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POLICY BRIEF

Implementing supportive policies to build a vibrant private sector as a driver of structural transformation

The private sector – one of the eight categories of the UNCTAD Productive Capacities Index – can be a catalyst for productive capacity development and structural transformation, required to achieve sustainable development.[1] Fostering entrepreneurship and stimulating private sector development and competitiveness through supportive policies and strategic actions should be a priority in the least developed countries (LDCs), to catch up with other country groups. Building on the private sector category of the Index, which reports on cross-border trade facilitation, access to finance and business support, this policy brief looks at how the private sector contributes to the development of productive capacities and at the policies that can be used to support its growth.

Key points

- Despite recent improvements, the private sector in LDCs lacks medium-sized enterprises and remains largely composed of informal firms, small firms and microenterprises operating in low value added sectors
- Constraints that prevent small enterprises from growing need to be addressed through government policies. The UNCTAD Productive Capacities Index can provide valuable information in designing effective policies
- Private sector policies should foster the creation of small and medium-sized enterprises and the scale-up of existing businesses
- Effective policies require extensive consultation and collaboration between the public and private sectors

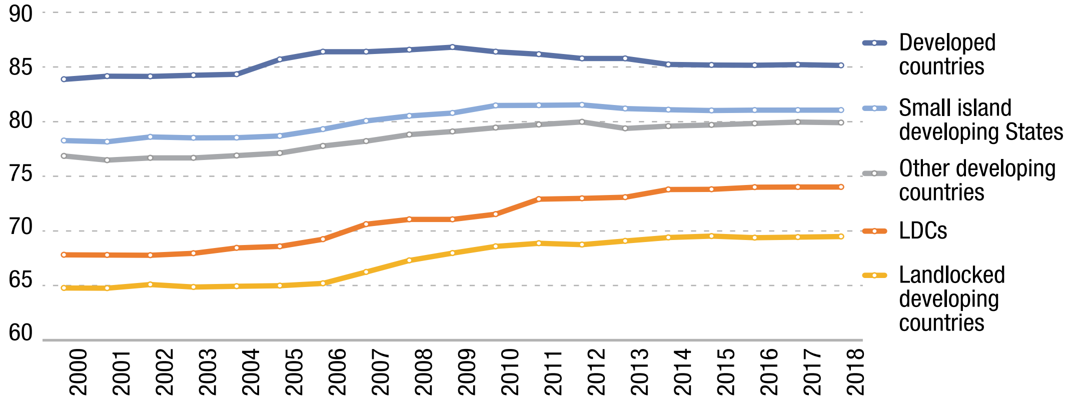
Current situation and challenges

LDCs have made considerable progress in the development of the private sector in recent years, thanks in part to the implementation of measures to improve the business climate and increase market openness. The evolution of the score in this category in 2000–2018 shows that developing countries and LDCs have made substantial improvements (see figure). An increasing convergence between developing and developed countries may be observed, driven by the high performance levels of developing economies in East Asia (China, the Republic of Korea and Singapore). However, LDCs and landlocked developing countries remain at the bottom of the distribution.

The private sector in LDCs is still composed mostly of informal firms, small firms and microenterprises driven by necessity rather than opportunity and often operating informally in low value added sectors. It is estimated that formal and informal

[1] The Index is a tool developed by UNCTAD to assess and measure the performance of productive capacities in countries. It aims to support developing countries in understanding the status of their productive capacities and how this can be improved. The eight categories are energy, human capital, information and communications technologies, institutions, natural capital, the private sector, structural change and transport (see https://unctad.org/topic/least-developed-countries/productive-capacities-index). Structural transformation refers to the movement of labour and other productive resources from low-productivity to high-productivity economic activities. It is a process resulting from capital accumulation, innovation and the densification of productive linkages. Structural transformation leads to changes in the composition of output, employment and trade, and is a major determinant of poverty reduction and long-term development in LDCs.

Evolution of scores of private sector category of Productive Capacities Index, by country group



Source: UNCTAD calculations.

microenterprises and small and medium-sized enterprises contribute more than half of employment and gross domestic product (GDP) in LDCs and that the informal sector alone accounts for around 35 per cent of GDP.[2]

Most microenterprises and small and medium-sized enterprises are not connected to global value chains, which prevents them from exporting to foreign markets effectively. As a result, these enterprises generally lack the potential to grow, innovate and contribute to job creation and, therefore, they have only a marginal effect on sustainable economic growth and structural transformation. At the other end of the spectrum, a few large enterprises have a disproportionate footprint in most LDCs in terms of output, employment and exports. This enhances the "missing middle" in these countries; the lack of medium-sized enterprises, essential to ensure connections between small-scale and large-scale firms and create jobs and wealth, remains a core challenge.[3] Furthermore, small enterprises in LDCs are often affected by supply- and demand-side constraints that prevent them from growing, operating efficiently and upgrading technologies.

To invigorate the private sector and enhance its contribution to productive capacity development and structural transformation, LDCs need to formulate and implement policies that support enterprise creation, development and growth.

Constraints to private sector development

The business environment is often cited as one of the main determinants of enterprise and private sector development. Largely shaped by government policies and legislation, the business climate is influenced by administrative conditions, the quality of institutions and infrastructure, political and economic stability and the effectiveness of regulatory frameworks, as well as the level of corruption. When the business environment is not conducive, it can increase enterprises' direct and indirect production costs, inhibit the adoption of new technologies, deter investment, weaken competitiveness and reduce market sizes.[4]

Lack of access to finance is another major constraint to entrepreneurship and private sector development, particularly for small and medium-sized enterprises in LDCs. To ensure improved access to finance, Governments need to build functional financial institutions, strengthen the banking sector and turn small and medium-sized enterprises and entrepreneurs into viable investment targets.

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2 UNCTAD, 2018, *The Least Developed Countries Report 2018: Entrepreneurship for Structural Transformation – Beyond Business as Usual* (United Nations publication, Sales No. E.18.II.D.6, New York and Geneva).

3 UNCTAD, 2020, *The Least Developed Countries Report 2020: Productive Capacities for the New Decade* (United Nations publication, Sales No. E.21.II.D.2, Geneva).

4 UNCTAD, 2018.

Action areas and policies supporting private sector development	
Building a business-enabling environment	Reducing the costs of starting a business (e.g. ensuring efficient licensing regimes and business registration systems) Improving the ease of doing business (diminishing risks and costs, e.g. improving tax policies and land titles, developing appropriate quality standards and investing in public infrastructure)
Expanding access to finance	Establishing a sound financial sector policy framework Promoting the entry of and competition among firms Promoting alternative sources of financing Strengthening the capacity of financial intermediaries to lend to microenterprises and small and medium-sized enterprises, including from development banks in the area of long-term sustainable financing (see https://unctad.org/webflyer/role-development-banks-promoting-growth-and-sustainable-development-south) Increasing entrepreneurs' financial literacy through education and training (see https://openknowledge.worldbank.org/handle/10986/6621)
Improving access to markets	Facilitating the flow of goods and services and lowering the costs of doing business with foreign customers Upgrading transport infrastructure Investing in trade logistics and facilitation Strengthening institutions responsible for standards and quality control and for providing market information and support services
Attracting foreign direct investment	Increasing the rate of return of foreign direct investment and reducing its costs and risks (see https://unctad.org/system/files/official-document/iteipcmisc3_en.pdf) Providing targeted incentives for the private sector in sectors with comparative advantages and the potential to foster productive capacities Ensuring efficient administrative procedures and ownership rules Establishing investment promotion agencies Developing export platforms
Increasing human capital	Investing in entrepreneurial education and skills development Implementing policies that facilitate skills matching Promoting vocational education and training Creating linkages between businesses and academic institutions Expanding and upgrading business support services

Source: UNCTAD.

Market access is also a cornerstone of enterprise growth and the inability to take advantage of such access is a constraint to private sector development. Expanding access to foreign markets and enhancing the export potential of firms can increase business opportunities, technological spillovers, the learning of new skills and overall productivity. In LDCs, trade costs and barriers are generally high due to the lack of market information, weak transport infrastructure, cumbersome administrative procedures and the lack of investment. Many firms are also constrained in their ability to comply with international standards. Addressing these constraints requires the implementation of enhanced trade facilitation measures, the meeting of international standards and the provision of training, to increase the competitiveness of the private sector.

Such efforts to harness international trade need to be complemented by consistent policies aimed at attracting domestic and foreign direct investment and fostering linkages between the latter and private firms.

Limited human capital development also significantly hinders private sector competitiveness. The lack of highly skilled human capital and skills gaps between the labour force and industry have a negative impact on labour productivity and technological progress. Skilled labour and new technologies drive the structural changes necessary to improve production systems and allow for diversification into more complex products. In LDCs, shortages of skilled labour are thus one of the main obstacles to enterprise growth and upgrading into higher value added segments of the value chain.[5] To invigorate the private sector, Governments need to refocus investments in education, skills training and knowledge development.

The Productive Capacities Index can be a practical tool for policymakers in assessing the strengths and weaknesses of some of the policies implemented in the past and in identifying future actions and the policy interventions best suited to country-specific conditions, to effectively support private sector development and build productive capacities. Some key policy options with regard to addressing these constraints are shown in the table.

Directing private sector development policies towards structural transformation

To effectively support private sector development, policymakers need to design policies tailored to the domestic private sector. The following key guidelines can help in maximizing the contribution of the private sector to structural transformation:

- Public policies should not be limited to supporting the creation of new businesses, but should also aim to sustain the development of existing enterprises throughout their life cycles. Development policies also need to target enterprises with a greater potential for high value added job creation and innovation. It is important to direct policies toward formalizing informal operations and maximizing their contribution to structural change. Furthermore, the focus should be on scaling up opportunity-driven enterprises with a significant potential for job creation, rather than fostering the creation of necessity-driven businesses. Taking full account of the heterogeneity of firms in the policymaking process is critical, to increase productivity and advance structural transformation.
- Enterprise and entrepreneurship development policies should be the product of extensive public and private sector collaboration, consultation and dialogue, aimed at building mutual trust and understanding and addressing complex and interrelated challenges. Public and private sector dialogue should enable the private sector to highlight key barriers to business operations and to propose targeted solutions. It can also provide an opportunity for the private sector to share business and market information with the public sector that can help shape

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