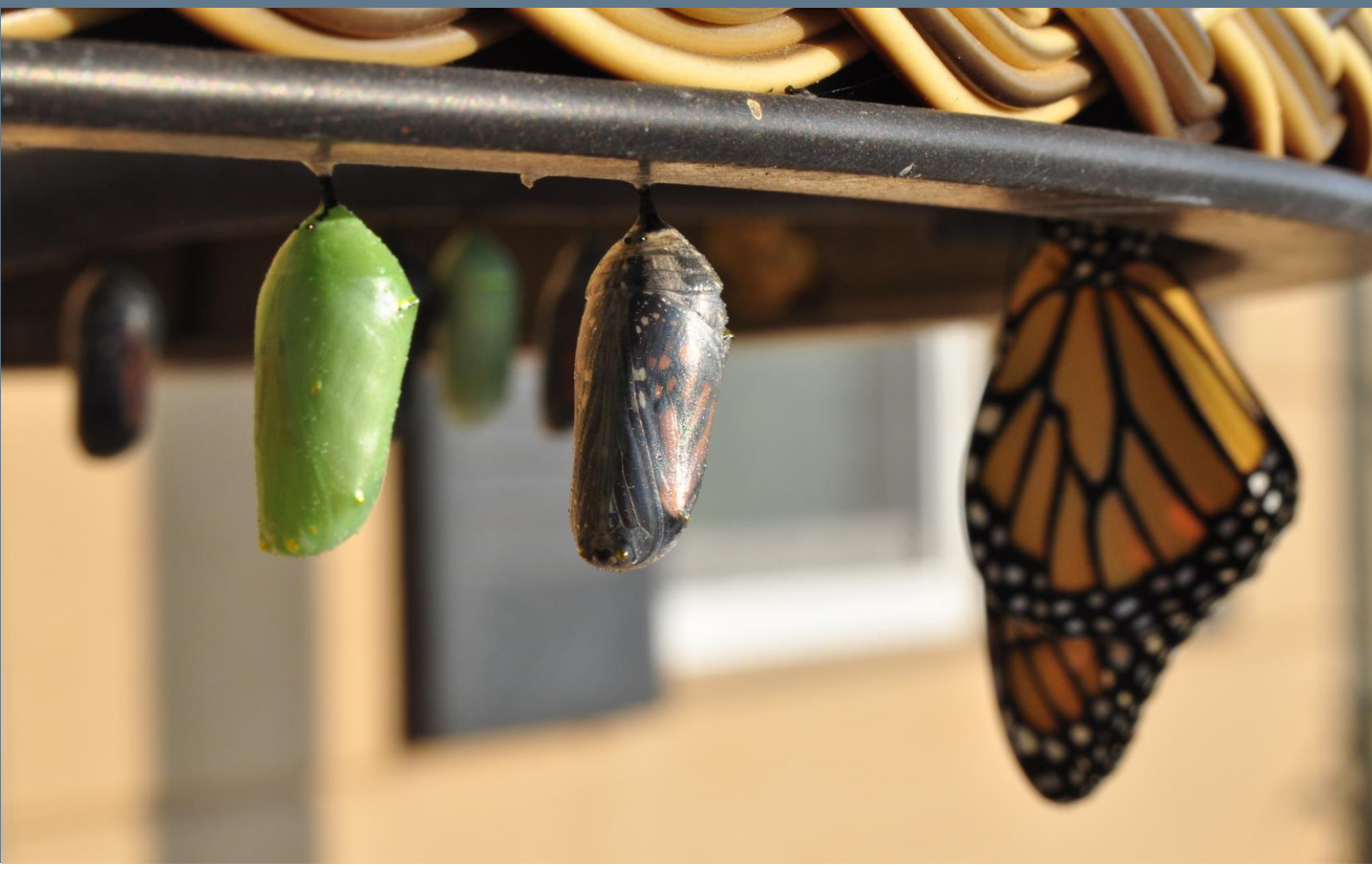
DONOR COMMITTEE FOR ENTERPRISE DEVELOPMENT

STUDY REPORT

Promoting Economic Transformation through Business Environment Reform

BUSINESS ENVIRONMENT WORKING GROUP



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DCED
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Abstract

The Donor Committee for Enterprise Development (DCED) Business Environment Working Group (BEWG) has asked ODI to examine how donors can support Economic Transformation (ET) through Business Environment Reform (BER). This report discusses findings by focusing on (i) definitions of ET; (ii) drivers of ET and how BER might promote it; (iii) current practices and challenges for donors in promoting and implementing BER to promote ET; and (iv) practical implications for donors and areas for further research. The study is based on a desk study and interviews with a selected set of donor agencies.

This paper provides suggestions for a definition of ET that can be used by agencies, together with a set of indicators on how to evaluate the ET content. It also assesses the literature on the links between components of BER and productivity, shows what type of analyses can guide the targeting of BE activities and discusses which complementary activities make BE activities more effective. The paper further reviews donor experiences in using BER and ET, and their synergies, and suggests way in which donors can overcome challenges to using BER for ET. It argues donors need to develop a theory of change from BER activities to ET and ultimately poverty reduction and that donor agencies should implement nine steps to successfully use BER for ET.

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Executive summary

The Donor Committee for Enterprise Development (DCED) Business Environment Working Group (BEWG) has asked ODI to examine how donors can support Economic Transformation (ET) through Business Environment Reform (BER). This report discusses emerging findings based on a desk study and interviews with selected development agencies and foundations.

While there tends to be a common understanding and definition of Business Environment (BE), this is not the case for ET. Donor agencies are catching up on the use of the latter term, yet there is a need for attention to ET, given the importance attached to this by developing county governments and institutions such as the African Union. The first implication is that **donor agencies clearly need to develop a common definition of ET, and the DECD can help provide a range of possible definitions in this regard.**

We suggest agencies use the following definition:

> *ET is the ongoing process of (i) increasing aggregate productivity by moving labour and other productive resources from lower- to higher-productivity sectors and activities (structural change) and (ii) raising within-sector productivity by sector-wide improvements, for example skills training or clustering of firms, as well as firm-level innovations.*

Agencies can **monitor progress towards this definition of ET** by asking:

- Does the strategy have clear objectives in terms of ET?
- If the strategy includes clear objectives to promote *structural change, within-sector productivity growth*, or *diversify production and trade* are these translated into the results framework?
- Are pathways to ET a core element of the strategy (horizontal interventions such as BE, education and training, new technology and innovation, high-value services and export manufacturing, value chains, trade facilitation, urbanisation and special economic zones)?
- Does the strategy prioritise moving to higher-wage or more productive employment as a key motivation for ET?

The literature and donor views are to some extent converging on the scope and limitations of using BER to support ET. Some agencies have developed their thinking, considering BE an important factor behind ET but also recognising that some BE activities work better than others. The academic literature provides examples of the positive productivity impacts of BE indicators of labour conditions, access to finance, conditions on trade and investment, competition and tax. Policy experts highlight the importance for productivity of reducing barriers to competition and unwarranted distortions to market prices, strengthening the legal framework surrounding property rights.

The literature also suggests that BE approaches should be targeted (better). We discuss a range of techniques that can be used to assess the transformational potential of sector activities, including export analysis, product space analysis, multiplier analysis and productivity analysis. This in turn can be used to guide the focus of BE, in addition to examining the political feasibility of BE activities.

Some agencies are also aware that BE needs to be implemented in conjunction with other factors. There are essentially two types of complementary activities: (i) general enabling activities that support factor markets such as skills and infrastructure and (ii) targeted ET activities that support trade, investment, innovation and clusters.

Taking this together, the **DCED should help develop general theories of change that provide a narrative how different aspects BER contribute to ET and to adopt some rules of thumb on what is working better and what is working less well.** Figure 1 (Section 2) in this report provides a starting point.

Our interviews confirmed that donor agencies face a range of constraints when implementing BER for ET, but also that they have overcome these in differing ways:

- To overcome the challenge of **lack of mandate or definitions**, agencies can draft concept notes or White Papers. For example, the UK Department for International Development published its first-ever **economic development strategy**, which resulted in a step change in discussions and emphasis on ET to another level, leading for example to specific ET projects such as Invest Africa and engaging the Supporting Economic Transformation (SET) project.
- Donor agencies may also learn from their existing projects or **improve knowledge management**. While some agencies may not have a mandate to work on ET projects explicitly, they do incorporate ET elements in selected programmes. These can offer valuable lessons and lead to a more systematic assessment of country programmes and projects. Other agencies have knowledge management activities that can be strengthened, and the implications implemented more vigorously.
- Agencies can overcome **coordination challenges and lack of flexibility within their own agencies**. For example, one agency transferred some of its support from direct small and medium enterprise support to upstream BE support. Another agency is leveraging different departments in its **creating markets** concept.
- Agencies can actively overcome **coordination challenges and vested interests** by working with staff on the ground. One agency overcame political economy concerns by working **closely and patiently around sectors with actors on the ground**.

This paper has collected emerging best practices that can be seen as **practical implications and guidance for donors**. Box 5 (in Section 4) in this report provides three main steps and nine mini-steps that donor agencies need to follow to explore synergies between BER and ET. In the first instance, agencies will need to go through a **learning process**. This could lead the agency to adopt definitions of ET and incorporate ET into its mandates and strategies. A practical way to do this is by publishing a country-specific economic development strategy. Second, agencies should **explore synergies between ET and activities that support it**, such as BER and complementary activities. Developing context-specific theories of change can be challenging but is crucial, for example in determining which BER activities are the most relevant. Finally, agencies can follow a number of **practical steps for implementation**. These include promoting flexible and adaptable donor approaches, allowing donor support to develop from firm support to upstream BE support and vice versa, leveraging different departments in an agency (or different institutions in a country) to create markets and support ET, coordinating relevant actors around targeted areas, such as specific (sub-)sectors in specific countries, and working politically, by carefully considering which actors and activities to work with.

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List of Acronyms

AU	African Union
BE	Business Environment
BEE	Business Enabling Environment
BER	Business Environment Reform
BEWG	Business Environment Working Group
CAS	Country Assistance Strategy
CPF	Country Partnership Framework
CPS	Country Partnership Strategy
DCED	Donor Committee for Enterprise Development
DFI	Development Finance Institution
DFID	Department for International Development
DRC	Democratic Republic of Congo
ECI	Economic Complexity Index
EDFI	European development finance institutions
EPI	Economic Policy Incubator
ET	Economic Transformation
EU	European Union
FDI	Foreign Direct Investment
G2B	Government-to-Business
GA	Gatsby Africa
GIZ	German International Cooperation
GVC	Global Value Chain
HHPSA	Hausmann-Hidalgo Product Space Analysis
ICT	Information and Communication Technology
IDA	International Development Association
IFC	International Finance Corporation
IMF	International Monetary Fund
IPA	Investment Promotion Agency
ITC	International Trade Centre
LAC	Latin America and the Caribbean
JOBS	Jobs, Opportunities, Business Success
LIC	Low-Income Country

LMIC	Lower-Middle-Income Country
MCP	Moldova Competitiveness Project
MENA	Middle East and North Africa
MSDWG	Market Systems Development Working Group
MSMEs	Micro, Small and Medium Enterprises
ODI	Overseas Development Institute
OECD	Organisation for Economic Co-operation and Development
PCI	Product Complexity Index
PPD	Public–Private Dialogue
PSD	Private Sector Development
R&D	Research and Development
RCA	Revealed Comparative Advantage
SBR	State–Business Relations
SET	Supporting Economic Transformation
SEZ	Special Economic Zone
Sida	Swedish International Development Cooperation Agency
SMEs	Small and Medium Enterprises
SSA	Sub-Saharan Africa
TMEA	TradeMark East Africa
TFP	Total Factor Productivity
UK	United Kingdom
UNCTAD	United Nations Conference on Trade and Development
US	United States
USAID	US Agency for International Development

1. Introduction

The Donor Committee for Enterprise Development (DCED) Business Environment Working Group (BEWG) is interested to learn how donors can support Economic Transformation (ET) through Business Environment Reform (BER) or BE activities.[1] BER relates to improvements of the general regulatory framework governing economic activities, and is most often general in the sense of being 'sector-neutral'. In contrast, ET – usually defined as the process of moving factors of production from low- to high-productivity activities – by definition targets specific sectors, activities or firms.[2]

BER is a well-established area for donors, and there are many years of programming experience on which to draw. But, given that the objective of fostering ET does not appear to have been at the centre of most donor approaches to BER, the DCED would like to address four sets of questions:

- Is there a role for BER to play in supporting ET? If so, which BER areas have the greatest potential? And what are the complementary non-BER interventions?
- Under what circumstances is support for a more targeted BER approach justified? How can such targeting be best carried out, and what criteria could be used?
- What are the links between BER and investment promotion to specifically promote expansion of 'transformative' sectors or businesses?
- What solutions are available to overcome particular organisational, procedural, political economy or programme design challenges for donors wanting to use BER programming to support ET?

This report presents emerging findings based on a desk review and interviews with donor agencies. This introduction (Section 1) is followed by three sections, discussing:

- drivers of ET and how BER might promote it (Section 2)
- current practices and challenges for donors in promoting and implementing BER to promote ET (Section 3) and
- practical implications for donors and areas for further research (Section 4).

The current version of this report is around 25 pages, but we also include information in 5 appendices. Appendix A includes a range of definitions of ET taken from the academic and grey literature. Appendix B provides a summary of a study on the transformational content of World Bank programmes, which can serve as an example for assessments of other agencies. Appendix C includes a list of indicators that can be used to assess the transformational potential of sectors.

[1] This work is being carried out in parallel to work commissioned by the DCED Market Systems Development Working Group (MSDWG) on how the Market Systems Development Approach can support ET.
[2] ET is about productivity shifts, although it has also been associated with other aspects, such as job creation, demographic shifts and urbanisation.

2. Drivers of Economic Transformation and how Business Environment Reform promotes this

We first discuss the links between BER and ET based on a brief literature review. Section 2.1 defines ET, BE and BER; Section 2.2 discusses the links.

2.1 Defining Economic Transformation and Business Environment Reform

We first provide definitions and interpretations of two key terms, Economic Transformation and Business Environment Reform. The literature on Economic Transformation has been evolving since the 1950s (see the review in McMillan et al., 2017a and a review of some terms in Appendix A). Taking this into account, McMillan et al. (2017a) define ET as the ongoing process of (i) increasing aggregate productivity by moving labour and other productive resources from lower- to higher-productivity sectors (structural change) and (ii) raising within-sector productivity by sector-wide improvements (moving resources from low productivity activities to high productivity activities within the same sector), for example skills training or clustering of firms, as well as firm-level innovations. ET is, therefore, a process that includes productivity change at macro, meso and micro levels.

The shift of resources from less productive activities to more productive sectors and activities is often thought of as moving away from 'traditional' sectors – such as agriculture – into more productive 'modern' sectors – such as industry and 'high-end' services. Moving productive resources between economic sectors to fill productivity gaps can be a significant driver of growth (McMillan and Rodrik, 2011; McMillan et al., 2014).

However, even within sectors often considered to be less productive, such as agriculture, the promotion of more productive firms and activities will raise average productivity in the sector and thus nationally (Dercon and Gollin, 2014). McMillan and Harttgen (2014a) illustrate changes in labour productivity in sub-Saharan Africa (SSA) between 2000 and 2010, stating that, while the movement of labour from agriculture into the much more productive manufacturing sectors drove growth in the period, in fact a greater percentage increase in labour productivity occurred *within* the agriculture sector.

Transformation of production structures is central to the definition of economic transformation. This is usually considered to consist of sectoral changes in employment and output. However, it can also be considered as productivity increases within sectors, value chains, or within firms. Transformation is a process involving doing things differently, doing them in more productive way, and about diversification away from traditional structures, at macro and micro levels. It is not just about job creation alone, but about creating jobs in activities that are more productive than were previously the case.

The Donor Committee for Enterprise Development (DCED, 2008) defines the **Business Environment** (BE) as the 'complex of policy, legal, institutional, and regulatory conditions that govern business activities'. It is a subset of the investment climate and includes the administration and enforcement mechanisms established to implement government policy, as well as the institutional arrangements that influence the way key actors operate (e.g. government agencies, regulatory authorities and business membership organisations, civil society organisations, trade unions, etc.). BER, as noted, often tends to be 'sector-neutral' rather than selective, though DCED recognises that BER may be sector- or region-specific.

Focusing on **Business Environment Reform**, this frequently involves *de jure* changes to regulations intended to reduce the costs and risks of business activity by improving poor government policies, laws and regulations, and to stimulate competition through new market entrants (DCED, nd). The DCED identifies several functional areas:

- simplifying business registration and licensing procedures
- improving tax policies and administration
- improving labour laws and administration
- improving the overall quality of regulation and compliance enforcement
- improving land title registers and land-market administration
- simplifying and speeding up access to commercial courts and to alternative dispute resolution mechanisms for commercial disputes
- broadening public–private dialogue processes with a particular focus on including informal operators, especially women
- improving business access to market information and
- enabling better access to finance.

While the definition of BER above is widely used across a number of recent studies (i.e. White and Fortune, 2015; Glanville et al., 2016), we could add functions to these elements, to expand the definition of BER to include:

- strengthening competition policy
- improving accounting, auditing and business transparency and
- establishing, implementing and ensuring compliance with standards (technical, social/labour, environmental).

The DCED (e.g. DCED 2013, DCED 2016, DCED, 2018) have developed several papers, appendices and briefings with guidance for donors, showing the development of the term business environment including links of BE with industrial policy, BER at the sector level, BER and quality infrastructure and BER and political economy. This report is consistent with much of these new developments, but with one significant new element which is to focus on BER and productivity change, diversification and economic transformation, and take economic transformation as the starting point, and not BER.

2.2 The links between Economic Transformation and Business Environment Reform

There are multiple potential drivers of ET. Pritchett et al. (2018) analyse 10 developing countries that have exhibited rapid growth consistent with ET. They emphasise the importance of political economy, and specifically a stable 'political settlement' where a dominant political party helps establish a more 'ordered deal environment', which kick-starts growth. In some countries, ruling parties or coalitions promoted pro-growth ideologies even though their immediate aim was to cement their power base. Even where there is no dominant political party, a shift towards a business-friendly environment (as occurred in India in the early 1990s) can initiate a period of transformative growth. In the India case, this was spurred by a macroeconomic crisis linked to the country's position in the international economy, reflecting how a crisis can become an opportunity to move towards a different, more transformative, growth path.

The international environment is another important factor. Trade access (for example in the EU) was crucial to stimulating growth in Bangladesh's garment sector, and from there to the economy as a whole. Close state–business relations (SBR) may further foster growth, for example in export-oriented sectors in Cambodia and Thailand (and earlier in Korea and Taiwan). There is a risk though, of course, that close SBR can present an obstacle to increased international competitiveness, and ET more generally. This has been one part of the problem in several African countries, where the state has protected some segments of business without eliciting reciprocal increases in productivity, to the detriment of transformation. Some degree of *autonomy* of the state from business, while the two maintain a close relationship, is therefore essential for successful transformation, so the state can play its role of nurturing, regulating and stimulating firms and markets to raise their productivity while also being able to withdraw support from firms and sectors that do not respond.

Many authors highlight the importance of high-quality BE institutions for the growth process, focusing especially on rule of law, the regulatory environment and the protection of property rights in the growth process. Support by high-quality institutions to positive changes to a country's investment climate can be a strong driver of growth, especially for promoting within-sector productivity increases. McMillan et al. (2017b) identify a series of 'fundamentals' required to stimulate productivity growth within sectors, based on seven developing country case studies. These fundamentals are particularly important drivers of productivity change within sectors, and include the political economy situation, which should promote macroeconomic and policy stability; labour regulations, which may support or hinder changes needed to support successful growth; BE institutions (as already discussed); the level of education and skills of the labour force; and, finally, the quality of infrastructure.

These drivers of ET link to the BER agenda. For example, labour regulation, the rule of law and the regulatory environment are all common components of BER, as is SBR and the public–private dialogue process. To further explore the links between the ET process and BER, we discuss some emerging literature on the links between specific components of BER and ET.

2.2.1 Selected overview of evidence linking the business environment with productivity increase

There is a growing literature on the links between BER and ET. Most studies examine the impact of BER on firm level productivity, and there are very few studies that examine the effect on structural change or diversification (with aid for trade studies being notable exceptions).. Bah and Fang (2015) identify a series of BE factors that affect firm output and productivity. The study uses a panel of 30 SSA countries and identifies five BER-related areas – **access to finance, business regulation, crime, corruption and infrastructure** – as significant explanatory variables to a 7% to 19% negative difference in productivity between SSA firms and firms in the US.

A core aspect of ET is to increase productivity through a reallocation of resources from less to more productive firms within a sector. Hsieh and Klenlow (2009) measure labour and capital levels of Chinese and Indian manufacturing firms, comparing these with US firms. They show that, if Chinese and Indian firms improved their processes to match those employed by US firms, this would result in an increase of between 30% and 50% in productivity in Chinese firms and 40% and 60% in Indian firms. The reallocation of resources from less to more productive firms could raise productivity levels, as shown by Bartelsman et al. (2013) using evidence from a cross-country firm-level dataset, covering five countries considered to be 'industrialised' and three 'transitional' economies. The study focuses on productivity dispersion within industries and finds that productivity growth has indeed happened by allocating resources from less to more efficient firms.

As BER often includes changes to **policy or regulations that would make it easier for firms to enter and exit** the market, this finding relates significantly to BER, as this productivity growth effect only grows stronger over time as (net) firm entry into the market increases. A body of studies have linked decreases in firm-level productivity with reduced business dynamism. A slowdown in the level of firm entry into and exit from a market causes productivity levels to drop as the rate of reallocation of resources from less to more productive firms drops. For example, Davis and Haltiwanger (2014) analyse the flow of labour between employers in the US and find a marked reduction in labour market flexibility in the US since the early 2000s, with negative consequences for productivity growth in the country. Decker et al. (2016) find that a drop in the rate of firm entry and exit in the US (between 1997 and 2013) is linked to an increase, over time, in the productivity gap between the more and less productive firms. These increases in within-sector productivity gaps are also found in high-tech sectors (Decker et al., 2018), meaning that even more 'modern' sectors are not immune to productivity gap issues.

There is also some limited evidence that, where more technologically advanced firms **'threaten' to enter markets**, this could spur productivity growth within those markets that are closer to the technological frontier. On the other hand, the opposite can occur in sectors further away from the technological frontier, as incumbent firms do innovate as they perceive limited gains from doing so (Aghion et al., 2009).

However, not all studies support this argument focused on **market entry and exit dynamics raising productivity**. For example, Li (2017) finds that, while the rate of business turnover (in the US) did decline from the 1970s, aggregate productivity growth has not followed suit, and that, even when the rate of new businesses entering the market was at its highest, existing firms lost very little market share to these new entrants. Li posits that older firms may be as innovative as newer firms, hence the mismatch between firm dynamism and aggregate productivity growth. Similarly, Garcia-Macia et al. (2018), using a US longitudinal business database between 1983 and 2013, find that incumbent firms generated the most growth through improvements in their own production systems.

Another important aspect of BER that can be linked to ET is **workplace conditions**. A DCED-commissioned paper (BSS Economic Consultants, 2016; DCED, 2018) illustrates links between this aspect of BE and labour productivity. It identifies a series of BE-related workplace conditions (i.e. worker training, innovation in the workplace, employee engagement and incentives and occupational safety) as potential channels to drive increases in labour productivity. The paper suggests that BER aimed at *improving* these identified workplace conditions can help promote ET through increases in labour productivity at the firm level as BER can target actions that would help improve workplace conditions.

Some research backs up the claim that BER that targets facilitating **innovation in the workplace** could increase productivity, showing how investments in labour skills, information and communication technology (ICT) and research and development (R&D) can contribute to productivity growth, more so in sectors that are closest to the technological frontier (Dabla-Norris et al., 2015). When firms increase their overall labour skill levels, so their uptake of advanced production techniques also increases (Doms et al., 1997). When a firm invests in technology (including through R&D), productivity gains follow, as shown from data from 12 Organisation for Economic Co-operation and Development (OECD) countries over a 16-year period (Griffith et al., 2000). Lower levels of innovation can act as a drag on productivity growth rates. For example, the UK's lower levels of firm R&D and innovation, compared with firms in the EU and the US, are cited as one of the main reasons for the country's lower productivity growth (Nickell and van Reenen, 2001).

Reforming **labour market** regulations is a core component of BER. Storm and Naastepad (2009) use OECD country data between 1984 and 2004 to assess the link between labour market deregulation and productivity growth, finding a negative relationship between the two. That is, countries with more rigid and structured labour market regulations show higher levels of labour productivity growth than countries that have deregulated their labour markets. The paper finds that the Nordic countries, with their system of highly regulated labour markets and coordinated industrial relations systems, show the highest growth in labour productivity rates.

Autor et al. (2007) find that increased costs of dismissing workers actually helped increase labour productivity in the US (between 1970 and 1999), as firms invested more in skills and capital deepening, a finding shared by Koeniger (2005) for OECD countries (between 1973 and 1998). However, a study by Bjuggren (2015) finds that exempting smaller firms (firms with fewer than 11 employees) from applying employment protection measures in Sweden (between 1998 and 2003) resulted in an increase in labour productivity. Autor et al. (2007) also find that total factor productivity (TFP) is reduced, and Okudaria et al. (2011) also find for Japan (between 1994 and 2002) that TFP is reduced for firms that apply labour dismissal protections. Hence, there is some inconsistent evidence on the effects of labour regulation reforms on productivity, alongside some consensus that reforms that protect employers do have a positive impact on labour productivity, which could also reduce TFP.

Evidence shows that **employee engagement and occupational safety** affect firm productivity. For example, previous evidence shows that human resource systems can affect firm performance. Firms that employ systems that promote a skilled and motivated workforce have higher levels of firm (financial) performance (Becker and Huselid, 1998). More recent research from Denmark and Sweden notes how an improved physical work environment and worker well-being is an 'important, statistically significant predictor of productivity' (Foldspang et al., 2014), which, though not stating causality, shows there is a link between the two factors. Thus, BER that target these areas could have a positive contribution to make towards ET.

BER activities can focus on improving firm **access to finance**. Access to finance can potentially positively contribute to ET by providing firms with the means to invest in productive capital, increasing their productivity levels, growth and thereby income and employment-generating capabilities. Studies have shown a link between improved access to finance and firm-level productivity. A recent investigation of manufacturing firms in SSA (Bopkin et al., 2017) found that access to credit improved productivity. Other studies in developing countries, such as Goedhuys et al. (2006) in Tanzania and Arnold et al. (2008) for a panel of countries in SSA, have also found that productivity increases where manufacturing firms have better access to finance.

A number of BER activities can also facilitate **firm participation in international trade**. Increased access to globally networked sources of finance can help facilitate trade finance for firms that want export goods. Firms that export tend to have higher levels of productivity. For example, evidence shows that export-oriented firms in Canada have higher labour productivity growth rates, higher wages and higher sales than non-exporting firms – even though they also have lower employment growth rates, posited to increased value addition of goods and a reduction in labour inputs (Baldwin and Gu, 2004).

Increased trade participation is closely correlated with greater firm productivity levels, though the direction of causality is not always clear: trade can raise productivity, but it may be that firms which are already more productive are those that engage in trade. More productive, internationally facing,

firms increase their market share (Melitz, 2003). BER that contribute to increased trade liberalisation outcomes can also contribute to ET. For example, in China, trade liberalisation policies led to increased firm productivity, reallocating labour from less to more technologically advanced (export-oriented) firms (Bloom et al., 2015). Increased distance to the technology frontier was also found to have a negative impact on productivity for export-oriented firms in Ghana (Damoah, 2016).

Aid for Trade (especially **trade facilitation** which is considered part of BER) reduce trade costs, increase productivity and diversify exports. Bearce et al. (2010) suggest a $1 investment of total US government assistance to trade on average would increase exports by $42–53. Busse et al. (2011) use a panel data estimation for a sample of 99 developing countries for the period 2004–2009 showing that aid measures reduce the costs of trading. Calì and te Velde (2011) examine the impact of AfT on trade costs and exports. They find a $1 million increase in AfT facilitation is associated with a 6% reduction in the cost of packing, loading and shipping to the transit hub. The estimations find that the elasticity of trade costs to increased AfT is significant with a value of around -0.10. A reduction in trade costs through trade facilitation is relevant not only for increasing the volume of exports but also for promoting export diversification (Dennis and Shepherd, 2011) and economic transformation. A 10% reduction in the costs of international transport and domestic exporting costs are associated with export diversification gains of 4% and 3%, respectively, in a sample of 118 developing countries. Trade facilitation has particularly strong effects on diversification in poorer countries.

The focus of BER on **increased competition** is an important source of productivity increases. Evidence from the UK (Haskel, 1991; Nickell, 1996; Disney et al., 2003) points out that higher levels of market concentration (i.e. lower levels of competition) have negative impacts on TFP. Cross-country evidence (Nicoletti and Scarpetta, 2003; Arnold et al., 2011; Bourles et al., 2013) shows that (i) higher levels of market concentration reduce productivity and (ii) the application of better competition regulations helps increase productivity. Studies in developing countries show similar results. Sekkat (2009) found that greater levels of competition in Jordan, Morocco and Egypt resulted in higher levels of productivity. Similar results were shown for South Africa (Aghion et al., 2007). Allowing access to domestic markets by foreign firms can help increase average productivity levels, as seen in a sample of 118 developing and transition countries (Waldkirch, 2014). Even increased competition from informal firms can help increase productivity, as Ali and Najman show (2015) for countries in SSA.

Tax rates can also potentially affect firm productivity. Vartia (2008) uses industry-level data from OECD countries to show that investment levels are negatively affected by corporate taxes, which have a negative impact on productivity. Arnold and Schwellnus (2008) find a similar result: their cross-country study found firms in inherently more profitable sectors to be less productive in countries with higher corporate tax rates, with the effect strengthening for firms that are catching up to the technological frontier – hence higher rates of taxation could be detrimental to technological catch-up. This result is also illustrated by Gemmell et al. (2012), who find that corporate taxes can

hinder firm catch-up to the technological frontier. These results of these studies posit that higher tax rates reduce the propensity to invest, in turn affecting productivity, the models used corporate taxes are proxied by increases in production factor costs increasing the user cost of capital rate. The results of the models that there is a link between taxes and firm level productivity which needs to be considered.

BER policies that promote engagement with foreign investors can also contribute to ET. For example, increased participation by domestic firms within international global value chains (GVCs) is shown to increase firm-level productivity (Criscuolo et al., 2016). Studies in Latin America have also found a positive relationship between participation in international trade and firm productivity, where firms that showed increased involvement in GVCs also showed increases in performance (Montalbano et al., 2014). The OECD (2013) identifies a number of trade-related issues (non-tariff barriers, standards, market access restrictions, etc.) that could be tackled through BER interventions.

Similarly, trade in intermediate goods also affects firm-level productivity, by lowering production costs and supporting technical change. In an analysis of productivity shifts on a sample of 30 sectors in 25 EU countries, Parteka (2013) found that, during the EU's eastward expansion phase, trade participation had a positive effect on intra-industry productivity growth – an effect that is stronger through intermediate goods trade. Strong international sectoral ties – that is, the use of foreign intermediate inputs into production – can have positive impacts on labour productivity in low- and middle-income countries. An increase of 10% in the export exposure ratio can lead here to a 0.1% increase in labour productivity (Kowalski and Buge, 2013).

Concluding, the literature clearly suggests a differential impact from different types of BER activities. Encouragingly, there are some signs of positive effects on firm level productivity of trade facilitation, worker conditions, labour market regulations, employee engagement (OECD), innovation in the workplace (UK), access to finance, participation in trade and foreign investment, competition (developing countries), but mixed evidence of entry, exit and firm dynamics (US). It is therefore important to examine different types of BER activities. Moreover, such regressions do not suggest weaker or stronger effects, or discuss heterogeneity of impacts depending on context.

One reason why BER activities may have different impacts is because different sectors can have different impacts on growth and productivity. It is therefore important to consider (i) whether and how BER activities can be sector focussed and (ii) how we know whether different sectors have different impact (i.e. whether we should expect benefits from targeting BER activities).

Sector focused BER can help promote industrial clustering, bringing firms into close geographical proximity, which will support firms' productivity growth and ET overall, especially if clusters contain firms in the same or similar sectors. Clustering enables agglomeration and scope economies and lowers transactions costs for firms to access inputs, including intermediate goods, labour skills, infrastructure services (transport, energy, communications and water) and logistics. For many firms

producing intermediate goods or services, it will expand their customer base (Fujita et al., 1999). This contributes to firm-level profitability (Rosenthal and Strange, 2003) and potentially raises wages (Glaeser and Mare, 2001). Evidence from Cambodia (Chhair and Newman, 2014), Ethiopia (Siba et al., 2012), Vietnam (Howard et al., 2014) and Tunisia (Ayadi and Matoussi, 2014) suggests there is a positive relationship between firm productivity levels and **firm agglomeration**.

The DCED have considered other sector-focused BER can also promote productivity growth and transformation, including **sector-specific tax incentives or subsidies and sector-focused public procurement policies** (White, 2015). These would need to be consistent with trade policy, and in particular with international trade treaty obligations, which often preclude preferential treatment for locally based firms. In such cases, however, sector policies may encourage inward FDI, which often has transformative impacts. Technical standards for products and production processes can be another mechanism to increase productivity. These are sector-focused but standard-setting and monitoring may be enabled by institutions with a broader remit than a single sector, and can be supported via BER policies. Improving environmental and social standards may also lead to higher productivity in many contexts, either directly or by encouraging firms to adopt new, more efficient technologies that meet these standards.

Balchin et al. (2019) discuss six cases of successful transformation and five failures and find that much of the dynamics happens at the sector level. They discuss factors that are relevant at sector level. These start with the correct identification of economic opportunities, which are often concentrated at the sector level, but other factors are crucial too: conducive political-economic conditions at the sector level; credible commitments to investors; reasonably good provision of public goods; specific efforts to tackle investment coordination problems; and taking advantage of a moment of unusual opportunity. A better business environment is one example of a credible commitment.

2.2.2 What sectors have the greatest ET potential for focused BER activities?

Several methods can be used to assess the **ET potential of a given sector** or to identify sectors that have more ET impact potential and on which **to focus BE activities**. Some methods examine labour productivity differentials across sectors which can be used to promote economy-wide productivity. Other methods uses multiplier analysis – that is, input-output tables (or Social Accounting Matrices) – to understand what effects changes in demand will have on productive outputs and employment, for different degrees of skilled labour.

It is also possible to calculate sectoral labour productivity levels, combining sectoral employment shares and sectoral value-added data. When combined, these can estimate labour productivity values, which can be compared to produce relative labour productivity data. This then help us understand which are the more productive sectors in an economy and which sectors employ the most people.

A problem with all of these is that statistical data in many low- and middle-income countries are scarce and of poor quality where available. Donor support for capacity-building in official statistical agencies is often a valuable ancillary investment to promote BER and ET.

There are also several trade-data based metrics that can help us understand what export sectors could contribute to ET. The Revealed Comparative Advantage (RCA) index is used to calculate the degree of trade specialisation within a country, to assess what trade goods a country has a comparative advantage on in terms of international trade. When calculated at the country level, higher scoring sectors exhibit a greater comparative advantage when globally traded.

The Hausmann-Hidalgo Product Space Analysis (HHPSA) uses RCA data to calculate several useful measures to evaluate the Economic Complexity Index (ECI) of countries. The ECI helps identify the degree of diversification of a country's exports in comparison with how common these exports are on the global market. Of additional relevance to the BER discussion is the Product Complexity Index (PCI), which is based on the ECI and can be used to evaluate the transformational capacity of individual products, as it ranks products by the 'amount of capabilities or know-how necessary to manufacture them' (Hausmann et al., 2014). Products with a higher PCI score can provide greater transformative potential as they represent higher productivity capabilities within an economy. It is also possible to use the PCI ranking as a proxy for technological intensity, as more complex products will likely require more technologically complex production processes. The HHPSA can be used to assess a country's Product Space. This is a graphical representation of the products a country makes and how these are connected to other goods.

Assessing sectors according to the average labour skill level of workers helps identify areas where positive spillovers – that is, from FDI or innovation – are likely to be more readily absorbed. National labour force surveys or specific sectoral surveys can be used evaluate the distribution of labour skills at the sectoral level. Labour skills also help absorb technology, as sectors that are closest to the technological frontier can both reap greater benefits from FDI and be more productive.

Estimating the potential to increase productivity within sectors, from a BER targeting perspective, provides additional information to assess how much productivity could grow in individual sectors, hence how to prioritise sectoral interventions. TFP measurements help assess sectoral TFP dispersions. This can be a useful metric to assess the potential for within-sector ET change. TFP dispersion groups firms by TFP levels in different sectors in individual countries. Sectors that exhibit a large discrepancy, between firms, in labour productivity are those where there is the greatest potential to fill the productivity gap and boost growth.

Firm-level TFP analysis can also be used to understand how far firms are from the global technological frontier. This can also compare sectoral average TFP with either the national average TFP or the global leader average TFP. The first comparison helps us understand how far the firms in a

sector are from the national technology frontier; the second is usually compared with the average TFP of what is the current technology frontier country. For example, Dabla-Norris et al. (2015) used the US TFP at the time as the accepted technology frontier.

Finally, increased participation in trade at the sectoral level can lead to higher productivity. Sectoral data can be used to provide a good idea of the degree of export orientation of the target sector *vis-à-vis* other sectors or the same sector in comparator countries and the degree of participation of the country within GVCs, where greater levels of participation in both metrics tend to result in higher levels of productivity and growth.

Lemma (2018) proposes several metrics (see Appendix C for further details) that can be used to understand the *ex-ante* potential contribution of an economic sector towards ET. Therefore, for the purposes of BER that can contribute to ET, they can be used to identify transformative sectors where BER could be applied to facilitate the transformative process. The table in Appendix C illustrates the main pros and cons of the methods discussed in this section. An important conclusion is that sector focused BER is possible and we should also expect greater effects from targeted impacts.

2.2.3 How do BER activities combine with other types of activities to promote ET?

McMillan et al. (2017a) classify a range of public policies that can be used to support ET, summarised in Table 1. Of these, BER activities are only one type, and fall under the investment climate reforms, which are classified as general enabling interventions. However, these are often not enough by themselves, and **need to be undertaken in conjunction with other interventions**, such as infrastructure investments, support to the financial sector, industrial development policies, etc. Therefore, it is important to consider complementarity between policies when implementing BER with an intended ET outcome. For example, Rodrik (2013) calls for complementary policies that improve both 'fundamentals' such as education and infrastructure – which would include BER policies – and policies that target growth in high-productivity sectors.

Table 1: Typologies of public actions used to promote ET

	General enabling interventions	Targeted interventions
Public actions to support structural change	• business environment/investment climate reforms (e.g. registration, land, tax, contracts) • financial sector development • strengthening SBR	• export push policies • exchange rate and tariff protection • selective industrial policies • spatial industrial policies • national development banks

Public actions to support within-sector productivity growth	• building fundamentals (e.g. infrastructure, education)
	• investments in basic production knowledge
	  • managerial good practices as public goods
	  • innovations
	• promoting competition
		• management training
		• attracting FDI
		• export diversification
		• developing GVCs
		• increasing agricultural productivity

Source: McMillan et al. (2017a)

Evidence from the International Monetary Fund (IMF, 2014) illustrates how important horizontal policies can be. For example, supporting education and improving access to export markets, infrastructure, the institutional environment and the regulatory environment (that most BE reforms are concerned with) has resulted in product quality upgrading, shifting resources to more productive activities and diversification. The effects of these reforms become stronger when partnered with structural reforms such as financial deepening and trade liberalisation. See Table 2 for the IMF's summary of findings on **policy clusters**.

Table 2: What clusters of factors drive ET?

Key elements	Selected interventions
Structural change	• manufacturing share: power, credit, labour market and business regulation • services: liberalisation of networks such as telecommunications
Sector productivity	• agricultural productivity: tariffs, interest rate controls • manufacturing productivity: capital account liberalization and FDI, roads, education
Export product diversification	Higher level of education and institutional quality, deeper financial systems, proximity to markets, globalisation including south–south trade, trade liberalisation, agricultural reform and devaluation

Source: IMF (2014)

BER could be used to promote investment that facilitates ET. A rapid evidence assessment carried out on behalf of the UK Department for International Development (DFID) (White and Fortune, 2015) shows there is some **evidence to link BER activities with increased investment outcomes**. BER policies that streamline tax submissions, encourage formalisation and improve access to markets are all significant contributors to increasing investment. There is considerable evidence that directed activities of investment promotion agencies (IPAs) also increase investment – mostly by large and usually foreign companies, and mostly in developing rather than developed countries – by helping overcome information asymmetries (Morrisset and Andrews-Johnson, 2004; UNCTAD, 2008; Harding and Javorcik, 2011). Studies have not explicitly investigated the link between BER and IPA activity, and it seems likely that IPAs cannot *substitute* for BER in the sense of enabling investors to avoid a poor BE. But IPAs do often assist (large foreign) investors to navigate administrative aspects of the BE, by providing 'one-stop shop' facilitation services, and in that respect may help compensate for a poor BE. Furthermore, IPAs – through their information and marketing functions – may *complement* BER in helping bring a country (or city or region) to the attention of potential (foreign) investors, and in providing information on the progress of specific BER initiatives, with which new entrants to a market may not be familiar.

It is worth noting that, because they have limited resources, IPAs in their marketing activities necessarily target potential investors in specific sectors or in specific source countries, or both. In addition, they have a potentially important role as policy advocates (UNCTAD, 2008), and through their contact with investors can collect information about investor needs. This can be helpful in prioritising within BER. As a result of these factors, they can be important partners in promoting ET, through BER and directly.

BER policies should therefore target investments that can increase the rate of ET by either identifying specific sectors – as illustrated in the methods above – or targeting the general business enabling environment to increase the overall level of investment within a country. Under this policy approach, the ET literature calls for investment climate reforms, including BER, to be undertaken as part of a broader ET-promoting intervention agenda. In practice, this should not be a particular issue: implementation of BER policies and complementary strategies such as industrial policy often requires the same set of institutional capabilities (DCED, 2013).

Page (2012) argues that too much emphasis has been placed on investment climate reforms alone in Africa but not enough on the 'basics', such as investments in infrastructure or education, essential to unleash within-sector productivity growth. As an example, the following areas show intersections between horizontal and BER policy spheres:

- Infrastructure: This includes transport, communication and utilities (including energy and water) infrastructure, as these can influence how efficient domestic and international trade is, affecting productivity and influencing the degree of access to markets.
- Institutions: More transparent and effective institutions, and more functional SBR, facilitate market (and firm) operations, enhancing productivity gains.
- Financial deepening: Firms that operate in more effective financial markets are better able to absorb FDI spillover effects, thereby increasing productivity levels.
- Education: The higher the percentage of the workforce educated at tertiary level, the greater the capacity to adapt and use more productive technologies, improving productivity outcomes.

Focusing on the role of BER, Newman et al. (2015) propose a combination of policies aimed at ET that can be defined as the 'investment climate plus'. While investments in fundamentals such as skills, infrastructure, institutions, education, etc. are needed to stimulate long-term growth in labour productivity, they need to be used in conjunction with complementary policies that support the growth of modern sectors, such as special clustering policies – for example support to special economic zones (SEZs) to promote firm agglomeration effects to stimulate knowledge-sharing, promoting exports and attracting FDI within targeted sectors (see Box 1 for a discussion on SEZs).

Focusing on FDI, there are a number of spillover effects from FDI that complementary BER activities could strengthen in order to promote positive ET outcomes:

- Promoting technical innovation: FDI into more capital- and technology-intensive sectors leads to more productive outcomes than FDI in other activities. Firms closer to the technological frontier have greater FDI spillover absorptive capacity and tend to have better productivity outcomes. Similarly, firms better able to carry out R&D activities are more capable of adapting FDI technology to local markets.
- Promoting better workplace systems: Firms with management systems geared towards longer-term outcomes tend to have better FDI productivity spillovers as they are better prepared to invest money in training (or capital) required to facilitate knowledge/technology adoption.
- Promoting worker training: A better-educated labour force increases the capacity of FDI to spread positive knowledge and technology absorption spillovers. More training given to employees increases firm-level absorptive capacity (i.e. technology adoption) but also improves the overall labour pool, ramping up other firm productivity levels when employee dispersion occurs.
- Promoting deeper market integration: Greater links (vertical and horizontal) between firms promote FDI impacts. There are stronger impacts between vertically linked firms, but horizontal links can also matter for productivity spillovers.
- Supporting financial systems: Availability of deeper/stronger financial markets can positively influence FDI spillover (especially technological adoption) effects.

Box 1: The role of special economic zones in driving transformation

SEZs are often used as second-best tools in contexts with weak business environments. Empirical studies on successful SEZs suggest SEZs can help drive ET and job creation, but achieving this is neither automatic nor free, and the experience in African countries has not been as impressive so far.

Countries that have successfully used SEZs for development include Ireland, Singapore and China (te Velde, 2003). Ireland has pursued an active policy to attract quality FDI and foster linkages between foreign and local firms (ibid.). A key aspect of spillover success in Ireland is the active way in which the country has attracted high-productivity firms with spillover potential. Local linkages have over time led to productivity impacts. From the 1990s, some 30 years after first attracting investors, local suppliers reached sufficient scale to become global exporters, thanks in part to earlier state support in the form of linkage programmes, clustering and R&D subsidies. Barrios et al. (2004) show econometrically that linkages have led to productivity spillovers from foreign firms to local firms. The impact varies by the level of absorptive capacity (measured by R&D expenditure). Barrios et al. (2006) further show that productivity spillovers to local firms depend on co-agglomeration of local and foreign firms, when local and foreign firms locate close to each other.

(continued on next page)

Active industrial policy in Singapore attracted FDI into SEZs and upgraded local firms, and the same upgrading pathways occurred as in Ireland. The local small and medium enterprise (SME) sector and interactive transfer of technology and knowledge became an important locational factor for multinationals (Chew and Yeung, 2001). The active policies have also led to positive impacts of FDI on productivity in local firms, especially those local firms that supply foreign firms (Moran, 2003; Jiajing and Leng, 2012). The positive interaction between local firms and foreign firms is supporting technology transfer both ways (Chew and Yeung, 2001).

One core element of the Chinese development model since 1978 has been the use of SEZs to attract investment and technology, used to develop the rest of the economy through linkages (Zeng, 2011; Kingombe and te Velde, 2015). The Chinese experience suggests that clustering and impetus for further reform are co-benefits from SEZs (Graham, 2004). There is much interaction between SEZs and the local economy in successful zones, encouraging mobility through transport links and labour mobility in Shenzhen (World Bank, 2008). A survey of Hong Kong garment firms in China shows that clustered FDI is significantly better at transferring technology than dispersed FDI (see Thompson, 2002).

There are clear lessons from these successful experiences. In terms of *zone design and operation*, policy-makers in-country have actively built up clusters through SEZs. This has involved sustained and consistent efforts over time, with net benefits emerging sometimes only after 10 years. *Zones have clearly been instrumental* in attracting large volumes of investment, rapidly increasing exports and employment. IDA Ireland attracted firms in software, electronics and pharmaceuticals clusters, whereas Singapore's Jurong Island Corporation used cluster development funds. Finally, a clear feature of these examples is how the *zones have supported the entire economy through actively pursuing local linkages* through linkage programmes and active local capability-building through R&D and skills programmes. The IPAs of Singapore (the Economic Development Board) and Ireland (IDA Ireland) are strong institutions.

SEZs in Kenya, Rwanda and Tanzania offer impressive localised results. For example, zones are responsible for 5% of total exports in Rwanda and Tanzania and 10% in Kenya. They may bring a valuable and more diversified manufacturing production to the countries. They also provide long-term opportunities for formal employment – for example nearly 20% of manufacturing employment in Kenya. Firms in SEZs in Rwanda, Tanzania and Kenya are also more productive. However, none has been as successful as those in China, Singapore or Ireland. African SEZs have generally failed to create good forward and backward linkages between firms inside SEZs and those located outside, and have been unsuccessful in supporting a process of structural transformation (Kingombe and te Velde, 2015). A new generation of African SEZs, for example industrial parks in Ethiopia, is beginning to have more significant effects more quickly.

The evidence on SEZs also suggests different (support) activities need to be combined to make SEZs a success. For example, SEZs require appropriate infrastructure (incl. roads, energy), an industrial workforce, investment promotion of anchor firms, one-stop shops of business licenses, trade facilitation, and learning and experimenting (as evidenced through various discussions and writings of Arkebe Oqubay).

Policies should consider the role of government institutions, especially how SBR are developed, as these can have an impact on ET. Lemma and te Velde (2015), in a synthesis of existing SBR studies, point out that, in quantitative studies, high SBR 'scores' (i.e. how well the state works with the private sector) are related to higher levels of firm productivity. This means that BER policies, especially those that could affect existing political economy arrangements, should consider how SBR dynamics are altered. One goal for BER policies is to contribute to an improvement in SBR to facilitate private sector investments in target ET sectors, but vice versa effective SBR can put more emphasis on transformational sectors, which can provide a context within which to provide BE activities.

Finally, the role of digitalisation to implement BER activities could also be considered, as digitalisation efforts could be an important route to promote ET outcomes by improving operational efficiency and increasing (and simplifying) access to both services and markets. For example, Banga and te Velde (2018) look at how digitalisation can be used in Kenya to promote employment in manufacturing, with the example of digital one-stop windows to be set up in the financial sector to support investments in manufacturing. Policies that support increased digitalisation can also be used to promote e-commerce, targeted at the wider BE and with a specific focus on transformative sectors. As the literature has shown, increasing international trade participation, firm access to markets and exports can have strong positive productivity effects. Digitalisation promoting policies can also target sectors that are further away from the technological frontier to promote greater levels of innovation and help introduce modern skills to laggard areas of expertise.

Analysis by the DFID funded Supporting Economic Transformation programme also points to the need to target BER and seek complementarities between BE and other ET activities. For example, to stimulate Kenyan manufacturing, BE reforms should be targeted at construction permits, paying taxes and registering property. But such BER activities need to be complemented by activities covering skills, finance and energy and targeted ET policy around exports, innovation and SEZs (Were et al., 2017). To promote economic transformation in Tanzania, Balchin et al. (2016) argue for five policy priority areas, including investment climate reform (targeted at energy governance, labour and trade taxes, starting a business and developing a public–private partnership unit) and infrastructure corridors, technical and organisational skills development, tax reform and developing priority SEZs. Mozambique's transformation needs to be supported by addressing constraints in the regulatory framework (in investment policy, trade facilitation, financial sector reform and land policy) complemented by better transportation infrastructure, dialogue with business and targeted sectoral policies to make better use of mega deals (Balchin et al., 2017). A closer look at policies to unlock the transformation potential of specific economies and sectors will lead to a consideration of *combinations* of policies, including targeted BER, policies to support factors of production and targeted ET policies around trade, exports and clusters.

In parallel to the complementarities between BER and other activities, there is also a related but different discussion on the potential for combining different types of instruments. Donors are increasingly blending aid grants and loans (e.g. through the EU blending schemes), aid and equity, or

aid and guarantees. For example, te Velde and Warner (2007) discuss how DFIs are increasingly using technical assistance to prepare business case or make loans more concessional in infrastructure. Technical assistance is often required to get a project off the ground.

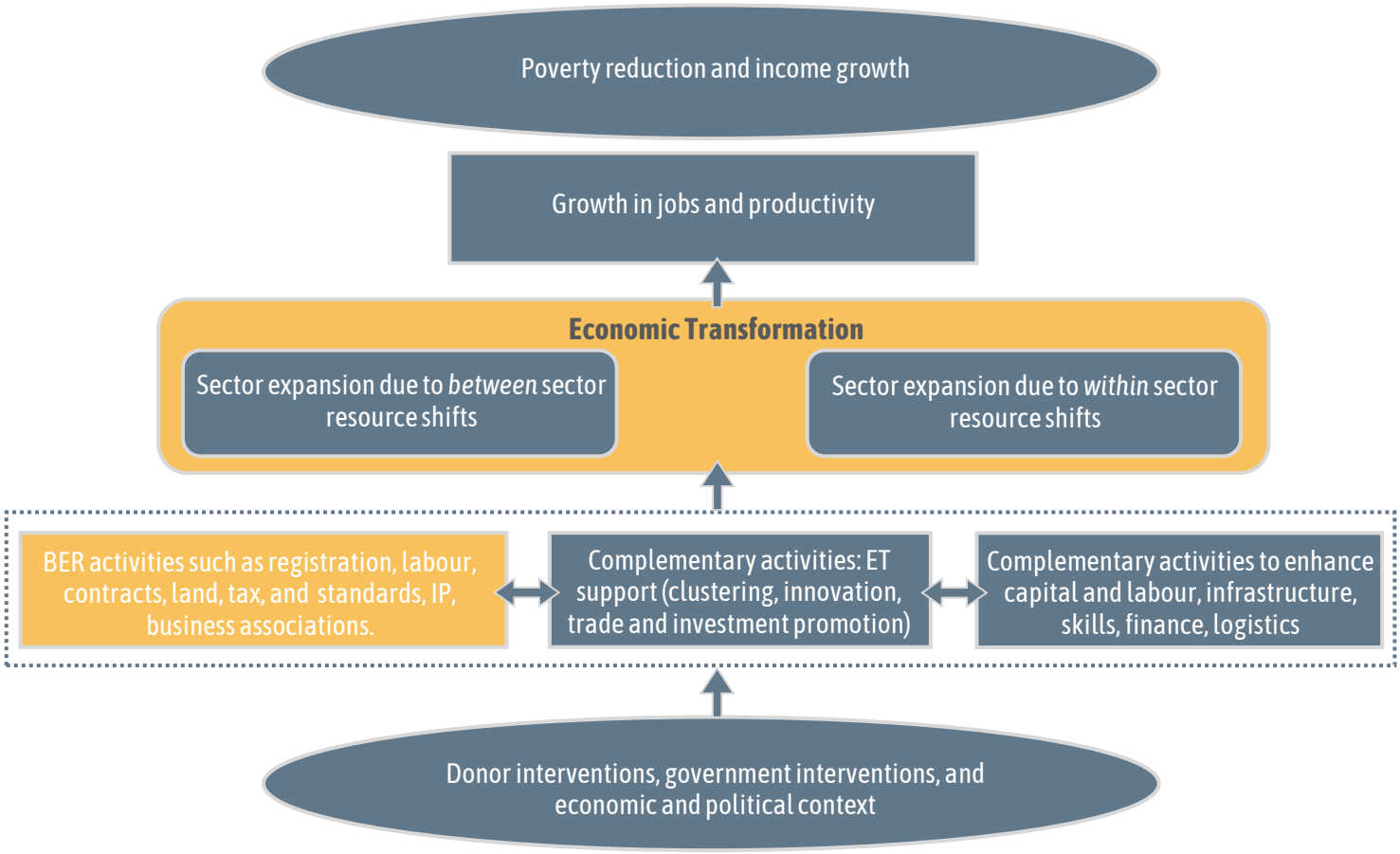
Figure 1 below summarises the discussion in Section 2 into a simple Theory of Change. The figure shows the process through which interventions by donors and developing country governments in particular contexts (depicted at the bottom) lead to poverty reduction and income growth for citizens (depicted at the top). The theory of change is structured around the process of ET, depicted in the third row, and in particular the distinction within that process between moving productive resources *between* sectors, from low-productivity agriculture to higher-productivity manufacturing and urban services, and moving productive resources *within* sectors, from lower-productivity firms to higher-productivity firms.

The donor and government interventions are divided into three sets, in the fourth row. Some BER interventions (e.g. around registration, contracts, labour, land, tax) often concern *both* types of resource movement comprising ET – that is, movements between and movements within sectors. Other BER interventions (e.g. standards, intellectual property, business associations) are sometimes targeted at sectors of relatively higher productivity, and aim to support firms further raising their productivity.

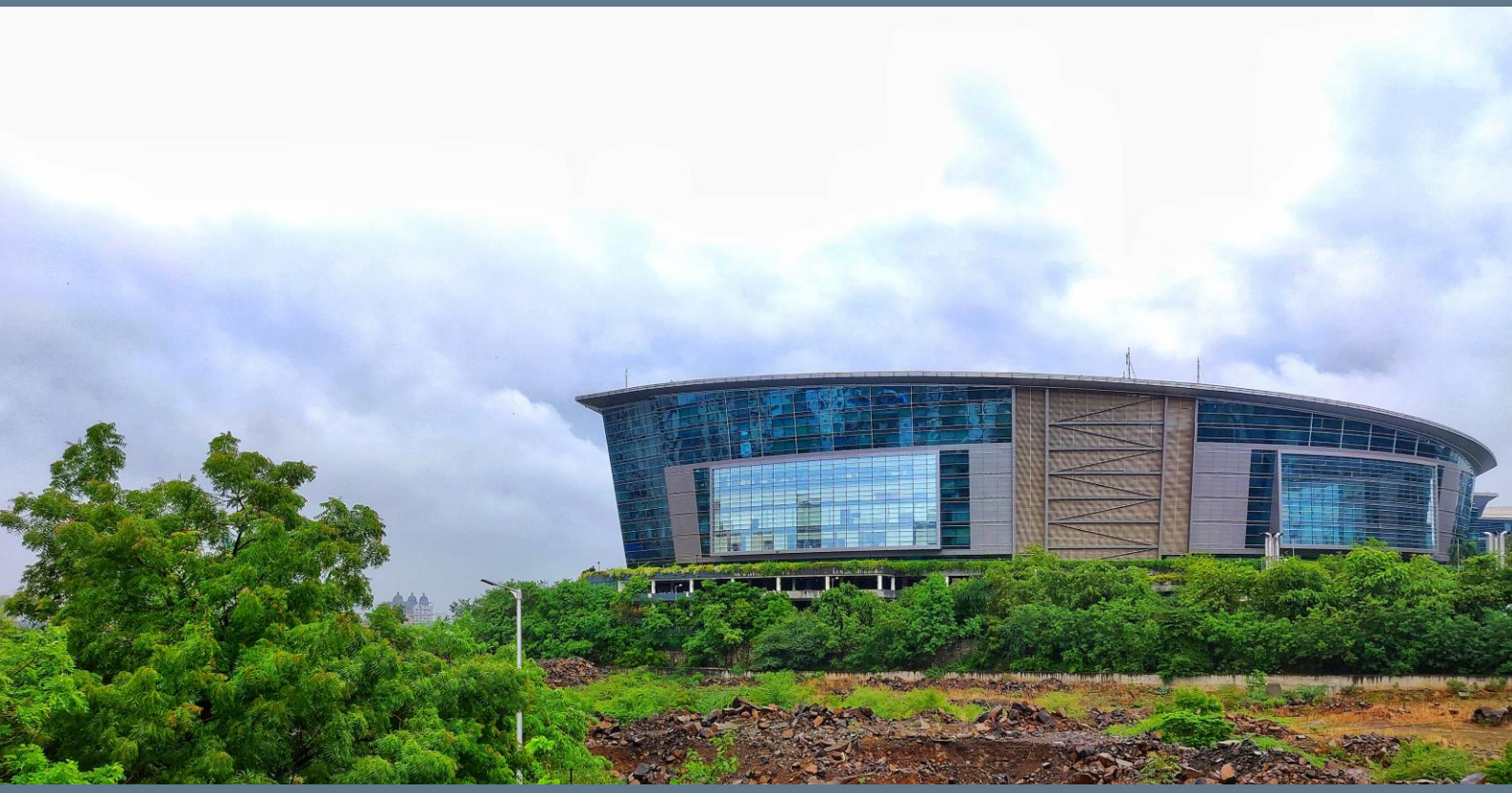
On the right hand side of Figure 1, complementary interventions are (i) those in 'productive factor' markets, intended to improve the quality and productivity of capital and labour across the economy and (ii) ET activities targeting ET explicitly, such as those that promote clusters, innovation, trade or investment. Both complementary ET interventions and other complementary interventions can potentially affect between-sector and within-sector transformation. Whereas BER activities focus on market conditions, ET interventions focus on enabling productivity improvements for specific firms (or groups of firms) or specific sectors.

The crucial message is that BER activities should be co-ordinated with other activities to gain the best impacts. The impacts of BER depend on what other activities are implemented alongside. It is not possible to state which activities and in what quantities or timing, as this depends on context. The next section provides successful project examples (e.g. TradeMarkEast Africa).

Figure 1: A theory of change from BE activities to ET and poverty reduction



Source: Authors



3. Current practices and challenges for donors in promoting and implementing BER to promote ET

While the academic literature has developed a range of definitions for ET, donors often do not use these in their activities. Nor is ET often the focus of BER activities. Here, we examine **whether and how donors use BER to promote ET**, on the basis of brief interviews and case studies. We cover the major DCED members, such as the World Bank (including the International Finance Corporation, IFC), the UK Department for International Development (DFID), German International Cooperation (GIZ), the Swedish International Development Cooperation Agency (Sida) and others (e.g. the US Agency for International Development (USAID) and Gatsby Africa (GA). While we have not interviewed development finance institutions (DFIs), the Overseas Development Institute (ODI) and the European Development Finance Institutions (EDFI) co-organised a session on impact of DFIs on ET and this provides relevant information (see Box 2).

Section 3.1 focuses on practices and challenges in donor agencies, based on detailed interviews; Section 3.2 focuses on a number of projects highlighted by interviewees as successful (based on project overviews not shown).

3.1 Practices and challenges in donor agencies

3.1.1 Definitions of BE and ET

There is comparatively little disagreement on the use of the **definition of BE**, probably thanks to the considerable work of the DCED. Several donor agencies interviewed so far do not have their own definition of BE but ascribe to the definition and guidance provided by the DCED (as discussed in the previous section). One agency uses an explicit and defined definition as part of the Standardised Programme Structure and Definitions (Element EG.5.1: Business Enabling Environment) (Office of U.S. Foreign Assistance Resources, 2016). One agency regards BE as a subset of wider investment climate work. Another does not have an operational definition of investment climate but associates itself with ODI's suggestion in the previous section. BE work at IFC has evolved but includes mainly regulatory work as part of the wider investment climate definition, which in turns fits in the IFC's private sector development work.

However, there is a great deal of variety in the use of the definition or **concept of ET**. DFID comes close to the most common definition used in the economics literature (see Appendix A and Section 2). DFID's Economic Development Strategy 2017 defines ET as 'moving into higher productivity sectors such as manufacturing and boosting productivity within existing sectors such as agriculture to steadily change the structure of economies'.

Box 2: Outcomes of a session on ET as part of impact conference organised by EDFI and ODI (5 March 2019)

The EDFI impact conference co-organised with ODI convened 80 participants from DFIs, donor agencies, think tanks and other institutions. Sessions covered the impact of DFIs on energy transformation, climate change, direct and indirect jobs and ET. There is renewed interest in the importance of DFIs to support ET. The participants in this workshop session, organised by CDC, discussed new ways in which impact can be measured when investors seek to promote ET.

Long-term impacts on transformation are different from seeing the immediate result of investments. Transformation is a longer process and requires patience. Participants discussed the use of different methodologies, such as what is the value of simulations and how new investment models could be used to provide *ex-ante* predictions of impact. With greater availability of firm and household data, practitioners can examine the impact of firm and household effects of an investment in agriculture, manufacturing or services sectors. Using certain assumptions, simulations suggested investments in certain sectors lead to increased gross national income per capita and lower levels of poverty, but higher levels of inequality.

Participants also discussed the role of investment in reducing productivity gaps (between sectors and firms) and how new models can direct investment to sectors where productivity gains may have the most impact. Under this type of model, investors can determine whether they want to strengthen sectors in which the productivity gap is small or whether they want their impact to be focused on larger productivity gains in low-productivity sectors.

There were three further points of discussion. First, it was raised that, when a third of EDFI's total portfolio is in the financial sector, it is unlikely that investments in the financial sector by themselves will lead to ET. Second, there is a need to foster greater partnership among investors in impact assessments, owing to capacity constraints. Third, DFIs need to work together and with other agencies to promote the large agenda of ET.

Source: Draft workshop report, EDFI Impact Conference, 5 March 2019

A further agency argues that it does not have a formal definition; in practice it uses a definition contained in a Youth Employment Paper (Fox and Kaul, 2017): '[Economic Transformation is] the creation of new economic entities that use new technology and produce at higher levels of productivity, and with an increase in productivity among existing firms and farms.' Productivity remains central to the definition.

Many agencies interviewed do not have an operational definition. For example, one agency uses the term 'inclusive economic development' and has no formal definition of ET. But that agency does, however, understand that ET is key to the development process, and involves diversification and creating jobs while aiming for high productivity. But ET also takes account of cross-cutting issues such as gender, environmental sustainability and digitalisation.

A further agency also has no general definition in use; according to this agency, it incorporates major disruptive trends such as climate change, digitalisation and urbanisation.

IFC does not use the concept of ET but focuses on the competitiveness of firms, which helps drive shared prosperity and jobs. Competitiveness includes concepts such as productivity improvements, product and export diversification and upgrading in GVCs.

The Gatsby foundation actively engages with the term 'ET'. In part, this reflects the view of its founder:

> *"I set up Gatsby to use its freedom as a private foundation to innovate, take informed risks and move the agenda forward. What we're attempting in East Africa is exceptionally ambitious and demanding. But if we succeed, we can help trigger economic transformation that will make a real difference to millions of East Africans."*

GA's mission is 'to accelerate inclusive and resilient economic growth in East Africa by demonstrating approaches to transforming key sectors'. It understands ET as the process by means of which an economy makes a step change in its competitiveness, ideally with enhanced inclusiveness and with resilience to these changes.

One stark conclusion from this initial review is that, while there is a reasonable consensus around the definition of BE, there is much less consensus about what ET is. In part, this is because the term has only recently become popular in policy circles (e.g. through the work of the African Union (AU), the UN Economic Commission for Africa, the 2015 UN Sustainable Development Goals and initial donor responses), despite the fact that the academic literature has used the term 'ET' or 'sector transformation' for a long time. But there is also still a large variety in views. For example:

- Some agencies consider ET as a gradual long-term process, and others see it as a large immediate or disruptive change.
- Some emphasise productivity change, implicitly assuming this needs to be broad-based; others immediately want to add explicit qualifying terms such as 'inclusive' or 'jobs-rich'.
- Some emphasise structural change between sectors, others within-sector transformation.

3.1.2 Projects focused on BE and ET

Most donor agencies have substantial lists of BE projects or projects with strong BE components. DFID, USAID and Sida are major providers of bilateral and multilateral BE programmes, worth tens to hundreds of millions each year. GIZ includes BE components as part of its projects. GA, on the other hand, does not have any BE projects, although it is aware of BE constraints in sector activities. IFC is a major supporter of BE activities as well as the main implementer of BER in value terms.

In our interviews, donor agencies struggled to come up with clear lists of ET projects in part because they do not use an explicit definition for ET, and hence the term does not appear in project documents, or because they do not have any such projects, as attention to this area is more recent. A clear exception is GA, which focuses on 13 sector transformation programmes, including through Kenya Markets Trust, a Kenya forestry programme, Tanzania cotton, textiles, forestry and tea sector programmes and a Rwanda tea sector programme.

However, when discussing more deeply, most donor agencies have projects that have an impact on ET, or components of ET, even when not stated explicitly as a core objective. For example, one agency mentioned support to the International Trade Centre (ITC) Middle East and North Africa (MENA) Textiles Programme; a guarantee instrument through Raffeisen Bank to SMEs in manufacturing and productive sectors in Bosnia and Herzegovina; support to an innovation centre in Kosovo; and a Moldova Competitiveness Project, which provides business development services in non-traditional sectors (e.g. ICT, fashion, tourism). An important observation on the latter is that, called a competitiveness project, its focus on blockages to non-traditional sectors also contributes to transforming economic structures and hence could be called an ET project. Hence, a focus on ET can be made more explicit by relabelling existing activities, but this is of course a small part of all activities, many of which continue to focus on 'more of the same', reinforcing the existing pattern of economic activities.

Many agencies also consider knowledge products as ET activities. For example, GIZ develops many toolkits around industrialisation or other topics. IFC has recently begun Private Sector Diagnostics in Ghana and Ethiopia.. DFID first used inclusive growth diagnostics and now country development diagnostics. Sida convened well-known economists in Tanzania to discuss the role of sectors in future development.

3.1.3. How do donors use BE for ET?

GA implicitly uses BER to support sector transformation, even though it is not engaged in stand-alone BER activities. It argues that BER is helpful in improving allocative efficiencies and hence in enabling and encouraging growth. GA is increasingly interested in the cross-cutting capabilities and development of checks and balances within and around governments to ensure markets function effectively. These are often part of BE (e.g. competition policy) but the greater capacity expected of governments as economies develop are not often considered. GA adds that BER is useful but not sufficient, and engages closely in BER to loosen on the sector's growth. It focuses on a range of sector-specific political economy factors and coordinates actors around the sector (see also Balchin et al., 2019).

This view is mirrored by DFID, whose governance and inclusive growth Position Paper (DFID, 2019) suggests DFID will concentrate governance expertise on reducing critical market failures in transformational sectors, focusing on the minimum reforms needed. DFID is currently considering

the role of BER. DFID argues it is **important to focus on sector approaches that include actions complementary to BE**, such as trade or investment facilitation.

One other agency interviewed had no official view but unofficially saw ET as the main mechanism for firm formalisation and growth. BER is important for ET but not the only component. The agency also points out that **some components in its BER definition have been shown to be more effective at raising individual firm- and even sector-level productivity than others**. Those that they perceive to work for productivity are:

- reducing barriers to competition and unwarranted distortions to market prices
- strengthening the legal framework surrounding property rights that is fair to men and women, the poor and other disadvantaged groups so they can protect and accumulate assets
- reducing incentives for corruption and promoting transparent business practices and
- strengthening the legal framework surrounding intellectual property rights.

On the other hand, for some BER elements they perceive there to be less evidence that they work for productivity change:

- reducing policy and regulatory barriers to establishing, operating and closing businesses, including micro, small and medium enterprises (MSMEs)
- contract enforcement and dispute resolution, along with the administration of those laws
- improving policies, laws and regulations affecting hiring and firing of workers, wages, working conditions and labour management relations.

This account has some commonalities with the literature summarised in Section 2. However, they are not the same. This could be because the implementation of BER activities may not be successful, but the impact might be significant if they are implemented.

The World Bank/IFC argued that the evidence on BER and ET is evolving. It uses a general theory of change, which includes a role for complementary factors. For example, it is now known that **business registration** by itself is unlikely to help without additional interventions, for example on **tax**. The complementary factors go beyond finance, and, following the new concept of IFC3.0, it hopes to leverage the close relationships between the World Bank and IFC. IFC also targets the concept of creating markets, by means of which individual investment have spillover effects, such as in the Bangladesh leasing sector. Appendix B2 includes more information on World Bank/IFC activities on BE and IFC 3.0.

Concluding, there seems to be a general typology of the interactions between BER and ET activities, distinguishing among:

- full integration (very few donors seem to be managing this, definitely not explicitly or intentionally; parts of DFID are beginning to emphasise synergies between BE and ET)
- overlapping and related (some BE projects incorporate ET components, see below)
- distinct programming areas (e.g. GA focuses on ET, but not on BE programmes, which are context-specific).

3.1.4. Challenges donors face in implementing BE and ET

We asked donor agencies about the constraints they faced in implementing BE reforms on ET activities. The main challenges can be summarised as follows:

- Lack of mandate in agencies: If bilateral agreements or country strategies fail to make reference to ET or similar activities, staff have little incentive to design projects.
- Lack of definition of ET: While some agencies use the term ET and design projects consistent with this, other agencies do not use the term and do not design projects in this area.
- Knowledge management: Some donors maintain their interest in BE reforms even when general experience suggests some of these are not proven effective because it is difficult to reach out and convince the staff who are designing BE interventions to drop certain BE reforms. There does not seem to be a nuanced view on which BE activities work best in which contexts.
- Short-term programming cycles vs. the long-term process of achieving ET results from BE: Both BE and ET activities involve the private sector and a long-term horizon, while the political incentives are for short-term results.
- Genuine concerns that ET or BE activities may fail to reach the (poorest of the) poor: While ET is required for sustained job creation in the longer term, there are different types of ET with different effects on the poorest within society, while others trade off short- and long-term objectives.
- Working effectively with government, identifying leaders and lead departments to anchor BE or ET activities, can be difficult.
- Failure to address coordination failures and address vested interests and political-economy constraints can be an issue.
- In reality, donor staff have little incentive to adjust predetermined programmes. Some donors also point out there is a lack of cooperation across thematic areas amongst donors.

Donor agencies have also overcome constraints to differing degrees. For example,

- To overcome to challenge of **lack of mandate or definitions**, some agencies have drafted concept notes or White Papers. For example, DFID published its first-ever **economic development strategy**, which resulted in a step change in the discussions and emphasis on ET to another level, leading for example to specific ET projects such as Invest Africa.
- Donor agencies may also learn from their existing projects or **improve knowledge management**. While Sida often does not have a mandate to work on ET projects explicitly, it does incorporate ET elements in selected programmes, such as in the Moldova project discussed below. These can offer valuable lessons and lead to a more systematic assessment of country programmes and projects (see Table 4). Other agencies have knowledge management activities that can be strengthened and the implications implemented more vigorously.
- Agencies can overcome **coordination challenges and lack of flexibility within their own agencies**. For example, GIZ transferred some of its support from direct SME support to upstream BE support. And the World Bank/IFC is leveraging different departments in its **creating markets** concept. USAID was able to work with key government officials at the highest, central levels at the early stages of a BE project, later handing over to line ministries.
- Agencies can actively overcome **coordination challenges and vested interests** by working with staff on the ground. GA overcame political economy concerns by working **closely and patiently around sectors with actors on the ground** (e.g. around cotton in Tanzania).

Table 3 shows what questions on ET indicators and ET pathways can be used to assess the transformational content of programmes based on the definition of ET proposed in Section 2. Table 3 is based on data presented in more detail in Appendix B which summarises a recent study undertaken by the SET programme on the transformational content of the World Bank/International Development Association (IDA) strategies and programmes. This analysis provides lessons on how to assess the transformational content of other donor programme, which can lead to better monitoring of transformation indicators that can be used to adapt programming.

Table 3: Assessing the use of ET indicators and pathways in country strategies

Aspect(s) of ET covered	Specific questions	Assessment criteria
- Structural change - Within-sector productivity growth - Diversification	Does the (country) strategy have clear objectives in terms of ET? Are pathways to ET a core element of the strategy?	Whether or not reference is made to one or more of the following core aspects of ET in the strategic objectives: (i) structural change (ii) within-sector productivity growth (iii) diversification of outputs and exports Whether or not reference is made to pathways to ET as a key to supporting economic development, growth or transformative processes, e.g.: - horizontal interventions to enhance productivity in all sectors (e.g. improved energy or transport infrastructure, better be, stable regulatory framework) - education, training and skills development to boost worker productivity - adopting new technology or management practices - commercialisation or technological innovations to boost productive capacity - development of high-value services and export manufacturing - private sector investment in productive or higher value-added activities - value chain development and integration into GVCs - trade facilitation and regional integration - improvements to efficiency of services (e.g. financial services) that support key productive activity - urbanisation, clustering and special economic zones
Structural change	Are objectives to promote structural change translated into indicators?	Whether or not there are quantitative indicators on structural change (i.e. shifts to higher value-added sectors)
Within-sector productivity growth	Are objectives to promote within-sector productivity growth translated into indicators?	Whether or not there are quantitative indicators on within-sector productivity growth. The ratio of within-sector productivity growth indicators that target the agriculture sector compared with those targeting other sectors (e.g. manufacturing services)
Diversification	Are objectives to diversify production and trade translated into indicators?	Whether or not there are quantitative indicators focused on diversification of outputs and exports
Transformation of employment structures	Does the country strategy prioritise moving to higher-wage or more productive employment as a key motivation for ET?	Whether or not reference is made in the strategic objectives to transforming the country's employment structure through: - increasing labour productivity - raising wage employment - reducing working poverty - increasing the quality of jobs (remuneration, job security)

Source: Appendix B

3.2. Illustrative examples

An earlier version of the paper provides further details of a number of programme examples, as identified by donor interviews. These examples can be used to bring out the extent to which donors link BER with outcomes such as ET, how they assess the type of activities to be engaged in and what initial impacts are (if any). The examples are as follows:

- The Moldova Competitiveness Project is an ongoing project implemented in 2015 by Chemonics International, with the help of USAID and Sida. The aim of the project is to improve the competitiveness of important Moldovan industries and thus create a stronger and more diversified economy.
- The GIZ Morocco project recognises that MSMEs comprise the majority of Morocco's private sector; however, they often do not reach their potential. Therefore the German Federal Ministry for Economic Cooperation and Development project, which began in 2015 and ended in 2018, offered public, private and financial services to help Moroccan enterprises create a business enabling environment as well as more employment.
- The GIZ Tunisia project Jobs, Opportunities, Business Success (JOBS) is an ongoing project that began in 2018 implemented by Chemonics International with the help of USAID. The project's objective is to support SMEs to create more employment opportunities for all Tunisians.
- DFID Invest Africa is an ongoing project that began in 2017. It aims to create ET on the African continent, generating jobs and helping less developed countries out of poverty by combining technical assistance in different ways.
- IFC 3.0 is an ongoing project that aims to create new and stronger markets in countries that have not benefited from investments.

This paper does not examine the details of these projects, but a number of general comments apply. The size of the projects varies markedly. For example, the size of the ongoing USAID–Sida Moldova project is $22 million. The size of the GIZ Morocco project was significantly larger, at $260 million. The GIZ Tunisia project amounted to $59.5 million. The budget size of DFID's Invest Africa is around $129 million; though the majority is still to be spent. The size of the Msingi project is $30 million.

Importantly, the projects focus on a range of sectors (many projects focus on SMEs), though some are more specific than others. These projects also include BER activities to various extents, including for non-traditional sectors, which implies that such BER activities are implicitly also targeting economic transformation. For example, the Moldova Competitiveness Project focuses on the following sectors: ICT; wine production and export in the tourism sector; and light industry. GIZ Morocco focuses on MSMEs. GIZ Tunisia focuses on the Tunisian private sector. Like GIZ Morocco, DFID's Invest Africa focuses on small enterprise development as well as industrial development, industrial policy and administrative management and business support services and institutions. IFC

3.0 focuses on multiple sectors and 'Sector Deep Dives', such as in power, digital economy and SME finance.

While many of the projects focus on tackling the structural constraints in selected sectors, approaches vary. For example, while DFID Invest Africa works (and intends to work) with country government agencies and private investors to draw in FDI to the government of the host country, including using improved regulatory practices, GIZ Morocco works with MSMEs through services and training tailored towards them. All projects emphasise the importance of the private sector in economic development and seek to remove business environment constraints that are holding back the private sector from playing a bigger role in development.

The use of complementary factors in the implementation of the projects varies, from financial inclusion of the smaller business owners, to trade and investment promotion, to opening up political dialogue with the host country's government, depending on the nature of the project. This is significant in that these projects have developed into or from activities that are complementary to BER. In general, while financial inclusion of businesses is the common complementary factor between USAID's project in Moldova, GIZ Morocco and GIZ Tunisia, government involvement is a common principle in the projects carried out by DFID and IFC.

It is difficult to determine at this stage whether projects have been successful or not. Many of the projects are still in the implementation phase or were launched very recently, making it hard to judge. However, the estimated results and prospects seem promising. IFC 3.0 had a pilot programme in Kazakhstan that resulted in implementation of the groundwork for government funding for the World Bank Group project in the country. GIZ Morocco, which is the only closed project out of the six example cases, resulted in more than 30,000 new sign-ups as auto-entrepreneurs.

A major implication of this short review of projects is that many donor agencies already support ET projects that include BE components and vice versa. This means that it will be rewarding to examine these projects in more details and understand how the lessons from them can be scaled up and be used to promote a more explicit definition of ET or implementation of ET projects. Some lessons can already be learned from TradeMark East Africa (TMEA), which is funded by ten donor agencies. TMEA aims to increase the efficiency of cross-border trade. Improvements in infrastructure can yield significant benefits, but practical experience suggests that not one factor is sufficient for transformation, and a number of factors play a role, including BER activities. Combinations of donor activities are most visible in TMEA's work on One Stop Border Posts (OSBP) and ports (see Box 3).

Box 3: How TMEA is combining policy measures to maximise transformational impacts

TMEA has worked alongside government partners to introduce **One Stop Border Posts (OSBPs)** in 15 locations along the borders of 6 East African countries since 2010. OSBPs are designed to combine physical border crossing facilities with the activities of immigration, customs and other agencies on both sides of the border so that traders only have to go through border formalities once in each direction. Operationalisation of one stop controls through adoption of an ICT system, known as integrated border management systems, enables sharing of information between and among various agencies and regulators on both sides of the border. OSBPs have also created an environment for transformation in inclusive trade. They have provided a platform to raise awareness on the ***Simplified Trade Regime (STR)***. Under the EAC Customs Union, the STR is a special provision aimed specifically at small traders who regularly transact in low value consignments. TMEA has trained women traders at the OSBPs on simplified trade regimes and traders can also access information through information centres within the border post facilities. Further, TMEA has also built platforms through which border officials and women traders hold dialogues to resolve issues and build trust. An independent time and traffic survey conducted in 2017 indicated that 10 out of 13 operational OSBP's record an average of **70% reduction** in crossing times. OSBP's have contributed to the EAC being touted as one of the most integrated on the continent.

TMEA has taken a comprehensive approach to supporting the **Port of Mombasa**. Port efficiency is about much more than **providing infrastructure and involves BER and other activities**. Of course, there are still major infrastructure needs. Infrastructure investments through TMEA's Mombasa Resilient Infrastructure Programme, implemented with the Kenya Ports Authority, are upgrading multiple facilities that load and unload cargo between ships and trucks to create efficient and environmentally friendly facilities. TMEA also supported KPA to procure four eco hoppers for loading/unloading coal and clinker cargo along three berths. The eco hoppers promote both efficient operations and a sustainable environment for discharge of bulk cargo. However, other activities, such as BER, are crucial too. TMEA supported the development of the Mombasa Port Community Charter whose initiatives have contributed to dramatically reduced time to transport cargo to Kampala—from 18 days to 5 days. The **Single Window System (SWS)** and other digital systems at the port have also contributed to more efficient trade, serving not only domestic imports/exports, but trade with the region. The time it takes for customs to process goods entering or leaving Mombasa port has more than halved, from 7 to 3 days, with the introduction of the SWS. With similar systems in use in Burundi, Rwanda and Uganda, traders are able to digitally submit regulatory documents at a single location. The information can then be shared and exchanged between different customs and border agencies, as well as with private sector stakeholders.

In the current phase, TMEA is also aiming to enhance productive capabilities by supporting the development of SEZs, involving multiple interventions.

Source: Contribution by TMEA staff

The Economic Policy Incubator is a further example of a donor funded projects that combines BER and other transformation policies (see Box 4) to maximise transformation impacts. It is also a locally-led policy initiative which has applied the principles of problem-driven adaptive thinking (Booth, 2018). Its logframe objectives includes a policy change, but does not specify *which* policy needs changing.

Box 4: How the Economic Policy Incubator is combining policy measures to maximise transformational impacts

The Economic Policy Incubator (EPI) has taken a co-ordinated and opportunistic approach to supporting improvements to Nepal's investment climate with the aim to contribute to economic transformation. EPI works with Government of Nepal to develop better policies to attract investment, to create quality jobs and to achieve inclusive and sustainable economic growth. Rather than take a diffuse approach, EPI focuses its efforts on those key constraints to transformative and inclusive growth which have both a high potential for transformative change and which are politically feasible. EPI and its government partners identified lack of investor-friendly business procedures and regulations as a key constraint to manufacturing and the service sector (including ICT and tourism).

In order to address the constraint, EPI has been providing both broad horizontal support to the enabling environment for investment and more targeted in-depth support to Nepal's emerging Special Economic Zones (SEZs). It has provided technical assistance to national and sub-national governments in policy reform aimed at simplifying business processes and making them more investor-friendly.

EPI has worked with government counterparts to improve Nepal's overall policy and legal framework for investment. Supported legislative changes include the Industrial Enterprise Act (IEA) 2016, the Company (Amendment) Act 2017, and the Foreign Investment and Technology Transfer Act (FITTA). These changes have removed many hurdles, simplified entry and exit processes for industries and strengthened the confidence of private investors.

The FITTA for instance, incorporates many investor-friendly provisions suggested by EPI. These include the use of venture capital for private companies, the automatic route [through which Foreign Direct Investment (FDI) is allowed without prior approval of government], an increased role for the Department of Industry (DoI) in industrial issues, no need of approval for re-investment, and a dispute settlement mechanism. The Companies Act includes a number of EPI suggested provisions including an increase to the maximum number of shareholders in a private company, relaxation of requirements regarding power to issue shares at premium, removal of provision of mandatory conversion of private company into public.

EPI has also worked with the government to remove the legal requirement for the submission of the Environmental Impact Assessment (EIA) report before industry registration. This has been amended and replaced by a clause that provides flexibility to complete the EIA/IEA after the registration of industries but before their operationalization. This amended has significantly reduced bureaucratic hassle and saved significant amount of time and cost of the private sector. Similarly, EPI supported to include the use of the electronic medium for registration and official communication and acceptance of a digital signature in the IEA Act. Later on this was also included in the Companies Act 2017 as well as FITTA 2019. The provision has the potential to significantly reduce the time and cost of company registration. In addition, EPI supported the development of standards on Industrial Villages for the GoN and has helped the government to declare and mandate local governments to establish and run the Industrial Villages at local level. Consequently, the GoN is also planning to declare 43 such areas across the country.

(continued on next page)

EPI also helped the government resurrect the SEZ Act and kickstart the creation of Nepal's first operational SEZ. This act had been parked for almost a decade but was enacted into law in 2016. EPI also helped the Government draft new SEZ regulations, strengthen the SEZ Authority and produce guidelines and standard operating procedures (SoP) for SEZs. EPI has also worked closely in the development of Nepal's first SEZ in Bharahawa on the border with India. It has worked closely with the SEZ authority, local authorities and investors to ease the way for investment in and operation of the Bharawa SEZ. This SEZ is now operational and its first factories are now in production. New and larger SEZs are now being rolled out along Nepal's border with India.

Source: Contributions by EPI staff. EPI is sponsored and overseen by Nepal's Ministry of Finance and funded by the U.K. Department for International Development (DFID).

4. Practical implications for donors

Based on a review of the literature and discussions with DFID, GA, GIZ, IFC, Sida, USAID, TMEA, EPI and others, it is clear that donor agencies are clearly catching up on using the term ET but the lack of explicit attention so far is a concern. There is a need for more attention to ET, given the importance attached to this by the academic literature and developing country governments and institutions such as the AU. But, at the same time, some agencies have begun to address the gap, which is encouraging. The first implication is that **donor agencies clearly need to develop a common definition of ET; the DCED can help provide a range of possible definitions (e.g. building on the ones in use by DFID or GA).**

As a practical step, we suggest agencies develop a definition such as the following:

> *ET is the ongoing process of (i) increasing aggregate productivity by moving labour and other productive resources from lower- to higher-productivity sectors and activities (structural change) and (ii) raising within-sector productivity by sector-wide improvements, for example skills training or clustering of firms, as well as firm-level innovations.*

The literature and donor views are also converging on the scope and limitations of using BER to support ET. Some agencies have developed their thinking, considering BE as an important factor but also recognising that some BE activities work better than others. The academic literature provides examples of the positive productivity impacts of BE indicators of labour conditions, access to finance, conditions on trade and investment, competition and tax. Policy experts highlight the importance for productivity of reducing barriers to competition and unwarranted distortions to market prices, strengthening the legal framework surrounding property rights.

There is also recognition that BE activities should be targeted better and be implemented in conjunction with complementary factors. To explore the synergies between BE and ET, the **DCED should help develop general theories of change that provide a narrative of how different aspects of BER contribute to ET and to adopt some rules of thumb on what is working better and what is working less well.**

It is challenging to provide detailed guidance on how ET might be best implemented, given that few agencies target ET explicitly and that those that do may not have much experience publicly available. On the other hand, several existing activities already have impacts on ET. We have also learnt a range of lessons in terms of constraints and opportunities in implementing ET and BE projects. For example, donor agencies often lack a clear **mandate to target ET, have poor knowledge management systems** and could be encouraged to take a **coordinated, iterative and portfolio approaches to BER and ET**. ET and BE action also require the alignment of programming cycles with long-term political processes, working effectively with government, such as identifying leaders and lead departments to anchor BE

or ET activities, and addressing coordination failures, vested interests and political economy constraints.

We discuss emerging best practices that could develop into **practical implications and guidance for donors**. Box 5 provides three main steps (and nine sub-steps) that donor agencies need to follow to explore synergies between BER and ET. In the first instance, agencies will need to go through a **learning process**. This could lead the agency to adopt definitions of ET and incorporate ET into its mandates and strategies. A practical way to do this is by publishing a country-specific economic development strategy position paper or briefing which can serve as the basis for initiating dialogue. Second, agencies should **explore synergies between ET and activities that support it**, such as BER and complementary activities. Developing context-specific theories of change can be challenging but is crucial, for example in determining which BER activities are the most relevant. Finally, agencies can follow a number of **practical steps for implementation** (and many of these will be familiar from other activities). These include promoting flexible and adaptable donor approaches, allowing donor support to develop from firm support to upstream BE support and vice versa, leveraging different departments in an agency (or different institutions in a country) to create markets and support ET, coordinating relevant actors around targeted areas, such as specific (sub-)sectors in specific countries, and working politically, which involves choosing appropriate actors and activities, and bringing the right stakeholders together at the right time.

Several practical steps in Box 5 are necessarily general and involve processes. This reflects the fact that there is no silver bullet that applies in all contexts. It is not possible to say upfront which BER activities generate the most impact on ET because often it depends on the country context, on the sector at which they are targeted and on the combination with other activities.

There is a large research and analytical research agenda ahead. It is most important for agencies to obtain context-specific information on what transformational activities are (in the past and in the future), the political processes that are at play, context-specific policy analysis and careful assessment of various relevant actors. McMillan et al. (2017a) present an analytical agenda, which can be elaborated to include more explicitly BER activities:

- Understand how the country has transformed over time, and what the likely transformational activities are using analytical techniques discussed for example in Appendix C.
- Understand the main economic and political blockages to further ET in a country (going beyond a growth diagnostic aimed at ET), which includes an understanding of the deep-rooted factors behind a weak BE.
- Analyse the role of different combinations of policies given a specific political economy (emphasising solving coordination challenges), involving BER activities and complementary factors.
- Analyse specific practical suggestions for implementation, including on BER activities.

Addressing the above analytical agenda is likely to provide country- and context-specific knowledge that complements the steps in Box 5. The main message of this paper is that donors should start from a well defined process of economic transformation and target the variety of policy tools of which BER activities can be important tools. Combining policy interventions is a skill and depends on context. It is not easy to suggest general quick wins. Progress can be made by working in-country, over a significant period of time and in co-ordination with partners.

Box 5: Practical guidance for donors concerned with synergies between BER and ET

I. Agencies need to go through a learning process to frame support for ET

1. Consider the importance of ET in development more broadly, taking into account timeframes and different types of firms and households.
2. Adopt a practical and commonly expressed definition of ET, which also indicates ET is a long-term process.
3. Develop strategies and mandates inside development agencies to support ET that can govern and coordinate bilateral and multilateral action.

II. Agencies need to improve their understanding of the synergies between BE activities and ET

4. Develop a theory of change around the role of BER in ET that considers
   a. lessons learnt from existing BE activities on the way BER already supports ET
   b. targeting transformative activities in specific contexts, by analysing which economic activities are expected to have the largest transformational impact (e.g. Appendix C)
   c. prioritisation of BE components that are crucial/binding constraints to ET in that context, based on evidence
   d. a mutually reinforcing role of BER, ET promoting and other complementary activities, including provision of finance, infrastructure, capacity-building and other policies.

III. Agencies need to follow a set of practical steps to implement BER in ways that also promote ET

5. Consider the political economy upfront, by working with appropriate partners to build long-term coalitions for ET.
6. Work with public officials, firms and other change actors in-country to prioritise action for ET.
7. Help improve coordination across national and development agencies relevant to the specific context.
8. Incorporate monitoring, evaluation and learning into BER support activities from the start to enable adaptive programming
9. Support feedback loops from evidence to redesign and implementation.

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Appendix A. A review of definitions of economic transformation

A review of definitions for McMillan et al. (2017a) across the concepts of economic development, ET, structural transformation, structural change, technological change and structural dynamics yielded interesting commonalities and differences. Table 4 provides an overview of theoretical definitions of concepts related to transformation. Table 5 provides an overview of the empirical literature and a sense of how transformation has been characterised.

Table 4: What does the theoretical literature say about definitions of economic transformation?

Concept	Definition	Reference
Economic development	'[A] process of structural transformation... the reallocation of productive factors from traditional agriculture to modern agriculture, industry and services... shifting resources from low-to-high productivity sectors... a capacity to diversify domestic production structure: that is, to generate new activities, to strengthen economic linkages within a country and to create domestic technological capabilities.'	Ocampo et al. (2009, p. 1)
Structural transformation	'The reallocation of resources across the broad economic sectors agriculture, manufacturing, and services… '	Originally by Kuznets (1966), reference from, e.g. Herrendorf et al., 2009 (p. 1)
Creative accumulation	'… describe the process of generating new knowledge, which builds on existing knowledge rather than replacing it' (Pavitt, 1986) *Refers to the second component of Ocampo et al.'s definition (above)*	Schumpeter (1934)
Linkages	Development is essentially the record of how one thing leads to another, and linkages are that record… They focus on certain characteristics inherent in the production activities already in process at a certain time. These ongoing activities, because of their characteristics, push or, more modestly, invite some operators to take up new activities. Whenever that is the case, a linkage exists between the ongoing and the new activity.' *Refers to the third component of Ocampo et al.'s definition (above)*	Hirschman (1958, p. 80)
Capabilities	*Refers to the fourth component of Ocampo et al.'s definition (above)*	Bell and Pavitt (1993)

Concept	Definition	Reference
Structural change	Syrquin (1998) defines this as a change in the relative importance of sectors within the economy, and as a self-sustaining process that may occur without intervention. Syrquin deems it significantly different from *economic transformation*, which refers to the 'interrelated processes of structural change that accompany economic development' (Breisinger and Diao, 2008, p. 3). Syrquin (2006), in a later paper, suggests that structural transformation is both a cause and effect of economic *growth*.	Syrquin (1988)
Structural change	De Vries et al. (2013) perceive structural change as the process in which employment and inputs shift across sectors, and signifies it as a driver of economic development: 'as labour and resources move from traditional into modern activities, overall productivity rises and incomes expand'.	De Vries et al. (2013, p. 3)
Structural change	The process of 'structural change' is something that happens alongside the process of economic *growth* and something that happens in a wider range of *economic* spheres: 'This rapid growth of the [Korean] economy was *accompanied* by considerable structural change in production, trade, and domestic demand, basically a transition from import-substituting towards export-oriented industrialization' [emphasis added].	Kim (1979, p. 123)
Technological change	Technological progress is seen as an important driver in the process of ET. Greenwood and Sashadri apply the concept of ET to refer to broader issues outside the economic sphere, such as the notions of fertility and the degree of woman in the labour market. They suggest that the notion of technology and technological change is something that can facilitate the process of transformation. In other words, it determines the *rate* of transformation.	Greenwood and Sashadri (2005, p. 1227)
Technological change	Romer (1990) suggests that technological change 'lies at the heart of economic *growth*' (p. 72). Romer states that '[t]echnological change provides the incentive for continued capital accumulation, and together, capital accumulation and technological change account for much of the increase in output per hour worked', that is, the *productivity* level (see also Abramovitz, 1956; Kendrick, 1956; Solow, 1956).	Romer (1990)
Structural dynamics	'The evolution of modern economic systems, especially since the inception of the industrial revolution, shows that, as time goes by, the permanent changes in the absolute levels of basic macroeconomic magnitudes (such as gross national product, total consumption, total investment, overall employment, etc.) are invariably associated with changes in their composition, that is, with the *dynamics* of their *structure*' [emphasis added by original author].	Pasinetti (1993, p. 1)

Table 5: What does the empirical evidence tell us about patterns of ET?

It is observed (from earlier Western developed countries) that the process of ET has been gradual rather than sudden.	Rosenberg and Birdzell (1986, p. 6)
As national income increases the share of agriculture decreases, or alternatively, income increases because of the decreasing agriculture share.	Timmer (2007)
Economies tend to shift the majority of economic activity towards the manufacturing sector and utilise the benefits that this sector provides.	Chenery (1960); Chenery et al. (1986); Kaldor (1967); Kuznets 1966)
Some scholars argue that transformation happens in distinct steps, from traditional societies to an advanced consumer society, with no short-cut in between.	Rostow (1990)
Transformation can be characterised as the dynamics in a *dual sector model*. Under a set of assumptions (e.g. wages in the manufacturing sector remain similar) and derived from empirical data, the shift of employment from the 'subsistence' sector to the 'capitalist' sector is a key element of transformation.	Lewis (1954)
Successful economic transformation depends strongly on the productivity of the agriculture sector to fuel the expansion of the more advanced sectors, such as manufacturing.	Kuznets (1961)
Empirical evidence suggests a considerable shift in the diversification of production as economies develop. That is, countries follow *on average* a (non-symmetric) U-shaped diversification process as income increases. Note that this observation is in contrast to what Rostow and Kaldor propose as the 'stage of development'.	Imbs and Wacziarg (2003)

Appendix B1. Assessing economic transformation content of World Bank/IDA strategies and programmes

This appendix is based on SET analysis assessing the extent to which ET is a central element of IDA country strategies and whether or not the programmes emanating out of these strategies are prioritising the ET agenda. To do so, recent Country Partnership Strategy (CPS) or Country Partnership Framework (CPF) (and, in one case, Country Assistance Strategy (CAS)) documents were assessed for a sample of 15 IDA borrowing countries – Bangladesh, Bolivia, Cape Verde, Djibouti, Ethiopia, Haiti, Kenya, Liberia, Mozambique, Myanmar, Nepal, Nigeria, Rwanda, Tanzania and Uganda. The sample includes variation in regional coverage, stages of economic development, country characteristics and qualifying criteria for IDA borrowing. The focus for each of the 15 countries in the samples is on whether or not core elements of ET (structural change, within-sector productivity shifts and diversification) are explicitly recognised in the relevant World Bank country strategy's engagement objectives and results measurement framework. In addition, the analysis also considers whether determinants of ET (which represent potential pathways to transformation) are articulated in the strategies; and whether movement to higher-wage, more productive or better-quality employment is emphasised as a key motivation for ET (over and above shifts to higher value-added sectors).

In assessing the country strategies, a common assessment framework with clearly defined assessment criteria and an objective coding system is used to compare the level of prioritisation of core elements of ET (structural change, within-sector productivity growth, diversification) in the strategic objectives and results frameworks; and to determine the extent to which determinants of ET are articulated and movement to higher-wage, more productive or better-quality jobs is highlighted as a key motivation for transformation. This is used to produce overall verdicts (either good, room for improvement or insufficient) on the level of prioritisation afforded to ET in the World Bank's country strategies for the each of the 15 sample countries.

The results show that most of the country strategies contain a good number of transformation elements, but there are also clear areas for improvement, and in some specific cases there are areas where the prioritisation of ET elements is clearly insufficient (e.g. if they do not contain objectives prioritising any core aspects of ET, make little reference to determinants of ET and/or do not consider the importance of transforming the country's employment structure towards higher-wage, more productive or better-quality jobs). For instance, all of the CAS/CPS/CPF documents include reference to at least one of the core elements of ET, but very few strategies make reference to all three elements together in their strategic objectives. Interestingly, three of the four country strategies where all core elements of ET are included in the strategic objectives are lower-middle-income countries (the exception is Haiti). This suggests that the level of development may influence what elements of ET are afforded priority in the country strategies and, specifically, that structural

change and diversification elements are more likely to be prioritised in the strategic objectives of countries at higher levels of development.

These cases aside, most strategies focus largely on the within-sector productivity growth or diversification dimensions, with very limited focus on the structural change element. Similarly, where relevant quantitative indicators are included in the results frameworks, they are overwhelmingly focused on within-sector productivity growth.

Across the country strategies analysed, the overriding focus from a transformational perspective is on increasing agricultural productivity. In line with this, the relevant quantitative indicators used to measure progress in the results framework tend to focus exclusively on agricultural productivity growth indicators, rather than on productivity growth in other sectors such as manufacturing or services.

There is emphasis on the major determinants of ET in most of the country strategies, although these are not always framed explicitly as supporting economic development, growth or transformative processes. There are, for example, many references to interventions designed to address binding constraints to growth and transformation, including objectives to develop infrastructure (especially energy and transport infrastructure) or skills and improve the business environment. Reference is also made in many cases to the adoption of new technologies to support productivity increases or to the development of value chains.

Notably, there is some evidence to suggest that the level of transformational content in the World Bank country strategies may be higher in the case of CPFs compared with the CPS and CAS documents. For instance, all four country strategies that prioritise all three core elements of ET in their strategic objectives are CPF documents, perhaps indicating that there has been a gradual shift towards a more holistic focus on ET in the World Bank's most recent iterations of the country strategy approach (although a larger sample may be necessary to reach a definitive conclusion).

The programme-level assessment shows that, in cases where within-sector productivity growth is central to specific project objectives, these are not always carried over into explicit quantitative indicators to measure progress in the results framework. Moreover, where specific quantitative indicators are included, they are mostly confined to indicators measuring intra-sectoral productivity shifts in the agriculture sector. More generally, at the programme level there are many projects that have transformational elements by design (e.g. they focus on supporting pathways to ET) but whose project development objectives do not make reference to structural change, within-sector productivity growth or diversification, and where quantitative indicators to measure transformational progress are missing from the results framework.

The following actions could assist the World Bank to ensure ET is prioritised in the IDA country strategies and project portfolios:

1. Propose that all IDA CPFs/CPSs include at least one strategic objective focused on transforming the employment structure of the economy towards higher-wage, more productive or better-quality jobs and integrate all of the three core elements of ET (structural change, within-sector productivity growth and diversification of production and trade) as the means to achieve it.
2. Propose that each IDA CPF/CPS contain at least one indicator that measures progress towards the strategic objective of creating more and better-quality jobs through ET. Progress could be measured in terms of either (i) shifts in labour and other resources from less to more productive sectors/activities (structural change); (ii) within-sector productivity growth; or (iii) diversification.
3. Propose that, if within-sector productivity growth is the focus of the IDA CPF/CPS strategic objective, then at least one quantitative indicator of productivity change in at least one non-agriculture (and non-extractive) sector such as manufacturing or services is included in the results framework to systematically capture the structural change dimension.
4. Propose that all IDA CPFs/CPSs have clear reference to recognised pathways to ET to achieve sustained job creation, relevant to the country context (natural endowments, opportunities and institutional capability) and as the central pillar of delivering economic development and growth.

The study examined each CPS/CPF against the following set of questions:

- Does the strategy have clear objectives in terms of ET?
- If the strategy includes clear objectives to promote *structural change*, are these translated into the country results framework?
- If the strategy includes clear objectives to promote *within-sector productivity growth*, are these translated into the country results framework?
- If the strategy includes clear objectives to *diversify production and trade*, are these translated into the country results framework?
- Are pathways to ET a core element of the strategy?
- Does the strategy prioritise moving to higher wage or more productive employment as a key motivation for ET?

It then devised specific assessment criteria (outlined in Table 6) from which to provide an objective assessment of each question. On the basis of the assessment criteria, a colour coding system is devised that enables us to allocate a colour 'score' to each element (see column 4 in the table) on the basis of whether it includes a good level of transformational content (green), some transformational content (orange) or insufficient transformational content (red).

Table 6: Framework matrix for assessment of prioritisation of ET in World Bank CPS/CPF

Aspect(s) of ET covered	Specific question	Assessment criteria	Coding	Key section(s) in CPS/CPF
- Structural change - Within-sector productivity growth - Diversification	Does the strategy have clear objectives in terms of ET?	**1** Whether or not reference is made to one or more of the following core aspects of ET in the strategic objectives: i. structural change; ii. within-sector productivity growth; iii. diversification of production or trade	Reference to (i) structural change, (ii) within-sector productivity growth *and* (iii) diversification of production and trade in one or more strategic objectives Reference to either (i) structural change, (ii) within-sector productivity growth *or* (iii) diversification of production and trade (but not all) in at least one strategic objective No reference to (i) structural change, (ii) within-sector productivity growth *or* (iii) diversification of production and trade in any of the strategic objectives (skip to assessment criterion 6)	- Executive summary - World Bank Group Engagement/Partnership Strategy*
Structural change	If the strategy includes clear objectives to promote structural change, are these translated into the country results framework?	**2** Whether or not there are quantitative indicators in the country results framework focused on structural change (i.e. shifts to higher value-added sectors)	At least one quantitative indicator in the country results framework focused on structural change One proxy indicator of structural change in the country results framework No indicators in the country results framework focused on structural change/not applicable	Annex on Results Monitoring Framework/Matrix
Within-sector productivity growth	If the strategy includes clear objectives to promote within-sector productivity growth, are these translated into the country results framework?	**3** Whether or not there are quantitative indicators in the country results framework focused on within-sector productivity growth	At least one quantitative indicator in the country results framework focused on within-sector productivity growth One proxy indicator of within-sector productivity growth in the country results framework No indicators in the country results framework focused on within-sector productivity growth/not applicable	Annex on Results Monitoring Framework/Matrix

Aspect(s) of ET covered	Specific question	Assessment criteria	Coding	Key section(s) in CPS/CPF
		4 The ratio of within-sector productivity growth indicators that target the agriculture sector compared with those targeting other sectors (e.g. manufacturing services)	Good balance between within-sector productivity indicators for agriculture and for other sectors Exclusively or mostly agricultural productivity growth indicators No indicators/not applicable	Annex on Results Monitoring Framework/Matrix
Diversification	If the strategy includes clear objectives to diversify production and trade, are these translated into the country results framework?	**5** Whether or not there are quantitative indicators in the country results framework focused on diversification of production or trade	At least one quantitative indicator in the country results framework focused on diversification of production or trade One proxy indicator in the country results framework focused on diversification of production or trade No indicators in the country results framework focused on diversification of production or trade/not applicable	Annex on Results Monitoring Framework/Matrix
- Structural change - Within-sector productivity growth - Diversification	Are pathways to ET a core element of the strategy?	**6** Whether or not reference is made to one or more of the following pathways to ET as a key to supporting economic development, growth or transformative processes: - Horizontal interventions to enhance productivity in all sectors (e.g. improved energy or transport infrastructure, better business climate, stable regulatory framework) - Education, training and skills development to boost worker productivity - Adopting new technology or management practices	Reference to at least one of the listed pathways to ET as key to supporting economic development, growth or transformative processes Some reference made to the listed pathways to ET but these pathways are not explicitly framed as key to supporting economic development, growth or transformative processes No reference made to any of the listed pathways to ET	- Executive summary - World Bank Group Engagement/Partnership Strategy*

Aspect(s) of ET covered	Specific question	Assessment criteria	Coding	Key section(s) in CPS/CPF
		- Commercialisation or technological innovations to boost productive capacity - Development of high-value services and export manufacturing - Private sector investment in productive or higher value-added activities - Value chain development and integration into regional and GVCs - Trade facilitation and regional integration - Improvements to efficiency of services (e.g. financial services) that support key productive activity		
Transformation of employment structures	Does the country strategy prioritise moving to higher-wage or more productive employment as a key motivation for ET?	**7** Whether or not reference is made in the strategic objectives to transforming the country's employment structure through: - increasing labour productivity - raising wage employment - reducing working poverty - increasing the quality of jobs (higher remuneration levels, greater job security)	Clear reference to transforming the employment structure towards higher-wage, more productive or better-quality jobs as a key motivation for ET Some reference to transforming the employment structure towards higher-wage, more productive or better-quality jobs, but this is not explicitly framed as a key motivation for ET No reference to transforming the employment structure towards higher-wage, more productive or better-quality jobs	- Executive summary - World Bank Group Engagement/Partnership Strategy*

*Note: * These sections are named differently across each of the CPS/CPF documents, but generally refer to the World Bank Group's Engagement/Partnership Strategy or Strategic Options.*

Key:

Good level of transformational content

Some transformational content

Insufficient transformational content

The colour-coded scores for each of the individual assessment criteria are then combined in order to make an overall assessment (either excellent, good, significant room for improvement or insufficient) of the level of prioritisation of ET in each country strategy. The overall assessment verdict is determined on the basis of the thresholds. The overall verdict for each country makes it possible to examine whether the level of prioritisation of ET varies according to particular country characteristics (e.g. income group, vulnerability to resource curse).

In addition, the overall assessment based on the score thresholds is augmented with a qualitative assessment of each country strategy. This focuses on the extent to which transformational concepts (structural change, within-sector productivity growth or diversification) and pathways to ET are explicitly understood and internalised (beyond the presence of indicators or specific references to key words) within the objectives of each country strategy.

A number of broad observations can be drawn from the assessment of the country strategies. First, **most of the country strategies contain a good number of transformation elements, but there are also clear areas for improvements, and in some specific cases there are areas where the prioritisation of Et elements is clearly insufficient**. None of the country strategies achieves a good verdict across all of the assessment criteria, although some strategies come close (Bangladesh, Bolivia, Haiti and Myanmar), but fall short owing to a lack of sufficient quantitative indicators to measure progress on structural change, within-sector productivity growth or diversification in their results frameworks.

Second, all of the CAS/CPS/CPF documents include reference to at least one of the core elements of ET (structural change, within-sector productivity growth or diversification) in the strategic objectives. However, **in most strategies, the focus is largely on the within-sector productivity growth or diversification dimensions, with very limited focus on the structural change dimension** (exceptions are Bangladesh, Bolivia, Haiti, Myanmar and Nigeria).

Similarly, **very few country strategies include all three core elements of ET together in the strategic objectives**. Indeed, only 4 of the 15 country strategies (for Bangladesh, Bolivia, Haiti, Myanmar) include explicit reference to structural change, within-sector productivity growth *and* diversification in the strategic objectives. Interestingly, three of these countries are lower-middle-income countries (LMICs) (the exception is Haiti). This suggests that country development may influence what elements of ET are afforded priority in the country strategies and, specifically, that structural change and diversification elements are more likely to be prioritised in the strategic objectives of countries at higher levels of development. That said, there are other LMICS (Cape Verde, Djibouti, Kenya and Nigeria) where the strategic objectives prioritise only within-sector productivity growth or diversification.

Third, **even when one or more of the core elements of ET are explicitly included in the strategic objectives, these are often not carried over into quantitative indicators in the country results**

framework. For instance, there are no quantitative indicators of structural change in the results framework for 13 of the 15 country strategies included in the sample. The exceptions are Haiti (where the number of jobs created in targeted value chains in agriculture, light manufacturing and tourism is measured in the results framework) and Ethiopia (where the number of new jobs created in targeted manufacturing and services firms is included). Similarly, the majority of the country strategies (13 out of 15) do not include any quantitative indicators focused on diversification of production or trade in the results framework. In most cases, the absence of indicators to measure progress is in line with the lack of prioritisation of structural change or diversification in the strategic objectives.

Instead, **where relevant quantitative indicators are included in the results frameworks, they are overwhelmingly focused on within-sector productivity growth**. The majority of the country strategies (11 out of 15) include at least 1 quantitative indicator of within-sector productivity growth in the results framework, although these tend to focus exclusively on agricultural productivity growth indicators (and not productivity growth in other sectors such as manufacturing or services).

Fourth, **pathways to ET are generally better defined**. At least one recognised pathway to ET is listed as key to supporting economic development, growth or transformative processes in 11 out of the 15 country strategies. However, there are some instances (4 of 15 country strategies) where there is room for improvement in the sense that specific pathways or interventions that can support ET are highlighted but are not explicitly framed as contributing to development, growth or transformative processes.

Fifth, the results are mixed in terms of the extent to which prioritisation is given in the strategic objectives of the country strategies to moving to higher-wage or more productive employment. Fewer than half (6 out of 15) country strategies make clear reference to transforming the employment structure towards higher-wage, more productive or better-quality jobs as a key motivation for ET. In many of the other cases, there is room to improve the way these shifts are framed in transformative terms. Furthermore, the Mozambique CPS makes no reference whatsoever to transforming the employment structure in this manner.

Finally, there is **some evidence to suggest that the level of transformational content in the World Bank country strategies may be higher in the case of CPFs compared with the CPS or CAS documents**. For instance, all four country strategies that prioritise *all* three core elements of ET are CPF documents, perhaps indicating that there has been a gradual shift towards a more holistic focus on ET in the World Bank's most recent iterations of the country strategy approach.[3] Furthermore, the countries in the sample with CPFs also all achieve a 'good' assessment in terms of

[3] That said, the other CPF document (for Uganda) prioritises only within-sector productivity growth (in agriculture) in the strategic objectives, suggesting that the general trend observed for the other CPF documents is by no means definitive.

providing clear references to pathways to ET; and, with the exception of Uganda, also to transforming the country's employment structure.

Appendix B2. Descriptions of BE, investment climate and IFC 3.0 activities at the World Bank Group

The World Bank/IFC has an extensive website that contains a range of resources and explanations. Here, we provide a summary of activities on BE, investment climate and IFC 3.0. The World Bank Group works with governments to design business regulations and improve regulatory delivery to create transparent and predictable operating environments conducive to business entry, expansion and international competition.[4] The World Bank Group's BE team, within the Macroeconomics, Trade and Investment practice, helps developing country governments improve policy formulation, enhance the quality of government-to-business (G2B) services and sustain implementation of reforms. BE activities include business entry reforms, business licensing and inspections reform, construction permitting reform and quality infrastructure and standards reform.

The website also includes lessons from the World Bank/IFC on comprehensive BE implementation at the national, sub-national and sectoral levels. These include (i) cutting government red tape by addressing inefficiencies to achieve improvements in predictability and speed of implementation; (ii) integrating a range of G2B services; (iii) putting in place effective, transparent, accountable and consultative reform processes; and (iv) targeting resources where regulation is most needed to ease unnecessary burdens on the private sector and free up scarce public sector resources for other uses.

World Bank/IFC project examples of BER include the following:

- Nepal adopted a comprehensive reform approach that cut time and costs and led the business registry and tax authority to launch government-to-government data-sharing. Digitisation changed physical company records into a digital archive.
- India promoted self-certification for annual inspections, extending the expiration of business licences from five to ten years and eliminating mandatory annual licence renewals.
- In Kenya, automation decreased approval times for provisional building permits from six months to thirty days. Construction permit applications increased by 300% between 2009 and 2010, reflecting significantly improved formalisation and construction safety compliance.

[4] https://www.worldbank.org/en/topic/investment-climate/brief/business-regulatory-environment

- Kyrgyzstan decreased the number of mandatory trade standards from 22,000 to 100 in 2016, and reduced the number of products subject to mandatory certification from 5,500 to 684.
- In Myanmar, a requirement to obtain import licences for half of imports was abolished, a reform that benefited some 5,000 domestic enterprises.

The discussion of these projects does not explicitly mention ET, but some projects that involve other activities get closer. The World Bank Group can mobilise a wide range of instruments – including advisory services and analytics, reimbursable advisory services and diverse lending products – to help developing countries, and can use experts on indicator-based reform, BE and investment policy & promotion to deliver integrated investment climate solutions. Examples include:[5]

- The Government of Guinea implemented an investment climate reform programme aimed at improving the country's BE, encouraging domestic linkages with its $30 billion mining sector and diversifying its sources of FDI and growth. Guinea was able to attract more than $710 million in non-mining investment, register more than 13,000 new firms and create more than 16,000 jobs during the life of the project.
- With the support of the World Bank Group's Investment Climate Team, the Government of Bosnia and Herzegovina eliminated the fee for obtaining work permits for foreign workers in Sarajevo canton. The annual fee amounted to $590 per request and had to be paid each year if work permits were to be renewed. This reform has the potential to save businesses a combined $0.5 million per year. Furthermore, an amendment to the country's company law cut the initial capital requirement for establishing a limited liability corporation by half, and court fees for registering a limited liability corporation were cut by 80%, saving the country's private sector $1.6 million in compliance costs annually.
- The Government of Haiti was able to attract $217 million in actual investments and create 13,700 new direct jobs in the country's garments sector, using the World Bank Group's Haiti Investment Generation Programme, which worked closely with public officials, the private sector and foreign investors on investment promotion strategies and SEZs.

IFC 3.0 (IFC, 2019):

> *The strategy for 'IFC 3.0' is embedded in the World Bank Group's vision. It recognises that, to be more ambitious in the most difficult geographies and to achieve impact at scale, the World Bank must move from responding to demand to working proactively to create markets and mobilise private sector resources at a greater scale by leveraging the strengths of the entire Group and other development partners. The evolution is*

[5] https://www.worldbank.org/en/topic/investment-climate

summarised in Figure B2.1. New tools and approaches are added, and these are meant to be complementary.

Figure 2: The evolution of IFC 3.0

IFC 1.0 (1956 to present)

Attract foreign private investments to emerging markets

- Advanced role of private sector as an economic agent.
- Developed IFC expertise in emerging markets by investing with foreign private sector investors and nascent local clients.
- Attracted Foreign Direct Investment in emerging markets.
- Created a syndication program to bring commercial banks to our countries of operations.
- Introduced equity as an engine for financial sustainability and higher impact.

IFC 2.0 (c.2000 to present)

Invest in local companies and banks with local private investors

- Expanded IFC global footprint.
- Deepened IFC's private sector enterprise by investing in local companies and banks and with local private investors.
- Used local presence as landing platform for North-North and South-South investments.
- Created financial vehicles to mobilize institutional investors.
- Provided Advisory Services to private clients and governments, moved from donor-driven model to business lines.
- Expanded operations in FCS and IDA.
- Introduced parallel loans through a Master Cooperation Agreement.
- Launched AMC to complement own account.
- Used blended finance in a selective way to de-risk several sectors (e.g. climate, SMEs, agribusiness).

IFC 3.0 (today)

Create Markets
Mobilize Private Capital

New Approaches to Create Markets

- Analysis & advocacy for reforms to strengthen private sector role
- Cascade approach to work systematically across WBG
- Risk-sharing projects through blended finance
- Upstream support for project development
- Innovation to create markets

New Tools

- Country Private Sector Diagnostics
- IFC Country Strategies
- Sector Deep Dives
- New Additionality Framework
- Anticipated Impact Measurement and Monitoring Framework

New Instruments and Platforms

- Creating Markets Advisory Window
- IDA Private Sector Window
- MCPP Infra, Financial Markets, URP, HKMA

New Organization

- Economics and PSD
- COO and Regional VPs
- Strategy & Resources
- Partnerships, Communication and Outreach
- Global Upstream Units
- Re-aligned AS Structure

Source: IFC (2019)

Appendix C. Indicators to assess sectoral ET potential

Lemma (2018) proposes several measures that DFIs can use to assess *ex-ante* the potential of investments to contribute to ET. The report reviews the literature on ET and examines how DFI investments are expected to contribute to ET by looking at the impacts of FDI. It proposes several quantitative and qualitative analytical methodologies that can be used to assess ET outcomes and impacts. It contributes to the ET literature by suggesting a set of metrics than can be used to evaluate firm-level ET impacts. These are all pre-existing metrics that, based on the ET and FDI impact literature, can feasibly be used to quantify the ET contribution of individual firms.

The report proposes 13 indicators that DFIs could use to assess the potential transformational potential of their investments. Such indicators can be used both *ex-ante* for investment decision-making and *ex-post* for impact monitoring and evaluation.

Apart from the firm-level indicators, these proposed metrics can potentially be used to understand the *ex-ante* potential contribution of an economic sector towards ET. Therefore, for the purposes of BER that can contribute to ET, they can be used to identify transformative sectors where BER could be applied to facilitate the transformative process.

Table 7: Summary of indicators

	Indicator	Reason
National sectoral level	National sectoral productivity contribution	Assess whether investments in the sector help raise national productivity levels
	Economic complexity	Investing in sectors with higher complexity (and connectivity) levels opens up production in multiple areas
	Sectoral multiplier effects	Investing in the sector has positive growth impacts in other sectors
Sector-specific level	Firm sectoral productivity contribution	Assess whether investments in the firm help raise sectoral productivity levels
	Local sourcing of goods and services	Higher levels of local input sourcing can result in greater local economy impacts
	Skilled employment effect	Sectors with higher levels of skilled workers exhibit higher productivity levels
Business environment	Transport, energy and communication infrastructure ranking	Better transport, energy and communication infrastructure facilitates more efficient firm operations
	Tertiary education levels	Higher education levels help generate capacity to adopt technology and knowledge through FDI
	Firm access to credit	Deeper financial markets improve firm capacity to absorb FDI spillover effects
	Transformative investment catalytic effects	Catalysing increased levels of funding can help improve the transformative impacts of the project by enhancing the scale of the project or by inducing or complementing other investments
Firm level	Product complexity score	More complex products indicate more productive technology and labour use
	Firm international trade participation	Increased exposure to international trade results in a higher productivity level

	DFI firm intervention plan	DFI interventions can help increase firm efficiency/productivity

The table below illustrates the main pros and cons of the methods discussed in section 2, discussing the data required and the objective of each technique.

Table 8: Pros and cons and of techniques used to measure ET potential at the sectoral level

Measure	Use/ET objective	Data required/level of complexity	Pros	Cons
RCA	Assess the degree of competitiveness of the country in the export of the product	• disaggregated country and world export • easily replicated and updated	• easily available • intuitive results • disaggregated analysis	• assessment based on past data • production capabilities not assessed • only available for goods
Export orientation and world demand analysis	Assess the export orientation of sectors and their expansion potential based on the response of world demand	• disaggregated world imports and national sectoral exports • easily replicated and updated	• easily available • intuitive results • disaggregated analysis	• assessment based on past data • only available for goods, not services
Economic complexity (HHPSA/ECI/PCI)	Based on the existing production capabilities, allows identification of other products and sectors	• disaggregated exports • calculations readily available	• prospective analysis • disaggregated analysis	• assessment based on past data • only available for goods • complex interpretation
Input-output multipliers and Social Accounting Matrices	Identifies the backward linkages of sectors in output and employment	• Social Accounting Matrix/input-output table • calculations are complex	• combines goods and services • goes deeper into the country's economy	• data available with important lags. • data may be costly to produce • data very aggregated • calculations are complex
Productivity (TFP) analysis	Identifies sectors/products with potential productivity growth	• firm-level productivity • calculations may be complex	• combines goods and services • allows to look simultaneously to structural change and within-sector productivity	• data available with important lags • data may be costly to produce • data very aggregated • calculations are complex
Labour skills analysis	Identifies where positive spillovers from FDI or innovation could be	National-level employment statistics	Easy to analyse and use in conjunction with productivity	• does not provide a granular overview of skills gaps • national labour statistics

Measure	Use/ET objective	Data required/level of complexity	Pros	Cons
	more readily absorbed		and input-output techniques to understand impacts of sectors on different skill levels	usually have significant time gaps (5 years) and may not be recent
Export participation – value chain activity	Identifies evolution of forward and backward linkages and participation in export through GVCs	• international input-output tables • calculations are very complex	• combines goods and services • captures trade in value-added	• data very aggregated • calculations are very complex • interpretation is complex


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