also take place in a socially and environmentally sustainable way. This means that development paths of countries with special needs must deviate significantly from business as usual and take social and environmental impacts into consideration in order to achieve the goals and targets of the 2030 Agenda for Sustainable Development.

II. Implications for poverty reduction

13. Countries with special needs have made great development gains in recent decades.¹ High economic growth in many of them has been accompanied by significant improvements across a range of development indicators. For instance, they have experienced large declines in the incidence of income poverty over the past several decades. Between 1999 and 2015, the number of people living in extreme poverty (defined as below \$1.90 a day) declined by 100 million in the countries with special needs. Today, the average poverty headcount ratio in these economies is 11.1 per cent, compared with 45.7 per cent in 1999.

14. Despite this progress, income poverty continues to persist, especially in the least developed countries and some small island developing States. On average, two in five people in the Asia-Pacific countries with special needs still live on incomes below \$3.20 a day (the standard poverty line for lower-middle income countries), compared with one in fifteen people in other developing Asian economies. At the same time, income inequality has been on the rise in several countries with special needs. For instance, between 1990 and 2014, the income Gini coefficient increased for 7 of the 24 countries with special needs for which data are available, including in Bangladesh, which is by far the largest country with special needs.

15. Moreover, the incidence of poverty in countries with special needs is concentrated in rural areas, where on average four poor people live for one urban poor person. Indeed, people living in rural areas are 2.4 times more likely to be poor than people living in city areas in countries with special needs.

16. Urbanization may be one way to alleviate rural poverty. However, in some smaller countries with special needs the process of urbanization has been accompanied by increasing shares of the urban poor. This has been observed in, for instance, Maldives, Mongolia, Nepal and Vanuatu. Indeed, rapid and uncontrolled urbanization, coupled with the difficulty in transitioning from farms to urban settings, could bring about increasing informality in urban economic activities. A lack of policy actions to address informality would have a particularly detrimental impact on gender equality, as women are more exposed to informal employment than men in most countries with special needs.

¹ The purpose of this section is not to provide a detailed description of poverty trends nor policy recommendations for poverty reduction but rather to highlight the role of structural transformation in reducing poverty.

17. While general social policies are essential to ensure access to education, health care and social welfare, Governments must also focus on structural transformation in general, and on rural development in particular, as more than half the population in countries with special needs is still expected to live in rural areas by 2050.

18. In theory, structural transformation plays an important role in reducing poverty as it generally leads to increases in productivity and output and raises incomes of workers. It also indirectly reduces poverty as higher levels of income tend to increase demand for goods and services, which in turn creates additional employment within and across sectors.

19. In practice, however, the response of poverty to structural transformation depends on several factors and conditions. These include workers' or firms' abilities to absorb new technology and to adapt to changes in the availability of natural resources or changes in input prices of materials and primary factors. Other pertinent factors include: the distribution of ownership of capital; the extent of backward and forward linkages among sectors of production; and access to markets as well as rural-urban connectedness, to name a few.

20. For instance, shifts towards capital intensive extractive industries in many countries with special needs have resulted in higher average economic growth. This has, however, been at the cost of lower long-run growth in other more labour-intensive sectors. The cost has also come in the form of pollution, greenhouse gas emissions, groundwater scarcity and biodiversity loss in the absence of appropriate environmental management policies. These environmental and potential health consequences disproportionately affect the poor and the vulnerable due to their greater exposure to environmental pollutants and limited capacity to cope with them. It has therefore limited the potential impact of structural transformation on income poverty reduction. While many of the resource rich countries with special needs may have the resources to address the environmental impacts of structural transformation, least developed countries and small island developing States will not be able to do so on their own.

21. What matters for poverty alleviation in the context of structural transformation is a reallocation of production factors that involves productivity growth of unskilled labour-intensive sectors. This is because unskilled labour tends to be the primary input of the poor to production processes. In addition, creating more jobs in more productive sectors with higher wages will have a more significant impact on poverty reduction than creating jobs in low productivity, low wage sectors.

22. Consequently, sustainable rural development and agricultural transformation are particularly effective in reducing poverty in many of the Asia-Pacific countries with special needs. Agricultural productivity growth can drive rural growth and catalyse a "pro-poor" development process, as it benefits poor and landless farmers by increasing production and employment. Promoting farm and non-farm activities in rural areas can in turn have a poverty reducing effect by increasing the demand for labour, goods and services in urban areas.

23. In addition, the potential of positive spillovers of agricultural productivity growth on other sectors increases with the level of agricultural development. This is because backward linkages of agriculture with other sectors evolve with increases in agricultural productivity. Hence, the more

productive agriculture is, the larger the benefits are for other sectors, and thus the more inclusive and sustainable rural development becomes.

24. Clearly, sustaining poverty reduction in the long run requires that sustainable agricultural transformation is complemented by dynamism in other sectors, particularly in manufacturing but also in high value-added services where the synergic effects of new technological advances are higher than in agriculture. One way to facilitate this transformation is to strengthen backward and forward linkages from existing domestic productive capacities. This entails, in the case of the Asia-Pacific countries with special needs, creating linkages from existing primary production, including agriculture and mining, to manufacturing of export products to increase inter-sectoral spillovers through input demand.

25. In contrast to poverty, the association between structural transformation and inequality is less clear as it depends on several factors. What is important, however, is that productivity growth can cause rapid declines in poverty if inequality can be kept at a low level during the structural transformation process. The historical experience of countries in the Asia-Pacific region has demonstrated that access to land is one of the important factors determining whether structural transformation increases inequality or not. In particular, inequitable access to land and unequal land rights increase the adjustment costs arising from structural transformation and can contribute to increasing or widespread informality in low productivity services. In doing so, it can exacerbate inequality by locking workers into poverty and reducing the resources available for redistributive policies.

III. Policy considerations to align structural transformation and poverty reduction

26. Asia-Pacific countries with special needs are a diverse group. Therefore, any discussion on policy options to effectively manage structural transformation to reduce poverty needs to reflect this diversity.

27. When exploring policy solutions, the experiences of the so-called East Asian miracle economies may provide important lessons. The East Asian development model was based on the centrality of the State, which guided structural transformation from an agriculture-based economy to a manufacturing-based one, gradually increasing value addition in production assortment. The process was accommodated by creating a domestic industrial base oriented towards exports and the engagement with global markets, using mechanisms and incentives that at times distorted market signals, navigating foreign direct investment flows, and supporting development of the domestic business sector. State industrial policy was based on targeting specific sectors for development. High rates of domestic savings generated additional resources, whereas investments made in education allowed for rapid increases in the quality of human capital. Japan, the Republic of Korea, Singapore and Taiwan Province of China are often seen as the main historical examples of the East Asian development model, and China is seen as the contemporary case. Some South-East Asian economies, such as Viet Nam, adopted some of the model's features at various stages of their respective structural transformations.

28. However, the East Asian development miracle took place during a time when economic interdependencies were more limited, the forces of globalization less advanced, and thus the availability of protectionist and interventionist measures perhaps greater. Moreover, as it ignored environmental considerations, the "development miracle" was accompanied

by significant environmental degradation. In the era of the 2030 Agenda for Sustainable Development, sustainability is an indispensable element to development, bringing to the fore environmental and social concerns of development outcomes, as opposed to mainly economic concerns. Nevertheless, some of the lessons can be selectively used, after adjusting for country-specific circumstance and experiences.

29. For instance, similar to the experiences of East Asia, in countries with special needs the State must play a decisive role in facilitating structural transformation, rather than only being a guardian of laws and institutions. This can be achieved through industrial policy. Industrial policies are a set of strategic interventions by the State that catalyse structural transformation. Such policies can be categorized as functional and selective policies. Functional policy involves a more general approach that seeks to improve the business climate and promote competitiveness. In contrast, selective policy involves a more interventionist stance in which the State explicitly targets the growth of certain sectors. Such an approach harnesses a country's latent comparative advantage going beyond existing strengths, by picking sectors that may hold a potential for development. Historical examples of successful interventionist approaches in the Asia-Pacific region include Japan and the Republic of Korea. After appropriately adjusting for country-specific circumstances, some elements of this approach can be considered in countries with special needs. It is worth highlighting that an effective pursuit of industrial policies will require high-calibre human resources in the Government and strong governance and institutional frameworks. Otherwise, the risk of non-productive loss-making State-led enterprises may increase. Moreover, different industrial policies will be necessary for least developed countries, landlocked developing countries and small island developing States.

30. The industrial policy of targeting certain sectors must reflect the specific needs of countries and must recognize that the private sector remains a key actor for ensuring its effectiveness. For instance, targeting in least developed countries must focus on creating productive capacities, which include development of productive resources (natural, human, financial and physical), entrepreneurial capabilities and backward and forward production linkages to the rest of the economy. Building a manufacturing base and becoming integrated into global and regional value chains – a solution difficult to some small island developing States with a limited landmass – may initially take place through special economic zones, which can facilitate absorption of labour moving out of the agriculture sector. In the process of establishing a manufacturing base, one needs to consider environmental impacts and ensure that the natural environment is not adversely affected, as this will slow or even reverse socioeconomic developmental achievements.

31. Foreign direct investment plays a crucial developmental role in Asia-Pacific countries with special needs. In least developed countries the emphasis should be on improving productive capacities and facilitating business for the private sector. Policies to promote foreign direct investment needs to be aligned with national development strategies. Special economic zones are an effective strategy to attract foreign direct investment to desired industrial sectors and to speed up development, as least developed countries often lack the capacity to create an enabling business environment throughout their territories.

32. Rural development is of particular importance for Asia-Pacific countries with special needs, especially least developed countries where agriculture employs a significant share of the labour force. Efforts should be made to increase labour productivity in agriculture by modernizing the sector.

This can be achieved through facilitating access to higher-yield seeds, commercializing agricultural production, mechanizing and using technology, linking agricultural production with market opportunities through development of the agribusiness sector and creating robust food processing industries that are linked to regional and global value chains.

33. As the rural sector develops and the agricultural sector moves from subsistence farming to more commercially oriented farming activities, productivity will increase, and less labour will be required. The resulting excess labour can then be engaged in higher productivity activities such as manufacturing. As factories are usually located in cities and well-connected areas (for example, coasts), this will contribute to urbanization, which will require ensuring basic urban planning in aspects such as providing public services (including electricity, water or sanitation, and education).

34. It will be vital that the labour force is trained to be employed in higher value-added activities (see next paragraph). For instance, were workers to move from agriculture to the services sector, they should be able to move to high-value services and not get trapped in low productivity services. Investing in rural infrastructure, combating environmental degradation and mitigating the effects of climate change are additional objectives that would help, as they favour labour mobility and resilience of the agricultural sector – making it less vulnerable to the negative effects of climate change.

35. Countries must strive to have well-functioning labour markets with supporting laws for structural transformation to translate into poverty reduction. In the short term, absorbing labour from agriculture requires concerted efforts to improve workers' employability in other sectors by developing their skills. This necessitates that workers be retrained to carry out different functions – those demanded by employers. At the same time, to climb the value added ladder, countries with special needs and particularly least developed countries will, in the medium to long run, need a critical mass of skilled human capital that can apply knowledge to productive processes. This presents two key benefits – it attracts foreign investment and allows countries to benefit from foreign direct investment in the form of knowledge and capacity gains that subsequently allows them to participate in global value chains. The education sector should therefore adapt the curricula to provide students with the skills to undertake high-value jobs. In many countries with special needs, improving the business climate can foster the development of the private sector, potentially attracting foreign companies. While labour market institutions can vary greatly, minimum wages, unemployment benefits or collective bargaining have been identified as mechanisms that should be in place to ensure that workers' conditions and the jobs are decent, especially to protect vulnerable segments such as women, children and people with disabilities.

36. For least developed countries, the role of the international community will be to provide more support to countries that are poised to graduate from the category of least developed country in the years to come. This comprises implementing fully official development assistance (ODA) commitments, including the commitment by many developed countries to achieve the target of 0.15 to 0.20 per cent of ODA as the share of gross national income to least developed countries. It also entails providing assistance to strengthen capacities that enable a smooth transition and the continuation of structural transformation in the post-graduation period, which are among the principle priority areas for these economies.

37. In landlocked developing countries, the two main policy targets concern (a) economic diversification to reduce dependence on extractive industries, together with the related policy of strategizing foreign direct investment that prioritizes manufacturing and value addition, and (b) preventing and mitigating consequences of premature deindustrialization, even a “primitivization” of the industrial base. The latter is particularly important for States in transition from the economic model based on central planning to a market-based one. For these countries, restructuring “socialist” industries is of paramount importance. While structural transformation is particularly difficult in resource-rich countries as the short-term incentives are limited, this points even more to the decisive role of the State to push for necessary changes. Economic diversification away from extractive industries and mitigating “primitivization” of the industrial base require an active State policy aimed at incentivizing development of the manufacturing sector and productive services. This policy needs to facilitate the domestic business sector’s development and its engagement with the regional value chains, as well as to increase access to global markets. Moreover, in resource-rich landlocked developing countries, environmental degradation caused by extractive industries must be addressed through effective State policies.

38. The international community must facilitate the cooperation among landlocked developing countries and their respective transit countries, through which they can have access to global markets. It can promote regional sectoral integration to increase inter-State economic interaction by promoting international frameworks that establish standards, rules and aims of cooperation.

39. For instance, the Eurasian Economic Union and the Belt and Road Initiative stand out as the integration initiatives with extensive potential to accelerate structural transformation in Asia-Pacific landlocked developing countries. This can be achieved either through building economic links (within, for example, global and regional value chains) or facilitating economic interaction with other economies in the region (for example, through eliminating trade barriers).

40. In small island developing States, targeting should be related to the concept of the “blue economy” and sustainable ocean management, considering that the total area of the exclusive economic zones of 12 Asia-Pacific small island developing States is 31 times more than their land mass. Fisheries could be considered among the main sectors for targeting, provided that their development is undertaken in an environmentally sustainable way and that it benefits local populations. Environmentally sustainable tourism can also be considered as a sectoral target among the larger Asia-Pacific small island developing States, while some may consider exploring options for commercial production of higher-value niche crops for export, the existing examples being beef production in Vanuatu and sugarcane production in Fiji. High productivity gains can also be achieved through the development of sea-bed resource extraction, including deep sea mining. In this respect, attention to environmental protection and sustainability is particularly important.

41. The role of the international community is critical for small island developing States that are susceptible to the effects of climate change, which can hamper their efforts for sustainable development and structural transformation. Concerted actions to address climate change can be undertaken by, for instance, supporting the take-up of carbon pricing instruments and energy subsidy reforms, promoting public and private partnerships for low carbon climate-resilient infrastructure investments, and improving

transboundary climate data collection. The international community must also help small island developing States mitigate and adapt to the consequences of climate change by scaling up finance for climate action and providing disaster risk transfer and financing instruments through financing mechanisms such as the Green Climate Fund of the United Nations Framework Convention on Climate Change. Concerted efforts of the international community would not only help mitigate climate change but also accelerate structural transformation of the region's economies towards more low carbon, resource-efficient ones.

IV. Conclusion

42. The issues and policies outlined above are examined in greater detail in the *Asia-Pacific Countries with Special Needs Development Report 2019*. The Economic and Social Commission for Asia and the Pacific is invited to deliberate on the findings and suggested policies of the report. It is also invited to provide guidance to the secretariat on the kind of targeted interventions that could be provided to support implementation of these policies, keeping in view the different circumstances and experiences of Asia-Pacific countries with special needs.
