IV. Strengthening productive capacities, trade and investment: The enabling environment

117. Productive capacities, trade and investment are interlinked and mutually reinforcing elements of the national and international economic structure. There is a great deal of cumulative causation between them. Reflecting this, an enabling environment needs to operate simultaneously at the global level through policies that promote an open and equitable environment, and at the national level through policies that foster growth, investment and entrepreneurship, as well as technology, innovation and employment. The enabling environment should also provide opportunities for inclusive development, extending the benefits of growth and income earning to vulnerable population groups, the poor and women.

118. The following sections describe key issues in the enabling environment, beginning at the global and macroeconomic level, and then moving to the national and more microeconomic level.

A. The global framework and the enabling environment

119. Policies fostering global economic governance through the development of a stable international financial system conducive to growth and development and an equitable international trading system, as examined in chapter II, are recognized as critical in creating an enabling environment for strengthening productive capacities in developing countries and transition economies. In addition, a number of new policy issues at the international level are increasingly attracting attention. These include policies fostering South–South cooperation, international investment agreements and issues related to intellectual property rights, as well as initiatives such as Aid for Trade.

1. The promise of South–South cooperation

120. There is an important window of opportunity for developing countries and the international community, as well as UNCTAD, to support the emergence of the new South in the wider effort to assist developing countries in maximizing development benefits from globalization. Support for effective and coherent policies, coordinated at subregional, regional and interregional levels, ensures that the dynamism of South–South trade and investment is sustained and contributes to positive economic and social development.

121. The emergence of the new South and the South–South trade and investment dynamism demand institutional and regulatory changes, adaptation and innovation in respect of both South–South and North–South development dialogue and cooperation. South–South liberalization needs to be consolidated and pursued further, including through rationalization of South–South RTAs. In that respect, the successful conclusion of the third (São Paulo) round of GSTP negotiations is a singular challenge facing the South in terms of strengthening a global instrument for South–South trade preferences. A successful conclusion with significant market access enhancement will set the stage for increased inter- and intraregional trade among developing countries. Investment in R&D and technological cooperation at the regional level are also needed in order to build the scientific and technological basis for future economic relations. The introduction and the implementation of

trade and development finance schemes to meet burgeoning South–South needs are necessary.

2. FDI and international investment agreements.

122. Today, developing countries are facing unprecedented challenges in terms of content and capacity resulting from the growing diversity and complexity of the IIA universe and the growing risk of overlapping treaty obligations. There are currently over 2,500 bilateral investment treaties (BITs), 2,700 double taxation treaties (DTTs) and 240 bilateral and regional free trade agreements with investment provisions. These include a growing number of South–South agreements, a fact that reflects the emerging status of some developing countries as sources of outward investment. In addition, there are the multilateral instruments dealing with specific aspects of investments (e.g. GATS, TRIMs, ICSID) and regional integration organizations that also include rules on investment (e.g. ASEAN, COMESA, MERCOSUR, OECD).

123. As a result, issues related to policy coherence are moving more and more to the forefront of policy consideration, for example in terms of aligning a country's IIA network with its domestic laws and economic development policies and between the different IIAs. The risk of incoherence is great for developing countries that lack expertise and bargaining power in investment rule-making. Another challenge is how to balance the rights and interests of foreign investors, on the one hand, and host countries, on the other hand, as reflected in the increasing number of treaty-based investor–State disputes submitted to international arbitration. Related to this is the question of whether reference should be made to corporate responsibilities in this regard. These are key issues in any IIA negotiation, and are at the heart of the debate about the future development of international investment rules. Finally, finding new methods to further strengthen the development dimension of IIAs remains a crucial issue.

124. These issues will need to be addressed when discussing the future prospects for working towards ensuring that international investment relations between countries are governed in a more uniform, predictable and transparent way.

3. Intellectual property rights

125. Intellectual property policies attempt to strike a balance between proprietary and public domain interests. The current landscape for developing countries is particularly complex as they seek to determine the optimal balance in the light of their development objectives, while at the same time many countries are negotiating and seeking to comply with international agreements that contain provisions on intellectual property that often restrict national policy space. There is a need for both developed and developing countries to understand better the implications of this landscape, and to be able to strategically deploy the flexibilities that they have under international agreements, such as the WTO Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS), in the light of their development objectives.

126. Developing countries that are rich in traditional knowledge, innovations and practices (TK) should be able to benefit from this resource, notably by addressing concerns that TK is being inappropriately exploited and patented by third parties

without the consent of its original holders and without the fair sharing of resulting benefits.

127. International cooperation for the management of knowledge as a global public good needs to address a number of challenges. First, the international community needs to give thought to the design of an “optimal” intellectual property system which supports research and the creation of knowledge, as well as its use and dissemination. Second, such a system should take into consideration the special needs of poor countries, for which the cost of access to the patent system may be too high. Finally, financial or technical cooperation needs to be reinforced in order to address the gap in science and technology education and research in developing countries. The question of technology transfer and sharing of knowledge is of prime importance for economic development.

4. Aid for Trade and development

128. Building productive capacity touches on almost all areas of development policy and hence requires a multifaceted approach to development assistance. Aid for Trade is an important way to jump-start the development process by creating a virtuous circle between trade and domestic productive capacity-building, and consequently economic growth, employment and poverty reduction in developing countries. This calls for ODA to be used more effectively to support proactive measures in areas such as physical infrastructure, national financial systems, domestic entrepreneurship and trade logistics. This is particularly important for LDCs, a number of which have not yet tapped the benefits of existing preferential market access provisions, and cannot benefit from an extension of such privileges without support measures for building productive capacities. However, while the concept of Aid for Trade has been accepted, its operationalization is still in the making. It is urgent that the mechanism be supported with substantial resources that should be additional to development aid, predictable and non-debt-creating.

B. National policies to promote an enabling environment

129. Policies to strengthen domestic productive capacities and mobilize resources need to be sufficiently flexible to address the varying economic, social and other development challenges. The multiplicity of these challenges inevitably calls for an appropriate “policy mix” or “diversity of policies” tailored to each country-specific situation, rather than a one-size-fits-all approach. This “policy space” should give countries the freedom to design policies which are consonant with their national development priorities. There are, however, some common themes that all countries will need to address:

(a) Pro-growth macroeconomic policies that set off a virtuous circle of investment, growth, development and poverty reduction. In this respect, trade and industrial policies should be complementary in order to achieve international competitiveness in increasingly sophisticated products. Trade integration should not be seen as an end in itself, but rather as a means for technological upgrading and increasing domestic value-added based on a close net of domestic forward and backward linkages;

(b) Structural change and diversification. Most developing country Governments have long acknowledged the need for structural change and diversification of their economies;

(c) The effective and enabling State. The experiences of the newly industrialized countries and other successful developing economies suggest that an effective and enabling State is a sine qua non for formulating and implementing national development strategies. This entails a strong and politically stable developmental State with a skilled and educated civil service capable of identifying and implementing a national development strategy that incorporates the requisite trade and investment policies, fosters technological development and builds the necessary infrastructure.

130. The sections that follow focus on policies supportive of investment and the business environment, as well as infrastructure development, technology and innovation.

1. Pragmatism in trade and industrial policy

131. Much controversy persists about the economic rationale for proactive trade and industrial policies, as well as their viability. Some of this is related to a questioning of the efficacy of such policies, which in the past were often identified with failed inward-looking, import-substituting strategies with open-ended government interventions and a strong bias towards protectionism. The controversy has also related to the possible adverse effects of such policies on efficient resource allocation. However, the historical experience of economic catch-up in mature and late industrializing countries shows that exclusive concentration on allocative efficiency implies that too little attention is paid to stimulating the dynamic forces of markets that underlie structural change and economic growth. As a recent study by the World Bank argues, “growth entails more than the efficient use of resources”. This is particularly true for developing countries, where economic growth entails dynamic investment and rapid changes in the structure and technology content of production.

132. Indeed, proactive trade and industrial policies should not be understood as inward-looking, protectionist defence mechanisms to support industries where production and employment are threatened by lack of demand or foreign competitors that have successfully upgraded their products or their production processes. Rather, the role of national support policies is to strengthen the lead role of innovative private enterprises and related capital formation. These policies should help resolve information and coordination problems in the process of capital formation and productivity enhancement. They should also ensure that cumulative production experience is translated into productivity gains. This industrial policy support should be complemented by a trade policy designed to achieve an open environment and international competitiveness in increasingly more sophisticated products.

133. Another lesson from recent evaluations of reform programmes of the last 10 to 15 years is that support for foreign and in particular domestic investment should be combined with an appropriate legal and regulatory framework to secure gains for development. In this context, there is a need for a pragmatic and strategic perspective in order to integrate FDI into a broader development strategy geared to structural and technological change.

2. The role of institutions in good governance

134. There is an increasing consensus that governance and institutional arrangements are critical determinants of economic development. But there is much less agreement as to what exactly the role of institutions should be in the pursuit of development objectives, and what types of institutional arrangements are the most appropriate for achieving those objectives.

135. Conventional economic wisdom suggests that the main role of institutions is to reduce transaction costs so as to create new markets and make existing ones function more efficiently. Economic policies should be supported by universally applicable types of institutions, particularly for granting and protecting property rights, in line with "global best practices", derived from the current institutional set-up in developed countries. Proponents of this approach point to empirical evidence from cross-country analyses, which typically find a positive correlation between the quality of institutions and economic growth.

3. Foreign direct investment and TNCs

136. The relatively high growth in inward FDI flows to developing and transition economies reflects the fact that these countries have continued to open up to FDI and to provide increasingly attractive environments for such investments. At the same time, countries are becoming more aware of the need to adjust their policy frameworks to ensure greater development gains from inward FDI. With a more knowledge-based global economy, some countries are furthermore seeking to integrate their FDI policies within a broader development strategy, linking them to such important areas as trade, education, science and technology, and enterprise development.

137. Increasingly, some developing countries are using both inward and outward FDI to upgrade the competitiveness of their indigenous resources and capabilities to facilitate structural changes in their economies, thereby promoting dynamic comparative advantage. For instance, outward FDI by a developing country's TNC can secure foreign knowledge and competitive advantages, which can then be absorbed by the parent company and the home country through various mechanisms. A good investment strategy is one that recognizes the risks and limitations associated with FDI (inward and outward) and the fact that FDI is not a substitute for domestic investment, but a complement to domestic efforts to meet development objectives.

138. The new focus of attention in the FDI arena is to design strategies to ensure that FDI serves development aims. This will not occur automatically, and an integrated cohesive approach is needed. Key policies include the following: (1) building a dynamic domestic enterprise sector; (2) addressing a number of policy and institutional areas, starting for instance with the development of an institutional framework that promotes investments and innovation; (3) improving the quality, reliability and cost-competitiveness of backbone infrastructure services; (4) enhancing the technology, human resource capacities and knowledge base of the economy; (5) supporting the internationalization of domestic enterprises, as internationally competitive firms tend to be in a better position to attract FDI and contribute to development objectives; (6) maintaining competitive markets; (7) improving the transparency and predictability of laws and regulations and consistency in their enforcement, while promoting higher standards of public

service and efficiency in policy implementation; and (8) creating synergies and effective coordination between institutions that are responsible for policy formulation and implementation, in particular in the areas of trade, enterprise and investment promotion.

139. The emphasis on policy coherence may be one of the most striking lessons learned from those developing countries that are now emerging as more important nodes in the networks of TNCs. In most of those countries, the starting point has been a long-term vision of how to move the economy towards higher-value-added and knowledge-based activities. For example, the recent success of some Asian economies in attracting FDI in R&D is no coincidence: it is the outcome of coherent and targeted government policies – evolving over time – aimed at strengthening the overall framework for innovation and knowledge inflows. In some form (and to varying degrees), those countries have actively sought to attract technology, know-how, people and capital from abroad. They have invested strategically in human resources, typically with a strong focus on science and engineering; invested in infrastructure development for R&D (such as science parks, public R&D laboratories, and incubators); used performance requirements and incentives as part of the overall strategy to attract FDI in targeted activities; and strategically implemented IPR protection policies.

140. Finally, the G8 Heiligendamm Summit gave a strong impetus to the development of an enabling environment for investment in developing countries, with a call for UNCTAD and the OECD to develop best practices for building an institutional environment conducive to increased investment and sustainable development, including through Investment Policy Reviews, and through engaging industrialized countries, emerging economies and developing countries in a dialogue aimed at building international consensus and disseminating best practices in this respect. In the coming years, UNCTAD will respond to this call and will assist interested member countries in sharpening the development dimension of their investment policy frameworks and building the institutional capacities needed to enhance the development benefits deriving from domestic and foreign investment.

4. Boosting domestic enterprise

141. To benefit from an increasingly globalized and interdependent world economy, developing countries need strong and competitive firms that are able to internationalize (e.g. take advantage of export opportunities, participate in global value chains and develop business linkages). A new focus by both Governments and the international development community on policies that help the growth of the private sector, particularly SMEs, in developing countries is necessary. In addition to the international policies mentioned above, national policy measures required include:

(a) Promoting skills development and innovation. Strengthening the supply capacity of local enterprises requires both good infrastructure facilities (such as technology parks) and the development of a range of skills, including technical skills in production processes and management know-how. Entrepreneurship development requires specialized training to shape personal behaviours and attitudes in order to develop the new business leaders of tomorrow;

(b) Improving access to finance, and the range and price of financial services available at all levels (e.g. banking and credit services for SMEs and the poor);

(c) Strengthening the accounting and insurance professions. Professional services in the areas of accounting and insurance are a crucial part of the infrastructure that facilitates investment and supports enterprise development. Insurance services facilitate investment, improve business continuity following disasters, and are an essential element of trade. Internationally recognized good practices in both financial and non-financial corporate accounting and reporting play a key role in enterprise development, allowing an enterprise to efficiently mobilize, allocate and account for both domestic and international investment capital. Developing countries need assistance in developing high-quality accounting and insurance services through the strengthening of professional and regulatory institutions;

(d) Developing business linkages and industrial clusters. Key strategies in enterprise development are the promotion of global business linkages and the development of industrial clusters. Building business linkages between domestic SMEs and TNCs is an effective way to access new markets, and upgrade technology and management skills. Cluster initiatives that promote cooperation among a network of firms operating in the same or complementary industries lead to the development of a local pool of skilled labour and allow policymakers to focus on the full range of issues affecting a specific sector.

5. Competitive practices

142. Competition policy plays an important role in promoting competitiveness, building entrepreneurship, facilitating market access and entry, enhancing the equity of the international trading system and ensuring that trade liberalization generates development gains. Accordingly, an effective enabling environment must include both national competition policies and international cooperation to deal with cross-border anti-competitive practices. Unfortunately, developing countries continue to face enforcement difficulties in addressing anti-competitive practices with international elements. Thus, helping developing countries to strengthen their enforcement capacity is a priority.

143. In recent years, in response to anti-competitive mergers and hard-core cartels, some developing countries have examined the anti-competitive effects of these on their markets and sought to impose sanctions on the companies concerned without being able to enforce any prohibition order. Enhanced international cooperation on competition law and policy is required in order to address anti-competitive practices that lead to losses by developing countries.

6. Transport infrastructure and trade facilitation

144. Trade-based globalization processes have been made possible largely through advances in the areas of transport and communications. International supply chains nowadays fully incorporate the distribution and inventory legs of global production and distribution processes. In such a context, all physical, technological and formal obstacles to cost-effective trade transactions should be addressed in a comprehensive manner, whereby investments in “hardware” solutions such as transport and storage infrastructure and equipment must be supported by corresponding streamlined managerial and administrative systems. Trade facilitation is crucial for ensuring that international trade requirements for efficiency are met by trade-monitoring administrations, such as customs. In order not to hinder

international competitiveness, both trading communities and public administrations in developing countries need to be institutionally and technologically aligned with their counterparts in neighbouring and overseas trading partner countries.

145. Trade-supporting infrastructure and services are increasingly provided by the private sector. The management of seaports, airports, roads and railways is often outsourced to national or international private companies. As the public sector withdraws from operations, there is a growing need for strengthened capacity to monitor and regulate the industry. Overcoming non-physical barriers to enhance the efficient use of existing physical transport infrastructure is a major objective to be pursued, particularly when investment resources are scarce. While trade and transport facilitation on its own may not be a sufficient condition for achieving structural change, it is however a necessary condition without which employment shifts to new industries and export-led economic growth will not materialize.

146. In order to ensure that development objectives are being met, Governments must give high priority to transport issues, must review and revise if necessary the legal and regulatory framework to allow greater participation of the private sector, introduce reform measures to make providers of transport services more responsive to user demands, streamline administrative procedures, introduce a system of transport performance indicators, promote the use of information technology and strengthen training programmes in this sector. In an ideal situation, these measures would form part of a coherent package to be applied at the national or even subregional level in order to take full advantage of the role that the transport sector can play in regional integration. At the international level it is important that policies and regulatory regimes be harmonized and Governments be assisted in devising the necessary policy measures required in order to ensure that transport supply capacities are created or strengthened and that traders are placed in a position to effectively take advantage of transport opportunities offered in liberalized and globalized transport markets.

7. Technology, innovation and knowledge, and the enabling environment

147. Without technological progress, capital accumulation faces diminishing returns. Improvements in production technology continually offset the diminishing returns to capital accumulation and generate improvements in labour productivity, both directly because of the improvements in technology and indirectly because of the additional capital accumulation that these improvements make possible.

148. It is now well established that the capacity to assimilate, diffuse and generate knowledge is crucial for sustainable growth and development, since knowledge forms the basis of technological upgrading and innovations. While knowledge is recognized as a public good at the national level, it has also become a global public good owing to its cross-border diffusion and access to it. Furthermore, knowledge is crucial for the provision of other public goods, such as prevention of the emergence and spread of infectious diseases and tackling climate change.

149. The challenge is therefore to harness knowledge for development, with an enabling environment being provided for the production of ideas and innovations, as well as for their dissemination and use by different actors, directly or indirectly involved in the production process. This involves a combination of domestic efforts to develop institutions, infrastructure and a policy and regulatory framework, as well as efforts at the level of international cooperation, in order to facilitate the

generation and use of innovative systems for knowledge-sharing and learning – that is, to transform knowledge into a global public good.

8. ICT policies

150. Countries that have benefited most from the development of ICTs are those that have created a sound ICT-enabling environment, including a trade and investment environment that is conducive in terms of telecommunications and the development of the ICT industry. Favourable national ICT policies include pro-poor ICT strategies, a legal and regulatory framework, the development of e-government services, policies for capacity-building and human resources development, and the promotion of accessible, high-quality and affordable technology and relevant content.

151. Countries that have already put in place national ICT policies now need to review their implementation and impact at the country level and carry out an analysis of the successes and failures in the implementation of their ICT plans, including the institutional framework, in order to make subsequent adjustments and revise their ICT development plans. Reviewing ICT plans on a regular basis and in coordination with the different stakeholders involved is crucial. It is therefore recommended that developing countries define, as part of their ICT plans, mechanisms for ongoing policy review, assessment and monitoring. Core ICT indicators as defined by the international community can help in this process.