

## Promoting Economic Transformation through Business Environment Reform and Market Systems Development

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**Background:** This Brief synthesises two studies commissioned by the DCED: [Promoting Economic Transformation through Business Environment Reform](#) (ODI, 2019) and [Promoting Economic Transformation through Market Systems](#)

[Development](#) (Impact Management, 2019). The DCED produces Policy Briefs to provide short, relevant guidance on specific topics related to donor and development agency support for private sector development.

### Key Messages for Donors and Development Agencies

- Economic transformation improves the quality and resilience of growth and is therefore central to sustained large-scale poverty reduction.
- Donors and development agencies should pay increased attention to the issue, given the importance attached to it by developing countries whose development plans include industrialization and job creation.
- The Market Systems Development (MSD) approach can provide the ‘organizing framework’ through which to diagnose, analyze and act on economic transformation deficits (rather than only focus on poverty here and now). In addition, Business Environment Reforms (BER) can create the enabling environment that together with complementary activities can raise innovation and investment crucial for economic transformation. Poverty reduction efforts should be more coordinated and build on the synergies between the MSD and BER approaches.
- In order to do so, donors and development agencies need to go through a learning process to frame their support for economic transformation, introduce more flexible programming that aligns with the long-term nature of transformational change, set clear expectations for programmes to ‘work politically’, and ensure that internal ‘enabling conditions and capabilities’ are in place to implement the agenda.

## Introduction

This short note synthesises two studies commissioned by the DCED on how donors and development agencies can support economic transformation through Business Environment Reform (BER)-related activities and the Market Systems Development (MSD) approach.<sup>1</sup>

The note starts by summarising the drivers of economic transformation, and the relevance of BER and MSD in supporting long-term productivity improvements. It puts forward practical suggestions on how donors and development agencies can incorporate economic transformation-inspired thinking in programme design, implementation and assessment; and identifies clusters of actions to better use MSD and BER activities together to catalyse transformational change.

## What is economic transformation and why is it important?

While not a new concept, there has recently been revived interest in the issue of economic transformation.<sup>23</sup> When governments united behind a Common African Position to input into the formulation of the Sustainable Development Goals (SDGs), for example, economic transformation was the first of six priority pillars they identified. There is consensus that for developing country economies, it

is not only the *quantity* of growth that matters for long-term poverty reduction, but its *quality*.

Economic transformation is defined as the re-allocation of factors of production (land, labour and capital) away from low- towards high productivity activities and sectors.<sup>4</sup> It involves two complementary processes. The first changes the sector mix of an economy and is called ‘**structural transformation**’. This is often characterised by shifting from ‘traditional’ sectors – such as agriculture – into more productive ‘modern’ sectors, such as manufacturing and services. The second involves boosting productivity within specific sectors and is called ‘**sector transformation**’. It is characterised by shifts within and between firms towards higher value-added, higher-productivity activities and innovations, which creates opportunities for firm growth and job creation.

No modern economy has been able to develop and prosper without undergoing a process of structural transformation. Ultimately, sustained improvements in aggregate productivity are what drives job creation and shared prosperity, and lifts up living standards. Evidence from academic literature and policy papers is clear: “the long-run success of poverty reduction hinges directly on a successful structural transformation”.<sup>5</sup>

However, there is tension in the trade-off between longer-term impacts created through economic transformation and shorter-term impacts created through interventions aimed at where the poor are currently employed. As noted by the UK’s Independent Commission for Aid Impact, transformation “may not immediately benefit the poor, while the contribution to poverty reduction through employment creation may be long and uncertain”.<sup>6</sup> People risk being ‘left behind’ by

<sup>1</sup> ODI (2019) ‘Promoting Economic Transformation through Business Environment Reform, Study Report, Donor Committee for Enterprise Development, Cambridge, UK; and Impact Management (2019) ‘Promoting Economic Transformation through Market Systems Development, Study Report, Donor Committee for Enterprise Development, Cambridge, UK.

<sup>2</sup> There is also renewed interest in the closely connected topic of ‘industrial policy’, conceived as active promotion of structural change and new economic activities of high potential in all sectors.

<sup>3</sup> Economic transformation is sometimes used in the context of the move to a low-carbon economy. While this was never within the scope of this paper, the general frameworks introduced could be applied for policy objectives related to the low-carbon transition as well.

<sup>4</sup> McMillan, M., Page, J., Booth, D. and te Velde, D.W. (2017) Supporting economic transformation: An approach paper. London: Overseas Development Institute. Hereafter referred to as McMillan et al (2017).

<sup>5</sup> McMillan et al (2017)

<sup>6</sup> ICAI. 2017. DFID’s Approach to Supporting Inclusive Growth in Africa: A Learning Review. Available at: <https://icai.independent.gov.uk/wp->

economic progress, fuelling increased inequality and even social unrest. Transformation supports poverty reduction in the long-run but can create both winners and losers in the short-term.<sup>7</sup> Economic transformation affects poverty through production, consumption and government services. The most direct route is through creating well paid jobs, but short-term effects can also be felt through cheaper food and accommodation.<sup>8</sup>

There is no generally accepted definition for *inclusive* economic transformation. A working definition of what constitutes an inclusive process of transformation is one that incorporates productive capacities to create employment and improve/sustain livelihoods for the poor and excluded, both today and in future.<sup>9</sup> A key concern for donors and development agencies therefore is to influence the potential for inclusive transformation, influencing the conditions that are in place – such as policies and practices – that can increase equality of opportunity and guide structural change onto “a path of inclusive and sustainable job-rich growth.”<sup>10</sup>

## How is economic transformation currently supported?

Economic transformation literature shows that growth and transformation cannot take place without both structural change *and* within-sector productivity growth. Structural transformation can fuel rapid growth, but if it is not accompanied by within-sector productivity change, this growth will not be sustained. Productivity gains without structural change leads to decreased competitiveness over time.

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<sup>7</sup> For further information see <https://set.odi.org/wp-content/uploads/2019/12/Economic-transformation-and-poverty-REVISED-SET-paper-5.pdf>

<sup>8</sup> For further information on links between economic transformation and poverty, see <https://set.odi.org/economic-transformation-and-poverty/>

<sup>9</sup> Adapted from UNDP

<sup>10</sup> ILO

Supporting economic transformation involves a better understanding of the determinants of productivity at the micro (firm) and macro levels and showing how, under the right conditions, resources can shift from low-productivity to high-productivity uses, diversifying a country’s productive capabilities, generating new sources of export competitiveness and expanding formal-sector employment.

If successful, the process of economic transformation can “set in motion many virtuous circles or positive feedback loops”.<sup>11</sup> Technological advances and productivity growth in agriculture can reduce rural poverty rates and increase resilience, including to climate shocks. Transformation is also associated with other aspects resulting from the declining share of agriculture in employment, such as demographic shifts, urbanisation and an increase in the number of registered enterprises that, in turn, can increase tax revenues for public expenditure.

### 3.1 Supporting economic transformation through Business Environment Reform (BER)

The business environment is defined as the “complex of policy, legal, institutional, and regulatory conditions that govern business activities”.<sup>12</sup> BER, in turn, frequently involves *de jure* changes to regulations intended to reduce the costs and risks of business activity by improving poor government policies, laws, regulations and administrative systems, and to stimulate competition through new market entrants. BER activities are often designed to affect the whole economy, although more recently there has also been interest in targeted BER around sectors and sub-sectors, sub-national territories or specific activities.

There is a growing literature on the links between BER and economic transformation. For example, BER

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<sup>11</sup> Brahmabhatt, M., Bishop R., Zhao, X., Lemma, A., Granoff, I., Godfrey, N., and te Velde, D.W., 2016. Africa’s New Climate Economy: Economic Transformation and Social and Environmental Change. New Climate Economy and Overseas Development Institute. London and Washington, DC.

<sup>12</sup> DCED

often includes changes to policy or regulations that would make it easier for firms to enter and exit the market, with the productivity growth effect growing stronger over time as (net) firm entry into the market increases. Bah and Fang (2015) identified five BER-related areas – access to finance, business regulation, crime, corruption and infrastructure – as significant explanatory variables to a 7% to 19% difference in productivity between firms in Sub-Saharan Africa and more advanced economies.<sup>13</sup> While BER can play an important role in enabling economic transformation, BER programmes are not usually targeted *exclusively* at economic transformation processes although they would include components that raise productivity and diversification.

### 3.2 Supporting economic transformation through Market Systems Development (MSD)

MSD is a poverty reduction approach – a set of principles and a body of knowledge - designed to guide practical interventions that can lead to long-lasting and large-scale change. The aim is to address the root causes of constraints to improving the performance and position of disadvantaged groups within market systems, such as people living in poverty, women or youth. MSD can be flexibly applied across a variety of sectors and industries – but often involves activities to stimulate more inclusive markets, such as through improving access to inputs, or to higher value-added markets.

Evidence shows that MSD programming is currently contributing to economic transformation processes, with 85% of programmes aligned to transformational change objectives. However, these programmes primarily support within-sector productivity, especially to increase agricultural productivity, develop global value chains and build fundamentals (e.g. skills, management capacity). A smaller proportion of MSD activities are geared towards structural change objectives, mainly through financial sector development.

<sup>13</sup> Namely the USA

MSD stresses a pluralistic approach to intervening in markets, bringing together public, private and civil society actors. Pritchett (2018) shows how this combination of private entrepreneurs' experimentation, supported by active government efforts to identify and remove bottlenecks to the sector growth, has been central to some of Africa's recent success stories, such as diversifying and commercialising floriculture in Ethiopia, and Kenya's flourishing IT sector.<sup>14</sup>

## How can economic transformation be better supported?

A central challenge in supporting *inclusive* economic transformation is to make sure people living in poverty are connected to both structural transformation trends and to the policy initiatives designed to ameliorate the distributional consequences of rapid transformation.<sup>15</sup> Herein lies the opportunity to better explore the synergies as BER *activities* at the policy-level,<sup>16</sup> and MSD as an overarching *approach* to intervening in sectors for lasting and large-scale pro-poor outcomes. As shown in the simplified theory of change in figure 1, MSD can provide the 'organizing framework' through which to diagnose, analyze and act on economic transformation deficits (rather than only focus on poverty here and now) – while reforms to make the business environment more supportive can help scale-up innovations and investment. Hence, targeted BER is one of several important components in an MSD approach focused on transformation.

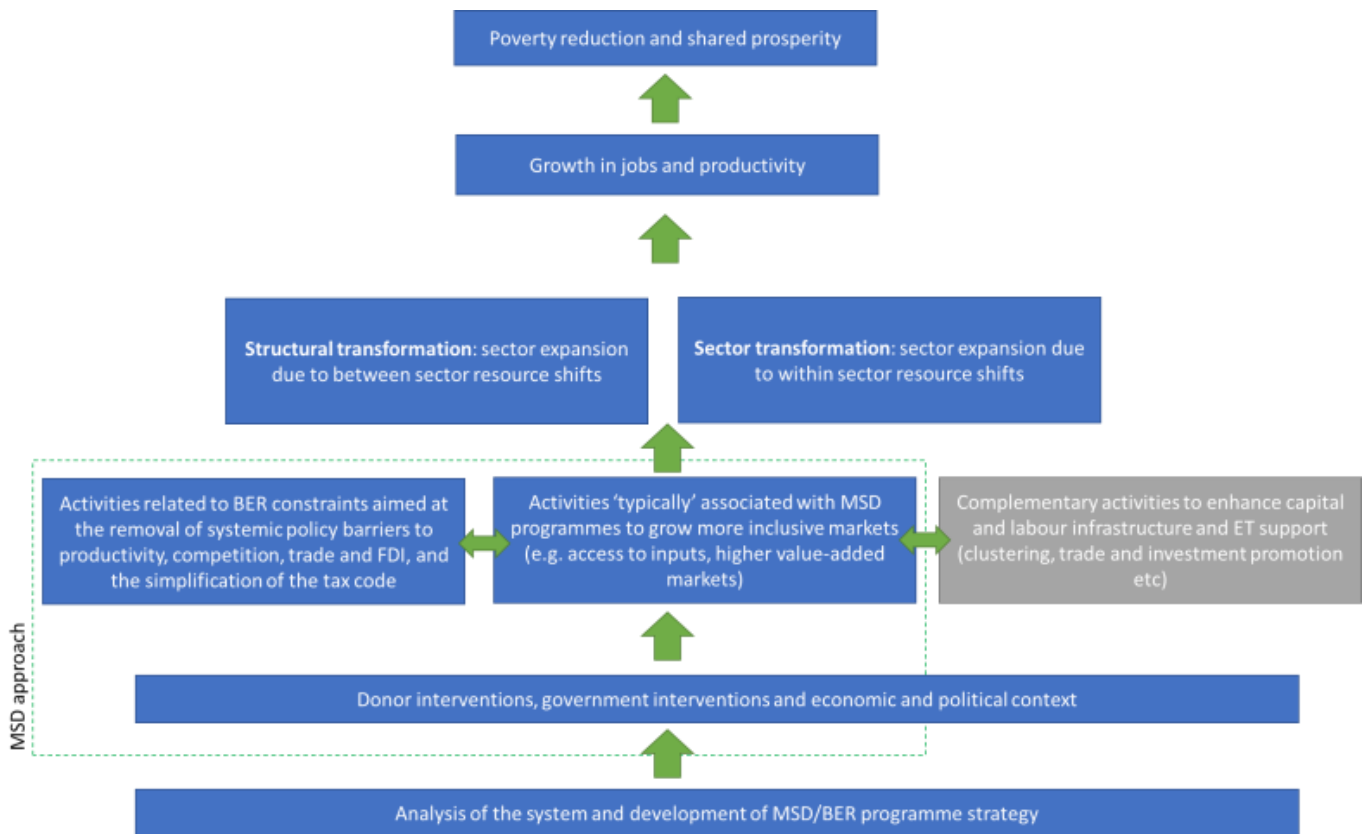
### 4.1 Better targeted BER and MSD for economic transformation

At its core, successful economic transformation is about identifying the most promising economic

<sup>14</sup> Pritchett, L. 2018. *Deals and Development: The Political Dynamics of Growth Episodes*. Pritchett, L. (ed.), Sen, K., and Werker, OUP

<sup>15</sup> Centre for Global Development

<sup>16</sup> This includes policy, regulatory and legal frameworks, as well as governance and implementation capacity

**Figure 1: A simplified theory of change for supporting economic transformation through MSD and BER**

opportunities to pursue, which are often concentrated at the sector level. With a lens of *inclusive* transformation, the aim is to build more competitive sectors that have the potential to become employment-rich over time.

The implication is that there is a premium on activities that target the most transformative sectors, and the highest-productivity potential opportunity within sectors. Identifying and prioritising the binding constraints to economic transformation in a given context involves a careful appraisal of the degree to which a “country’s economy has already experienced some transformation and what remains to be done”.<sup>17</sup> The idea is to avoid ‘quick fixes’ that lead to only incremental poverty reduction and have “limited success in addressing the underlying structural limitations facing most...economies”.<sup>18</sup>

To do this, market systems analysis can be harnessed more explicitly to understand the root causes of constraints to sector and structural transformation. MSD sector selection criteria can also be more

targeted towards high-productivity sectors, while BER activities should be more selective rather than ‘sector neutral’. A range of techniques can be used to assess the transformational potential of sector activities, including export analysis, product space analysis, multiplier analysis and productivity analysis.

#### 4.2 More joined-up action

Successful economic transformation requires numerous enablers to ‘come together’ like energy, roads, water, labour, research, inputs, markets, investment, tax, regulation and finance. Interventions into markets therefore need to be interdependent. For economic transformation there is increasing recognition of the merit in bringing several sets of actions together into ‘strategic clusters’.

A more joined-up donor and development agency approach to economic transformation could cut across private sector development programming and include other disciplines, including governance. ‘Smart’ and coordinated action between donors and governments would be required to target specific

<sup>17</sup> McMillan, et al., 2017

<sup>18</sup> African Center for Economic Transformation



sectors. Here, MSD and BER can play a mutually reinforcing role to achieve one of three strategies:

- a) *Seed* transformational processes. Support disruptive innovations that seek to kick-start or contribute to the early growth of new, more modern economic activities and sectors (structural transformation).
- b) *Scale* transformational change. Backing sectors that are already rapidly emerging, such as ‘industries without smokestacks’<sup>19</sup> (within-sector transformation).
- c) *Support* consequences of transformation. Seek to diversify rural livelihoods (e.g. off-farm employment) whilst continuing to raise on-farm productivity, in order to manage the ‘downside risks’ of economic transformation.

#### 4.3 Working politically

Finally, economic transformation implies a large element of active government engagement to create a strong enabling environment and to catalyse private sector investment, R&D and technology upgrading: It has been described as a “nation-building project” with shared commitments extending well beyond a single electoral term, with concerted public actions required to accelerate the movement of land, labour or capital resources into higher productivity activities – or to change the fundamental composition of the economy.<sup>20</sup> As such, transformation is a political economy agenda and not merely a technical one. Programming needs to embrace the political economy of change, and address vested interests in both the government and private sector that can hinder the adoption or prevent the pursuit of economic transformation policies.<sup>21</sup> Both BER and MSD need to better ‘work

with’ rather than ‘work around’ political economy constraints, which implies an explicit focus on ‘rules and regulations’ that will inevitably take market systems programming into business environment reform activities.

## Conclusion: What should donors and development agencies do differently?

There are a number of immediate steps that donors and development agencies can take to harness both MSD and BER to better support economic transformation.

### 5.1. Go through a learning process to frame support for economic transformation

Donor and development agencies are catching up on using the term economic transformation: There is currently little clarity in what economic transformation is and what it entails – beyond a general sense of ‘big changes in the economy’ and getting people ‘out of agriculture’. The first step is therefore to develop a shared understanding of the importance and key characteristics of economic transformation, based on the definition outlined in this paper. The second step is to examine implications for programming – recognising that transformation is a long-term process. Agencies also need to improve their understanding of the synergies between MSD and BER activities and economic transformation. Mandates inside development agencies can then be developed to support economic transformation and govern and coordinate bilateral and multilateral action.

### 5.2. Ensure the ‘enabling conditions and capabilities’ are in place for donors to support economic transformation programmes.

Donor decisions about how to commission, design, structure and evaluate programmes shape both the incentive and capacity of implementers to pursue

<sup>19</sup> Although the manufacturing sector is known to have a unique role in structural transformation, industries without smokestacks share some of the same characteristics - these include tradable services (e.g., IT, tourism, transport), horticulture, and agro-industry - and can provide new opportunities for export development in low-income countries and in turn drive economic growth.

<sup>20</sup> McMillan, et al., 2017

<sup>21</sup> McMillan, et al., 2017

economic transformation objectives. There are a number of actions donors can take to create the necessary ‘conditions’ for programmes to support transformational change. This includes:

- Having goals with reasonable impact expectations that are consistent with the timeframe of the programme and the level of risk appetite
- Commissioning longer-term programmes that are more targeted on transformational change objectives
- Introducing mechanisms to explore risk-sharing between donors and implementers (Box 1)
- More joined up programming across PSD and other disciplines, particularly governance
- Having the flexibility to utilise different instruments – for example combining institutional strengthening with innovative financing (private sector collaboration, guarantees, etc.) to catalyse transformative investments, or coordinating between donors and Development Finance Institutions (DFIs)
- Setting expectations for programmes to ‘work politically’ and developing parameters to guide programmes (Box 2)
- Incorporating strong monitoring, evaluation and learning systems from the start to enable adaptive programming
- Instituting feedback loops from evidence to redesign and implementation
- Building knowledge and experience of economic transformation approaches within the organisation

### 5.3. Develop strategic portfolios

Donors should be more explicit about their strategic choices, and the implications this has for economic transformation. In the words of Fields (2013), “the cost of using resources to help the poor where they are is to *not* have those resources available to help the poor get out of where they are”.

## Box 1

### Sharing the risks and rewards of successful structural change

There are risks involved in supporting structural change: New sectors may not ‘take off’ and grow, or the gains may fail to benefit people most in need. The relative gamble of backing new sectors which may be important to help people break out of poverty in the long-term (instead of the safer bet of sectors that sustain livelihoods in the short-term, like agriculture), should not just be made by implementers. As one donor has noted, *“Asking programme teams to identify the big opportunities for long-term transformative change and evaluate which ones are likely to be successful is even more challenging than standard...questions of asking what are the constraints and evaluating the options for how these can be tackled and by who”*. This implies that programme strategy-setting and sector selection could become more of a joint activity between funders and implementers. Donors should explore innovative approaches to give implementers the ‘safe space’ they need to experiment and to share risks across donors, implementers and government counterparts.

An economic transformation agenda does not mean abandoning agriculture. As Timmer et al. (2008) note, “unless the non-agricultural economy is growing, there is little long-run hope for agriculture [yet] at the same time, the historical record is very clear on the important role that agriculture itself plays in stimulating growth in the non-agricultural economy”.<sup>22</sup>

Donors should therefore aim to have short-term and long-term interventions that complement each other, based on an understanding of what transformational changes are needed, taking into account timeframes and different types of firms and households. The central challenge for donors is to address these issues strategically and have a realistic understanding of which interventions help in the short versus the long term. In general, the higher the potential impact on economic transformation, the

<sup>22</sup> Timmer and Akkus, 2008

higher the level of risk required; and the longer the timeframe required.<sup>23</sup> Different donors and programmes will of course have varying levels of risk appetite – which will affect the type of portfolios they build. Shorter timeframes and more risk-averse portfolios should set their impact expectations accordingly.<sup>24</sup>



## Box 2

### Set clear expectations for programmes to ‘work politically’

Donor and development agencies need to consider the political economy upfront, decide whether or not to intervene, and then work with appropriate partners to build long-term coalitions for economic transformation. This requires the alignment of programming cycles with long-term political processes, working effectively with government to identify leaders and lead departments to anchor MSD and BER activities, and addressing coordination failures, vested interests and political economy constraints.

This, in turn, should inform expectations for how donor-funded programmes need to work collaboratively with local institutions towards achieving shared outcomes over in long-term time horizons. Donors can stipulate one of three strategies for programmes:

- **Align** – Ensure programmes are fully aligned with sectorial transformation priorities of the government, and that the focus of interventions is complementary to public policy. Systemic change comes about which is supportive of government actions.
- **About** – Rules of the game are an explicit focus of the programme, and the programme works to improve public policy processes and priorities etc. Systemic change comes about through strategic government actions.
- **Absorb** – The programme is located close to or within the government, effectively improving the political market system so public actors can play a better facilitation role themselves. Systemic change comes about because of government actions.

These strategies, however, will need to be highly country specific and will depend on domestic political processes – something that, as commentators have noted, donors often understand poorly. An initial practical step may therefore be to better understand the experience of MSD and BER programmes that have already attempted to work with and through governments for structural change objectives, and identify lessons learned so that funders and programmes go in with their ‘eyes open’ as to the pros and cons of working politically towards transformational change.

<sup>23</sup> Impact refers to expectations of both being able to achieve and evidence impact on economic transformation processes. Here, evidence refers to the risk that transformation will not happen (sectors fail), and/or that transformation is successful but fails to lift up people out of poverty (i.e. is not inclusive).

<sup>24</sup> DCED will continue to research Economic Transformation and the roles that approaches such as MSD and BER can play in inclusive economic growth, job creation and poverty reduction. Topics for further exploration might include ‘defining inclusive growth’, ‘balancing short- and long-term impact strategies’, ‘making programme impacts sustainable and resilient to future risks and opportunities’, and ‘implementation guides for practitioners’.

*Disclaimer: The views in this study are the author’s or derived from secondary and tertiary sources and are not necessarily endorsed by the Donor Committee for Enterprise Development or any of its members.*

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