International Labour Organization

FINANCING INCLUSIVE STRUCTURAL TRANSFORMATION

Key messages

- Structural transformation is essential for growth, decent job creation, and sustainable development. The lack of financial resources, in particular long-term financing to support the expansion of productive capacities, often limits these transformations in developing countries while the lack of structural transformation itself exacerbates financing challenges.
- Structural transformation can be financed by (i) strengthen national public development banks to provide long-term finance and counter-cyclical lending; (ii) establishing and strengthening public-private alliances on structural transformations, including with a view to overcoming financing coordination failures; (iii) undertaking national consultations on country-specific pro-structural transformation macroeconomic frameworks that support stability, decent jobs and actively promote long-term investments in dynamic sectors.
- In these actions, the active involvement of social partners (governments, workers' and employers' organizations) is critical in ensuring national buy-in of structural transformation policies and their financing strategies.

Problem statement

Structural transformation—the reallocation of resources and labour from low-productivity to higher-productivity activities—is central to economic growth, the creation of decent jobs, and overall development. Such a reallocation enhances aggregate productivity, which in turn can lead to higher incomes and improved working conditions. Recognizing its importance, the Sustainable Development Goals underscore the critical role of structural transformation in achieving sustainable development.

Many developing countries however are facing significant challenges in fostering sustained and inclusive structural transformation. Rather than following the classical path of structural transformation that involves a shift from agriculture

RELEVANT ACTION AREAS

Domestic Public Resources

Science, technology, innovation and capacity-building

International Development Cooperation

ABOUT THIS SERIES

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The Inter-agency Task Force on Financing for Development is comprised of more than 60 United Nations Agencies and international organizations. The policy briefs in this series were not subject to review by Task Force Members, and represent the views of the authoring organizations.

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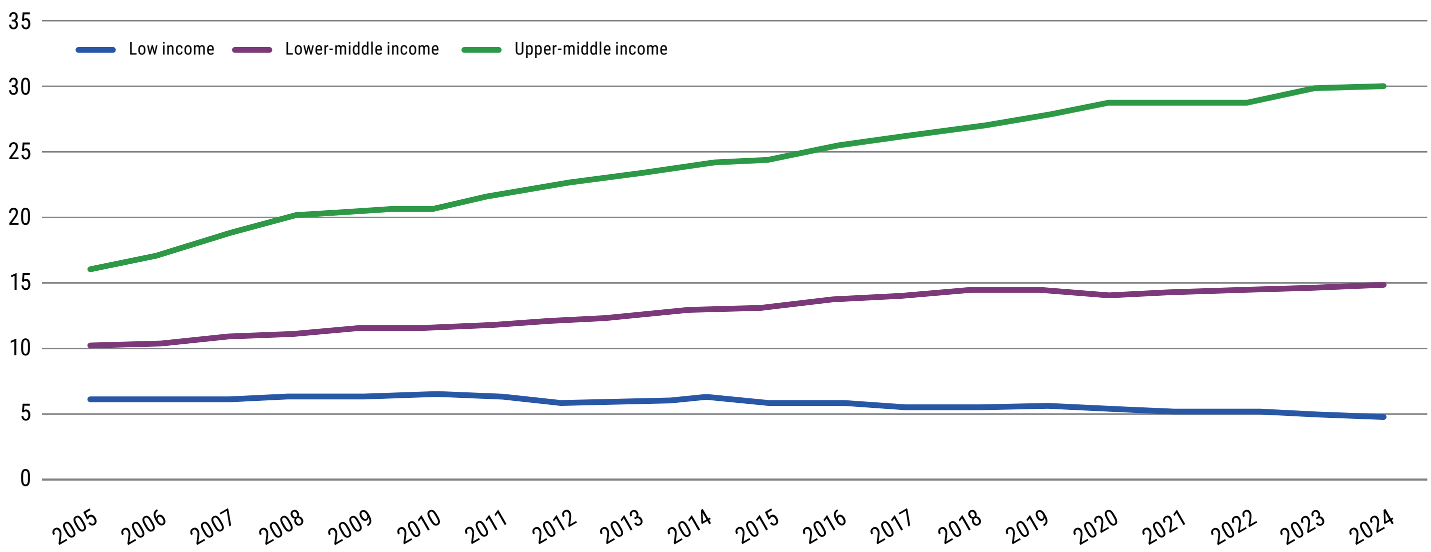
to manufacturing and then to services, many developing countries have experienced a direct shift from agriculture to services, bypassing manufacturing—a phenomenon termed "premature deindustrialization" (Dasgupta and Singh 2006; Rodrik 2016). This trajectory raises concerns that these countries may miss out on the benefits that manufacturing has traditionally offered, such as economies of scale and productivity spillovers that drive growth and employment.

Furthermore, rather than towards modern, high-productivity services sectors, structural transformation in today's developing countries has often been towards traditional, low-productivity services (Dasgupta, Kim, and Pinedo-Caro 2017). In some cases, structural transformation has even shifted from higher-productivity to lower-productivity activities (McMillan et al. 2014). As a result, low- and lower-middle income countries have struggled to close the productivity gap with high-income countries (figure 1). Moreover, as the world grapples with significant environmental challenges, it is increasingly clear that the "brown" development paths of the past— typically characterized by heavy industrialization at the cost of environmental degradation—are neither feasible nor desirable for today's developing countries. Instead, these countries are challenged to pursue "green" and more productive patterns of structural transformation.

The lack of technology, infrastructure and skills are some of the factors behind the unfavourable pace and direction of structural transformation. The lack of financial resources, in particular long-term financing to support the expansion of productive capacities, is another. Furthermore, the lack of structural transformation *itself* exacerbates financing challenges. When the process of structural transformation is stalled, countries remain dependent on traditional sectors like agriculture and the informal economy, which typically generate lower income and tax revenue. As a result, the state's fiscal base remains narrow, limiting its ability to invest in sustainable development. Large segments of the workforce engaged in low-productivity activities not only perpetuates poverty and inequality but also reduces the state's capacity to mobilize domestic resources through taxation. Labour markets with limited formal employment opportunities fail to generate significant social security contributions, further constraining the state's ability to finance social protection systems needed to cushion the creative destruction processes of structural transformation. Moreover, the

Figure 1.
Level of labour productivity as percentage of that in high-income countries



Source: ILO modelled estimates, November 2023.
Note: Labour productivity measured in output per hour worked (GDP constant 2017 international $ in PPP).

absence of structural transformation leaves economies vulnerable to external shocks, such as commodity price fluctuations, which can destabilize public finances. Additionally, inadequate structural transformation can restrict access to international financing, as countries with low levels of economic diversification are often perceived as high-risk by international investors and lenders, leading to higher borrowing costs and reduced access to credit.

Policy solutions

Given the challenges, a greater appreciation and consensus has emerged on the need for the structural transformation process to be shaped and governed to achieve the desired economic, social and labour market outcomes, including through industrial policies (or sectoral policies) whereby governments make proactive strategic efforts to support specific industries or sectors. These policies have enjoyed a renaissance in recent years, in both developing and advanced economies. Industrial policies are instrumental in fostering inclusive structural transformation. Contemporary industrial policies are playing an important role in facilitating the transition towards net zero, promoting diversification and structural change, and nurturing strategic sectors. Key success factors for such policies include an in-depth self-discovery process, the availability of sufficient finances and functioning institutions and the active engagement of a broad range of stakeholders (Kucera, Schmidt-Klau and Weiss 2020).

While traditional industrial policy tools such as public subsidies and credit guarantees remain relevant, modern industrial policies increasingly focus on sustained public-private collaboration around shared transformational goals (Aiginger and Rodrik, 2020). Such collaboration is crucial for overcoming coordination failures, particularly in financing. Often, multiple investments or actions must occur simultaneously for a sector or project to become viable over the long term, yet independent actors operating in their own self-interest struggle to align these investments. Public-private alliances, which include employers' and workers' organizations, can play a key role in coordinating financing flows, addressing market failures, and de-risking investments. Public development banks, in particular, are vital in bridging the short-term outlook of private financial institutions with the longer-term investment horizons required for structural transformation.

The macroeconomic environment plays an important role in facilitating structural transformation but also in determining the cost of capital (United Nations 2023). Macroeconomic policies are typically geared towards maintaining stability, whether in terms of prices or public finances, but it has become clear that maintaining stability alone is insufficient to support sustained and inclusive structural transformation and broad-based productive employment creation. The Great Recession and the COVID-19 pandemic and its aftermath have led to a reconsideration of macroeconomic policies, including a greater appreciation of counter-cyclical fiscal and monetary policies in fighting recessions and of policy frameworks that support productive jobs, inequality and climate change. Indeed, in a time of increased disruption and income dispersion from digital transformation and climate change, maximizing the synergy between production, jobs and distribution within an economy needs to be a central priority of macroeconomic policy (Samans 2024). Building on these developments, pro-structural transformation macroeconomic policy frameworks, tailored to country circumstances, can influence the financing landscape for countries.

Mobilizing the financing needed to support structural transformation requires a coordinated approach. This involves not only public-private collaboration and coherent macroeconomic frameworks but also multilateral cooperation. These elements form the foundation of the United Nations Global Accelerator on Jobs and Social Protection for Just Transitions. The Accelerator aims to bring together member states, international financial institutions, social partners, civil society, and the private sector to help create 400 million decent jobs—particularly in the green, digital, and care economies—and extend social protection coverage to the 4 billion people currently excluded. Through the Accelerator, integrated national frameworks for the adequate and sustainable financing of social protection and employment initiatives, both essential for long-term structural transformation, can be supported and implemented.

Specific recommendations for FFD4

The Outcome document of FFD4 should:

Strengthen national public development banks to provide long-term finance and counter-cyclical lending, thereby contributing to structural transformation and the SDGs. National public development banks (PDBs) can provide the long-term financing that private capital often avoids due to perceived risks and coordination failures. By offering counter-cyclical lending during economic downturns, PDBs can also stabilize critical investments and mitigate the impacts of external shocks. Fostering regional cooperation between national PDBs, particularly those in small economies, can serve to pool resources to finance structural transformation across borders.

Establish and strengthen public-private alliances on structural transformations. These alliances can serve to identify and overcame the primary constraints required for structural transformation. If driven by strong political leadership, these alliances can coordinate collective actions, identify different financing opportunities and motivate investment and risk taking. The active participation of employers' and workers' organizations in these alliances are critical in ensuring national buy-in of policies and their financing strategies over the longer-term.

Undertake national consultations on country-specific pro-structural transformation macroeconomic frameworks. National-level discussions should engage a broad range of actors, including the government ministries, central banks, social partners and others, to design macroeconomic frameworks that are tailored to the unique structural challenges of each country. These frameworks must go beyond traditional stabilization policies to actively promote long-term investments in dynamic sectors and generate decent jobs. These consultations should also embed counter-cyclicality and resilience into macroeconomic policies to better withstand external shocks in order to ensure a conducive environment for long-term financing of structural transformation.

Encourage member States, the donor community, international financial institution, national public development banks to continuously support to the United Nations Global Accelerator on Jobs and Social Protection for Just Transitions. The Global Accelerator in particular can be an important means for knowledge sharing on national financing frameworks and the mobilization of public and private domestic and international resources to invest in universal social protection and inclusive labour markets.