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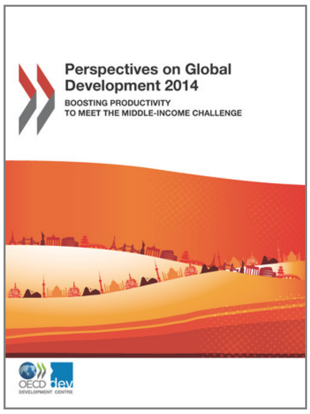
Perspectives on Global Development 2014

Boosting Productivity to Meet the Middle-Income Challenge

Summary in English



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Many middle-income countries are not on course to converge with OECD per capita incomes: Strong growth over much of the past decade has substantially boosted developing countries' share of the global economy. But will this process of "shifting wealth" allow these countries to eventually converge with the average OECD per capita income level? After a long period of impressive progress, growth rates have begun slowing in some middle-income economies. At current growth rates several middle-income countries will fail to converge with the average OECD income level by 2050. Their challenge is deepened by the slowdown in China, where rapid growth has up to now benefited its neighbours and suppliers, in particular natural-resource exporters.

Productivity growth is key: During the transition away from being a low-income economy, productivity is boosted by shifting labour from lower to higher productivity sectors. This shift can continue to be an important factor even in middle-income countries, for example India and Indonesia. But once this process slows down, the focus needs to turn increasingly to productivity gains within sectors. This shift is evident in overall productivity growth in OECD countries. It is also evident in China, which has raised productivity in many manufacturing industries by tapping global knowledge through foreign direct investment and by importing capital goods and components.

But productivity is rising only slowly: For sustained convergence, productivity growth needs to accelerate. Over the past decade, productivity growth made only a marginal contribution to economic growth in many middle-income countries. It was also insufficient to significantly reduce the very large gap in productivity with advanced countries. In Brazil, Mexico and Turkey, the gap even widened. By contrast, China recorded impressive growth in productivity: around 10% annually in labour productivity and above 7% in total factor productivity in manufacturing and services. India also experienced considerable total factor productivity growth over the past decade, although the gap between it and advanced economies remains substantial.

Some traditional drivers of growth are fading: Improving productivity is especially important as many middle-income countries can no longer rely on the advantages that lower-income economies usually enjoy as they move up to middle-income status. These include low labour costs and fast growth driven by foreign investment-led development of export industries. Moreover, the demographics in middle-income countries become less favourable to growth. The rise to middle-income status is often accelerated by a demographic transition where mortality rates fall faster than birth rates, so increasing the supply of working-age people. Some regions still have the potential to reap this demographic dividend, notably South Asia and sub-Saharan Africa. But elsewhere the demographic dividend is fading.

Middle-income economies can boost productivity by:

- **Diversifying continuously into higher value-added sectors in agriculture, industry and services:** Diversification is particularly important in middle-income countries that are seeing rising wages, as well as those rich in natural resources.
- **Innovating by using global knowledge and developing domestic capabilities:** Even the more advanced middle-income countries still have significant room for technological catch-up. Besides better integration into the global trading system and tapping foreign knowledge through trade,

foreign direct investment and other means, countries also need to develop capabilities to innovate new products and processes to better suit their own needs and create their own competitive edges.

- **Reforming product, labour and financial markets, and developing skills:** In many middle-income countries, the development of competitive, innovative businesses is often constrained by an inadequate regulatory environment and lack of skills.
- **Fostering competitive service sectors:** The domestic service sector can grow to meet the demand of the growing middle classes. Services can also increase the competitiveness of manufacturing and be a source of export earnings.

They can also continue to exploit "old" drivers of growth by:

- **Shifting labour from lower to higher productivity sectors:** Many middle-income countries, including India, Indonesia, Iran and Malaysia, still have potential to benefit from workers in agriculture, manufacturing and services making the move up to higher productivity sectors.
- **Fully reaping factor accumulation-led growth:** Most middle-income countries still have room for improvement in how they use labour and can further accumulate human and physical capital. Also, efficiency in the use of production factors can be improved.

They can work to spread the benefits of growth by:

- **Ensuring equal opportunities:** In many middle-income countries, poverty is still widespread and/or income inequality has risen during the last decade. Frustrations among the "middle classes" over living standards and their lack of a say in decision making have created tensions in some middle-income economies. These social challenges need to be addressed by providing better public goods, improving people's quality of life, providing more job opportunities and ensuring a greater voice in the economy.
- **Developing effective regional policies to support more equitable growth and reduce regional disparities:** This requires identifying regional competitive edges and tailoring public services to local needs with priorities to heavily populated poor areas.
- **Increasing energy efficiency and environmental sustainability:** Diversifying into less energy-intensive sectors and adopting energy-efficient technologies would reduce vulnerability to fluctuations in energy prices and changes in regulations and preferences. In addition, more attention has to be paid to environmental sustainability in crafting successful development strategies.

And they can make government more effective by:

- **Developing greater capability to formulate and implement plans:** Better training of government officials and improved coordination across government ministries is essential to ensure effective planning and implementation. Bold changes in strategies may be politically difficult and costly though less so than no change. Effective communication strategies and the right timing and sequencing are critical to obtain support by multiple stakeholders to implement these reforms.

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© OECD (2014), *Perspectives on Global Development 2014: Boosting Productivity to Meet the Middle-Income Challenge*, OECD Publishing.
doi: 10.1787/persp_glob_dev-2014-en