

Non-tradeables and inclusive growth

Working paper

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Introduction

This note is about why we should care about non-tradeable sectors if our prime concern is inclusive growth and structural transformation in low-income countries. The note does not question the general premise that really significant growth requires structural transformation in low-income countries, nor that export-oriented industries of some sort are normally the drivers of rapid growth. However, it will show how non-tradeable sectors are really important for jobs and so are fundamental to inclusive growth. It also challenges the idea that a growth-promoting policy or industrial policy should focus only on the direct problems of key export-oriented sectors. Ignoring the business environment for non-tradeables and letting extractive practices persist will be inflationary and will hurt competitiveness even in tradeable sectors: this is bad for inclusivity because there will be less investment and growth in non-tradeables, and it is bad for growth because there will be less investment in tradeable sectors too.

In recent years there has been growing interest in the prospects for structural transformation in sub-Saharan Africa and other developing regions. This is fuelled by concern that a combination of domestic and international factors have produced de-industrialisation and structural change of the wrong kind in Africa and elsewhere (McMillan, Rodrik, and Verduzco-Gallo 2014), (Newman et al. 2016)). It is also thought that the downturn in world commodity prices and the transformation of coastal China into a middle- (upper middle-?) income zone may create new possibilities for Africa and other new regions to compete in manufacturing again. There is a concern that dependence on natural resource exports has produced 'jobless growth' (Ancharaz 2011), and that a far more inclusive growth path is one that is driven by manufacturing exports since manufacturing is a sector with the highest potential labour productivity gains and is more labour-intensive than, for example, drilling for oil. The following quote is taken from the UK Department for International Development's (DFID's) Economic Development Strategy 2017 (Department for International Development 2017):

'Manufactured exports help countries cut poverty rapidly. The growth of manufacturing creates many labour-intensive jobs, raises productivity and incomes, and helps firms to learn how to compete in international markets – creating a basis for lasting growth.'

These sorts of concerns are reinforced by some of the new literature on urbanisation in developing countries. Fast-growing cities are found to follow a fairly predictable trajectory of structural transformation from a specialisation in market-town type services for the hinterland, through manufacturing and then high-productivity tradeable services. There is concern that rapid urbanisation in Africa is occurring without specialisation in manufacturing and that Africa is developing large but high-cost 'consumption cities', producing only non-tradeable services meeting demand fuelled by rents captured from natural resources, taxes or corruption (Gollin et al. 2015). There is the possibility of a city-level competitiveness trap in which high costs, congestion and low productivity move the city farther and farther from competitiveness in tradeable production (Venables 2017).

These are all valid observations but our fear is that these observations can lead to an over-emphasis on manufacturing at the expense of high potential natural resource production and of non-tradeable services – the focus of this note.

There are three distinct channels through which non-tradeables have an impact on inclusive growth.

This note argues that non-tradeables are intrinsic to inclusive growth in most cases, for three distinct reasons:

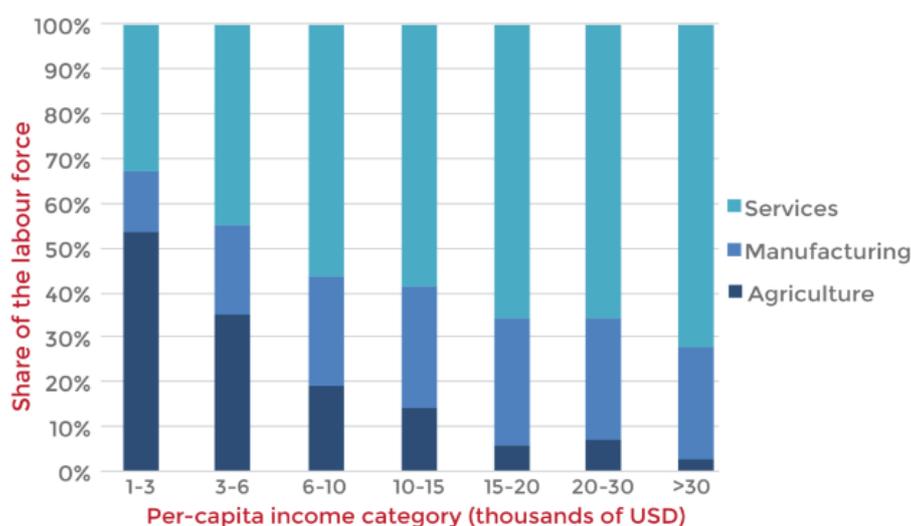
- Non-tradeable services are the prime mechanism by which output growth is converted into labour-using, inclusive growth - this is even more true now than in the past, since there are now fewer jobs in manufacturing or natural resource extraction.
- Non-tradeable sectors are vulnerable to extractive institutions because it is relatively easy to use regulation and informal coercion to extract rents in sectors which do not take international prices.
- Distortion in the non-tradeable sector not only reduces its potential for job-generating inclusive growth, there are also strong linkages back to traded sectors because non-tradeables are important to producers and consumers, and high prices mean high production costs and, probably, higher basic wages.

Why non-tradeable sectors create most of the jobs in structural transformation

We know that low-income country to middle-income country (LIC-MIC) transitions typically involve a major shift in the structure of production, a 'transformation' of the economy...

Upper middle-income countries (UMICs) never retain the structure of production and employment that lower middle-income countries (LMICs) exhibit. LICs are uniformly characterised by a very high share of the workforce being engaged in agriculture, typically 60%–80%. Figure 1 shows that, on average, countries in the \$1,000–3,000 per capita range still have more than half of the workforce employed in agriculture. This falls away rapidly as we climb up the income categories up to the high-income country (HIC) threshold of about \$13,000, where agricultural labour stabilises at a few percent. LICs put a very large share of their labour into agriculture; by the middle of the MIC category this falls below 30%. Typically, the amount of labour in manufacturing grows modestly and the amount in services increases a lot.

Figure 1



Source: Brooks, J.(ed.) (2012), *Agricultural Policies for Poverty Reduction*, OECD Publishing, Paris, DOI: <http://dx.doi.org/10.1787/9789264112902-en>

...it is usually productivity gains in tradeable sectors, meeting international demand, which are seen as driving economic growth in LICs.

If something creates significant potential productivity gains in a tradeable sector so that an export market can be supplied competitively, the export market can absorb a lot of output and this can provide an opportunity for a prolonged burst of high-output growth in an LIC – compared to anything based on the small domestic market. This might be the discovery of new reserves of natural resources which are profitable to extract, or some cost or productivity change in manufacturing industries which makes investment there profitable.

'Transformation' refers to when productivity gains and growth produce big, permanent shifts in investment, employment and production

Annex 1 illustrates a simple framework for thinking about these structural shifts. It focuses on labour and assumes that capital is mobile. Thus, workers move from job to job but the number of workers is fixed, whereas the amount of capital can change and new investment in one sector does not necessarily displace the same amount of investment from another.

'Transformation' has a lot to do with where people work, but to focus on structural changes we make some simplifying assumptions about the labour market and take increases in the real wage as implying inclusive growth.

In the simple framework we assume that workers are all the same (all 'average'), that the nominal marginal product of labour is the same in every industry and that there is a wage level that extends across all industries. So we ignore differences between workers and social barriers that stop some groups from working in some jobs. We also ignore the fact that self-employed workers enjoy some returns to the capital or land that they own and can therefore pay themselves a low 'wage' – because even though this is true, these workers will still be prompted to shift jobs if wages increase in other sectors. These sorts of issues are discussed very nicely in (Teal 2015). We assume that returns to capital are very narrowly distributed, whereas returns to labour – the (average) real wage – are much more widely distributed, and that increases in the real wage represent inclusive growth.

So, changes in technology, or risks or rules or prices which make an export industry more profitable, can trigger new investment, although capital-intensive industries do not employ many workers and will not create very inclusive growth directly...

For example, gas and oil discovery may attract major new investment, without diverting capital from other industries, and will also divert a small number of workers who will have extremely high average productivity. If a trade agreement makes garment manufacturing more profitable, it may attract major new investment and divert a somewhat larger number of workers from other industries – more labour demand means more upward pressure on wages, despite the lower labour productivity in garments versus oil. Nevertheless, relatively capital-intensive export competing industries might not employ very many people and might not push up real wages much, so the first round of impact might not generate much inclusive growth – investors will be better off, workers not so much.

... there would be a second-round impact as demand is created for non-tradeable industries, and if these industries are much less capital-intensive than the growing export industries, they might employ more people.

In the same example, earnings from the newly productive export industry boost demand, including for non-traded goods and services that cannot be imported, like electricity, construction, local transport, education, healthcare, security, restaurants, and shops. This will push up prices for those goods and services in the local market, making them more profitable to run, attracting investment, and drawing in labour from traded sectors. This happens without any real productivity gains in the non-tradeable sectors – increased prices make them profitable anyway. In fact, we expect labour productivity to fall as these sectors expand.

...we could call this 'Dutch disease' but it can be good for growth...

If boosted demand for non-tradeables draws labour away from sectors with higher capital intensity and higher average labour productivity, we call it 'Dutch disease', and it means lower output and lower growth than with weaker domestic demand. However, the traded sector can contain quite varied industries and it may be that non-tradeable industries are more capital-intensive, with higher average labour productivity, than some traded industries – for example, traditional agriculture. If that is the case, increased domestic demand for non-tradeables will boost investment and employment in a more productive sector than traditional agriculture and this could further boost the growth created from the original investment in the capital-intensive traded sector.

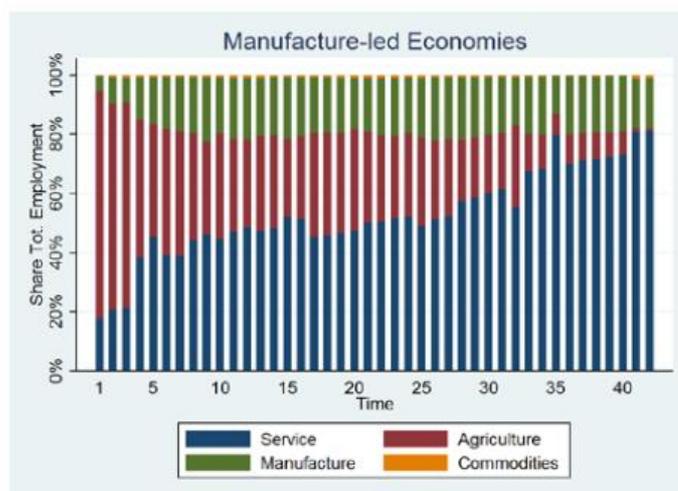
...and is a mechanism for translating export-led growth into more inclusive growth.

Even if the second-round stimulus to non-tradeable industries partly offsets the productivity and output gains generated in the initial export industry growth shock, it will not do so completely. If non-tradeable sectors employ more people than traded sectors they will push up real wages more.

Familiar conditions in LICs might mean increases in manufacturing or natural resource productivity produce growth, and big shifts in labour from traditional agriculture to non-tradeable services...

As mentioned, LICs typically contain a traditional agricultural sector which employs most of the workforce, with very low capital and very low average labour productivity. Non-tradeable services, even quite petty services in towns and cities, are more productive in terms of output per worker. However, in the global economy manufacturing is likely to be much more capital-intensive, with much higher output per worker. In these conditions, a boost to labour productivity in manufacturing might be sufficient to create significant investment and growth. Some labour will be drawn from traditional agriculture to work in manufacturing. Manufacturing exports generate income and demand, including for non-tradeable services, pushing up prices until investment is attracted to services too ('Dutch disease'). Labour is drawn into services, most likely also from traditional agriculture. Services are more capital-intensive, with higher labour productivity, than agriculture so labour transfer from traditional agriculture to services means growth. Services are much less productive than manufacturing so if service output increases in step with manufacturing, for example, much more employment will be generated in services than in manufacturing. **This is why services are so important for inclusive growth.**

...and this is what we see.

Figure 2

Source: Elaboration based on ILO Statistics.

Figure 2 (Vanino 2015) shows the pattern of labour force transformation from a set of countries with sustained growth episodes in modern times, led by manufacturing exports. The x-axis shows number of years into the sustained growth episode and the divided columns show how the workforces are split, on average, as the growth episodes progress. There is some increase in manufacturing employment at the start of the episode but the big shift, on average, is overwhelmingly out of agriculture and into services.

In modern times, the transition from traditional agriculture to services dominates every structural transformation and there are no countries where manufacturing employs more people than services.

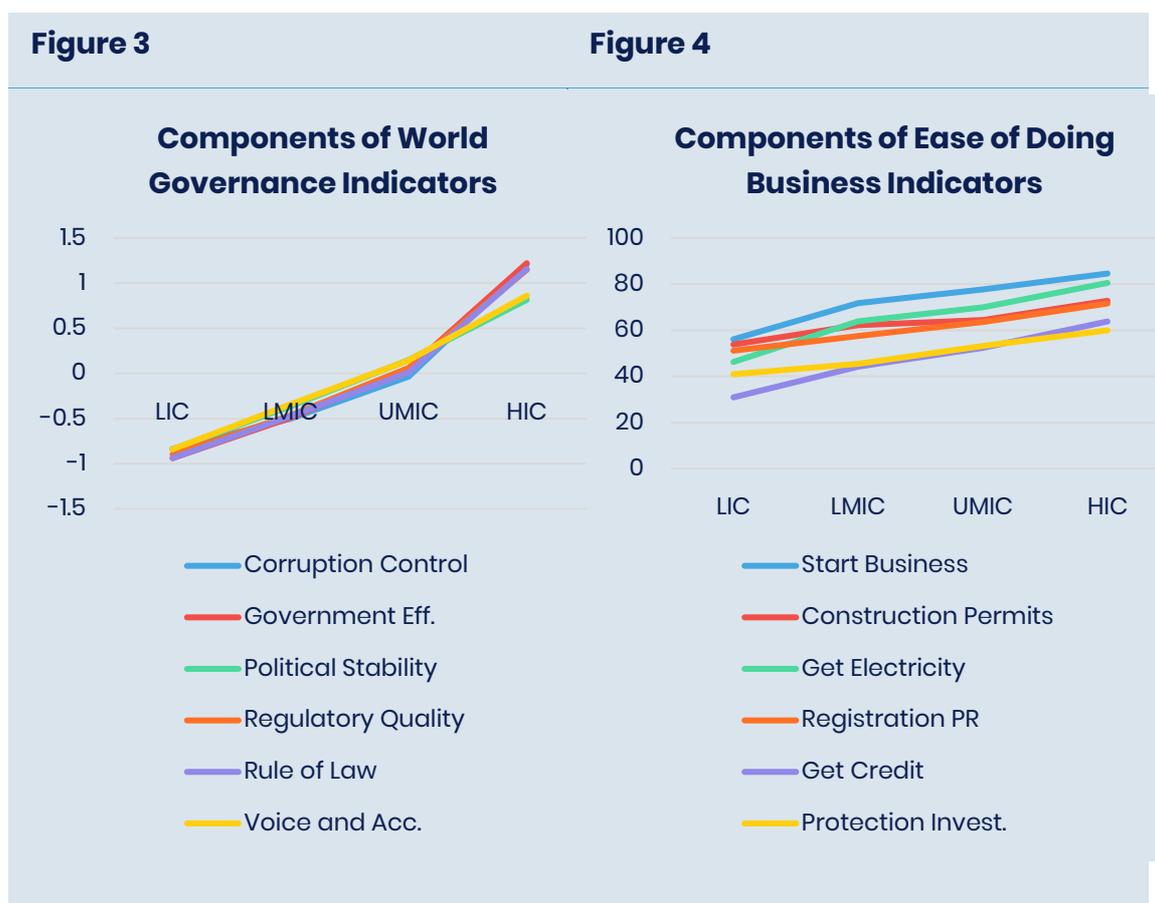
Annex 2 covers some of the history on this. In the late 18th century and early 19th century, Britain's industrialisation was just starting and there was a structural shift from agriculture to manufacturing – partly to do with agricultural productivity growing faster than manufacturing productivity in this period. Britain had a very large share of its workforce: 36%–39% – for over 120 years. The transition from agriculture to services was very slow over this period. There was then a fast transition from manufacturing to services, from 1960 to 1990. Today, even in countries with large and fast-growing manufacturing sectors, like China and Bangladesh, things are different. Right from the start of the growth/modernisation period, workers have transited from agriculture to services. In modern times services almost always employ more workers than manufacturing or wider 'industry'. No countries reach the historic British levels of manufacturing employment. The probable explanation is that manufacturing has overtaken agriculture and services by so much, in terms of labour productivity, that the same processes produce a different pattern in modern times and history does not repeat itself.

Why non-tradeable sectors are susceptible to extractive institutions

There are two ways in which extractive institutions generate and remove rent from the private sector.

We can define extractive institutions as those designed to create and redistribute rents for private gain. This can be like a type of taxation where those in authority use their discretionary power to extract rents from enterprises, whose costs are ultimately passed on to the consumer, or it can be a discriminatory use of tax and regulation to create monopolistic rent opportunities for select enterprises to take rents – again, these rents ultimately must derive from the consumer. Extractive institutions may also appropriate rent from the public sector.

Extractive institutions are everywhere, but more in poorer countries.



There are extractive institutions in every type of country but pervasive extractive institutions are much more common in poorer countries – they keep countries poor by ruining investment opportunities and competitiveness. Figures 3 and 4 show that every component of the World Governance Indicators (WGIs) and Ease of Doing Business (EDB) Indicators improves as we move through the income spectrum from LICs through to HICs. This includes things like corruption control, rule of law, regulatory

quality, cost of starting a business, construction permits and investment protection, which are closely associated with extractive institutions.

It is hard to extract rents from a trade-competing, export-oriented productive sector – it is much easier to extract rent from non-tradeable sectors where costs can be passed on to consumers.

The two main channels for extracting rents from the private sector involve passing on the costs of rents to the consumer. One is simply appropriating rents using official authority or the threat of it. The other is to eliminate competition, using official authority, and to protect monopolistic profits for selected firms. For traded goods the consumer is international and will not accept higher prices, and this is why non-tradeable service sectors are much more vulnerable to extractive institutions. The exception is where industries are protected, partially or fully, from foreign competition – for example by high tariffs or import bans or natural trade barriers – which means entry into the industry can be restricted and rents can be extracted. This means goods sectors can be made ‘non-traded’.

The case of Tunisia

The Ben Ali regime in Tunisia was an example of extractive institutions generating rents in non-tradeable sectors. The Ben Ali family developed business holdings focused on highly profitable sectors which they could make even more profitable by using legal and regulatory means to make private gains. The man who triggered the downfall of the Ben Ali regime in Tunisia by self-immolating himself in 2010, was a market trader – a non-tradeable business that is vulnerable to the other type of extractive institution which uses authority to extort vulnerable enterprises. (Rijkers, Freund, and Nucifora 2012) use exceptional data from the Ben Ali years in Tunisia to show that the extended family of President Ben Ali owned about 220 firms, accounting for 3.2% of Tunisian national output. They were extremely concentrated in non-tradeable, regulated sectors like transport (rendered non-traded by regulation), telecommunications and real estate. The family created near monopolies in these sectors and managed to generate about 21.3% of profits in Tunisia. Their holdings had almost seven times the profitability of other firms.

The case of African roads

Freight and passenger transport can both be competitive, tradeable services but it is also fairly simple and common to use regulation to eliminate foreign competition and render the industry effectively non-traded. Once this has happened, extractive institutions can generate rents essentially by passing costs on to the domestic market. (Teravaninthorn and Raballand 2009) show how the price of transporting freight in Africa has virtually nothing to do with the underlying costs of transport, including the quality of infrastructure, and more or less everything to do with the way the trucking market is regulated. Where entry to the sector is restricted and rationed formally or informally, rendering the sector both non-tradeable and creating rents, prices are highest – regardless of infrastructure investment.

In Annex 1, the same framework used to think through structural changes is used to illustrate the impact of an extractive institution's 'tax' on non-tradeable sectors.

If the extractive institutions increase the 'tax' on non-tradeables, consumers face inflation whilst producers face reduced profit and withdraw investment. Part of the tax is passed on to tradeable sectors which consume non-tradeables as inputs. Real wages and total income is reduced, but inflation may mean that nominal wages are increased. This note examines some of the empirical evidence around these effects. Do extractive institutions push up the relative price of non-tradeables (for consumers)? Do they also push up nominal wages? Does non-tradeable inflation reduce the competitiveness of traded sectors?

Oxford Policy Management (OPM) analysis shows a strong statistical relationship between the quality of institutions and the relative price of non-tradeables...

There is more detail in the technical Annex A3, where OPM compares governance indicators and price index data to test the hypothesis that **with extractive institutions, the direct impact of rent extraction will fall on non-tradeable sectors**. We take a general WGI measure to represent 'extractive institutions'. We look at changes in the WGI composite index and changes in the prices of non-tradeable goods compared to general prices using price indices. In a cross-country panel regression allowing for country and annual fixed-effects, growth and unemployment, we found a strong inverse relationship between governance quality changes and the changes in the relative price of non-tradeables. Interestingly, the global results were strongly driven by data from LICs and LMICs, where the negative relationship between governance and non-tradeable prices was strong. So, in poor countries where governance indicators and extractive institutions are getting worse, the relative price of non-tradeable goods increases.

...consistent with extractive institutions targeting non-tradeables which pass costs on to the market.

In a country with 10% background inflation, a deterioration of 1% in the quality of institutions pushed up non-tradeable price inflation by 1.2% relative to traded goods. This estimate increases to 2% in the LIC and LMIC subsample (i.e. the WGI-elasticity of non-tradeable prices is -0.2). These estimates are therefore both statistically significant and of economically significant magnitude. This is a correlation, not a proven causal relationship, but it seems robust enough to be interpreted as supportive of the hypothesis that worsening, more extractive institutions squeeze more rent from non-tradeable sectors and push up costs in the non-tradeable sector. Mechanisms might include the African and Tunisian examples: a regulatory regime in transport that protect high profits for domestic trucking companies, or extortion of small enterprises based on the threat of invoking highly pecuniary regulations.

So, the policy maker who is interested in the inclusiveness of growth should not neglect corruption and limited competition in the service and non-traded sectors.

From the first section of the note we know that structural transformation in the modern world always involves big shifts in labour from agriculture to non-tradeable services. Even if growth is export-led, income growth and demand lead to expansion of services which employ a lot of people and increases labour demand and real wages, making growth more inclusive. However, if extractive institutions are taking rent from the

service sector or other non-traded sectors, consumers and investors will be worse off, and reduced labour demand will reduce real wages: less growth and less inclusive growth.

Why underperforming or distorted non-tradeables sectors hurt export-led growth as well as inclusiveness

A distorted non-tradeable sector hurts export-led growth as well as the inclusiveness of growth. The previous sections show how non-tradeables are an engine of employment and inclusive growth. It also shows how they are vulnerable to extractive institutions and that distorted non-tradeable sectors attract less investment, create less jobs, and increase growth by less than would otherwise be the case. These distortions push up prices for non-tradeables, a bit like a tax. In a macro sense, the price of non-tradeables is the real exchange rate – if it is higher, traded exports and import substitutes will be less competitive. The micro-foundations of this are through two channels. First, non-tradeables are important urban wage goods and if they are expensive, urban wages are likely to be higher. Urban wages are an important cost for export-oriented industry. Second, non-tradeables are important inputs for traded good production. So if prices are high, the costs of tradeable production are pushed up through both urban wages and non-tradeable input costs. This would hurt the competitiveness and profitability of export-oriented industries.

Non-tradeables are widely consumed by workers, especially urban workers...

Non-tradeable goods and services are necessarily purchased by domestic consumers or producers. Thus, consumer goods and services are consumed by domestic consumers – mainly workers. In LICs, large numbers of people are rurally based, semi-subsistence farmers who consume a lot of their own production. This includes food but also other goods and services, like housing, fuel, and transport. To move to urban employment in non-agricultural sectors involves a switch to purchasing food, housing, and other goods and services and workers will not do this at a lower real wage than is achieved in rural settings. Costs are always higher in urban settings, so there is an urban wage premium – a higher nominal wage than in the rural setting. However, if basic goods and services are really expensive then the nominal urban wage will be even higher.

...so we might hypothesise that costly non-tradeables will push up the basic urban wage.

This means that the cost of non-tradeable consumer services should have a significant impact on the basic urban wage in a transitioning, still highly rural LIC. And if the non-tradeable sector is exposed to extractive institutions that push up costs, the basic urban wage is likely to be higher than would otherwise be the case.

'Consumption cities' can be an example of costly non-tradeables pushing up urban wages and preventing traded sectors from being competitive.

As mentioned in the introduction, there is some concern that African countries are experiencing 'urbanization without industrialization'. (Gollin *et al.* 2015) describe the phenomenon whereby natural exports produce demand for non-tradeables without much demand for domestically produced manufactures – the result can be growing

cities whose production is very skewed to services. Of course, other factors may also be at play. (Venables 2017) describes how cities might get 'locked in' to non-tradeable specialisation, including with an urban form that suits high-cost non-tradeable production but not competitive manufacturing, and he describes the impact of high-cost non-tradeables themselves on the nominal urban wage. Services can survive with high nominal wages, high input costs and congestion costs which prevent tradeable sectors from being competitive and profitable – Venables suggests there may be some path dependence in this, and it is noticeable in his model that a shock reduction to non-tradeable costs might be enough to alter the path and 'break into tradeables'.

OPM analysis shows a strong statistical relationship between the quality of institutions and the basic urban wage, via the price of non-tradeables...

There is more detail in the technical Annex A4 where OPM estimates the degree to which wage costs are pushed up by non-tradeable prices, using the same data as in technical Annex 1, supplemented with quite detailed data on wage levels from the International Labour Organization (ILO). There is some clear endogeneity between the price of non-tradeables and wages – wages are a cost in the production of non-tradeables, as well as other goods and services. Therefore, we instrumented non-tradeable prices using changes in governance scores; so, effectively, we estimate the impact of extractive institutions on wages *via* the price of non-tradeables. The results were that there was a significant impact of governance scores on wages *via* non-tradeable prices, in general, and more strongly for urban wages and in the service sector. Again, these results were stronger in the LIC and LMIC subsample (in LMICs the WGI-elasticity of urban wages is -0.379). In agriculture there was no significant impact of non-tradeables on wages – which is what we would expect if agricultural workers produce a lot of their own services.

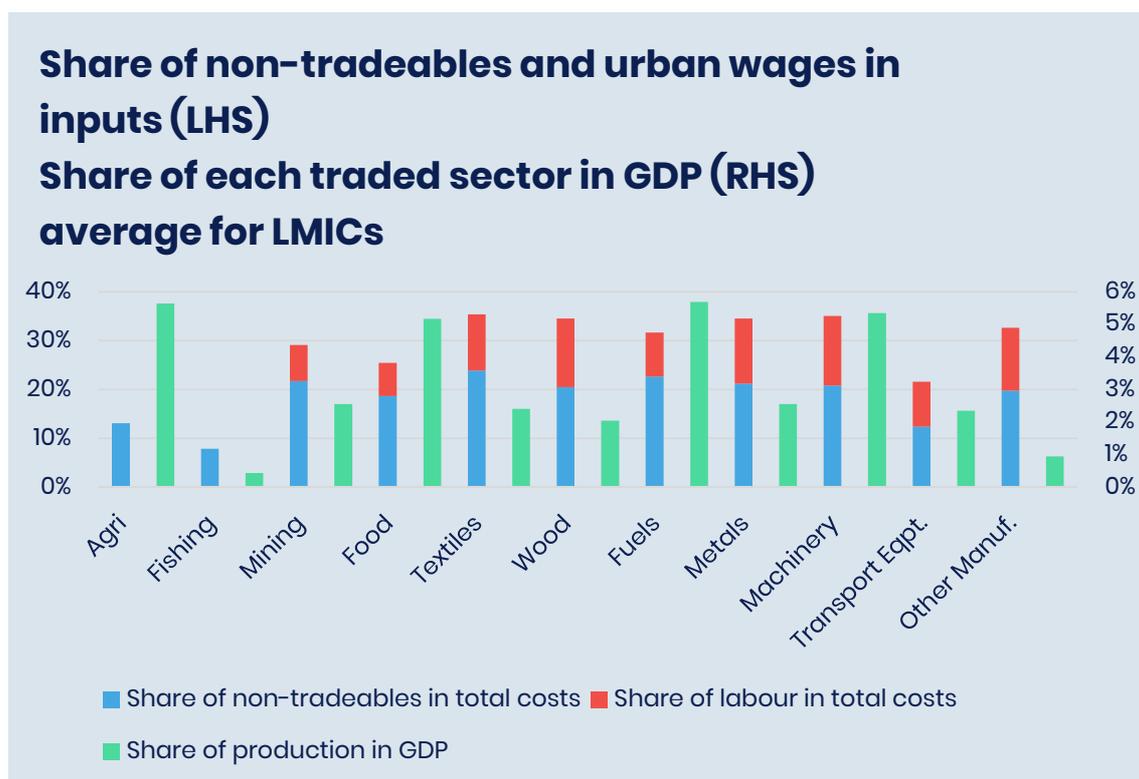
...consistent with the hypothesis that extractive institutions push up the costs of non-tradeable goods and of urban labour.

Analysis shows that worse governance indicators (more extractive institutions) go along with higher urban wages, rather than otherwise. This is a correlation not a proven impact. However, it is also an estimate of the significance and magnitude of an effect we expect to see based on other evidence: costly non-tradeable services and consumer goods will push up the basic urban wage in LICs with substantial semi-subsistence rural populations.

OPM analysis of input-output data shows that non-tradeables and labour count for a substantial share of production costs in tradeable sectors, including manufacturing...

Technical Annex A5 describes more detail. Figure 5 shows the share of non-tradeable inputs, and also labour, in the production costs of traded sectors in LMICs. Non-tradeable services account for 15%–25% of costs in all tradeable sectors, except for agriculture, fishing and transport equipment, in LICs. Employment (wages) count for 8%–17% of costs in all tradeable sectors. Clearly, in agriculture and fishing these are not urban wages. For most tradeable sectors, urban wages and non-tradeable inputs are 20%–35% of total costs.

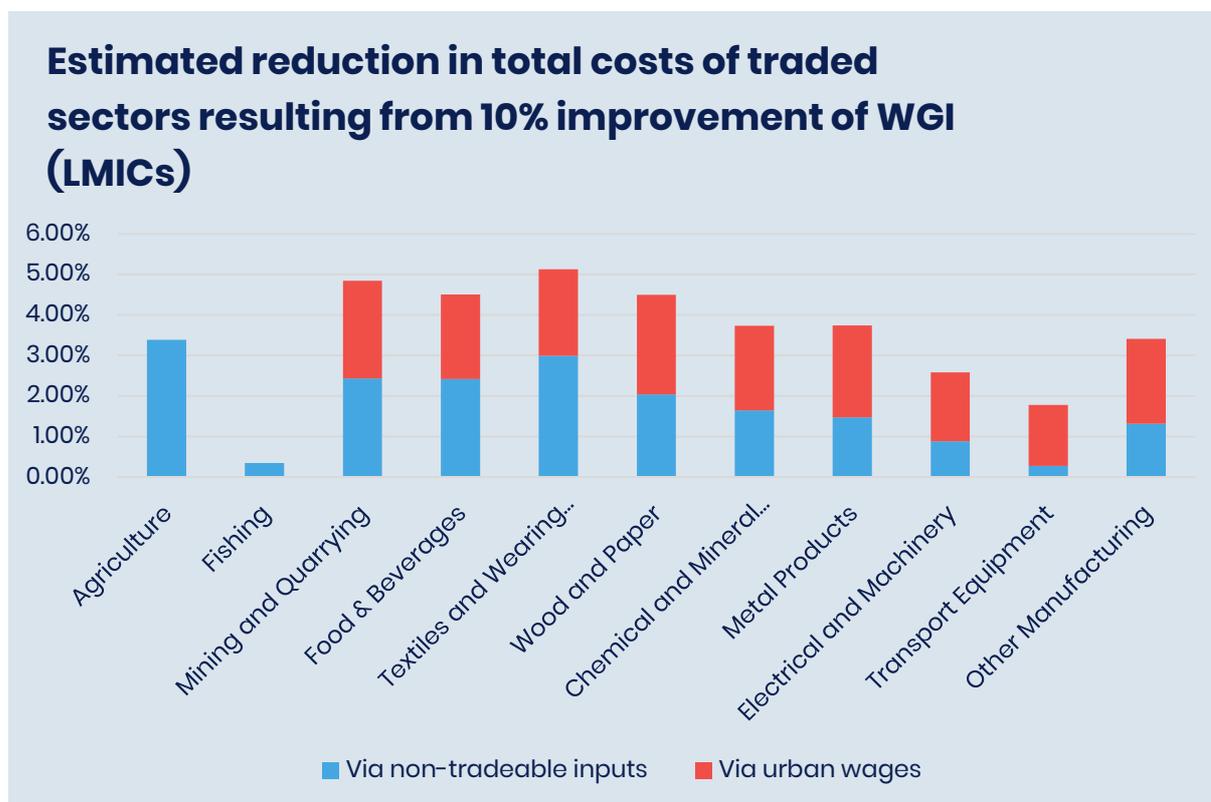
Figure 5



This means the magnitudes of impacts of non-tradeable sector distortions on non-tradeable costs and urban wages are sufficient to have a significant impact on the costs and competitiveness of traded sector enterprises.

If non-tradeable inputs and urban labour make up 20%–35% of costs in most traded sectors, clearly anything that impacts significantly on non-tradeable prices and urban wages will materially impact the competitiveness of those sectors. In technical Annexes A3 and A4 we estimated, respectively, the institutions-elasticity of non-tradeable prices and of urban wages. Figure 6 shows the estimated impact of a 10% improvement in the institutional score in terms of reductions in total input costs for the various traded sectors. For most sectors there is a 3%–5% reduction. Exceptions are fishing and transport equipment, which seem to have very low levels of non-tradeable inputs.

Figure 6



This reinforces the point that it might be perilous to ignore distortions to non-tradeable sectors in pursuit of competitiveness in exports – highly distorted non-tradeable sectors have a big impact on traded sector competitiveness.

Figure 6 shows the estimated cost reductions from a 10% improvement in WGI scores. In fact, the average WGI score in LICs is -2.1, whereas the average in LMICs is -1.04. On these estimates that sort of reduction in extractive institutions could produce a 25% reduction in total production costs in many traded sectors, just *via* the non-tradeable sector – easily enough to be the difference between being a low-cost platform for investment and not being one.

Implications for policy: don't ignore non-tradeables in the pursuit of inclusive growth

This note has presented evidence for the following five conclusions.

- i. In modern times, structural transformation is about a shift of workers from traditional agriculture to services, and non-tradeable services are the engine of inclusive growth in transforming economies, even if the engine of output growth is exports.*
- ii. A non-tradeable sector with serious supply-side problems will attract less investment, so even if there is export-led growth, overall growth will be slower and less inclusive, with lower real wages, if the non-tradeable sector is significantly distorted.*
- iii. Non-tradeable sectors are very susceptible to distortions from extractive institutions.*
- iv. Non-tradeables are major inputs for traded industries so distorted costs directly undermine competitiveness.*
- v. Distorted costs for non-tradeable prices can push up urban wages, which could also undermine the competitiveness of tradeable goods.*

The last two points are about general equilibrium effects: an industrial policy that ignores these effects and focuses only on the direct problems of export-oriented sectors may be sub-optimal, and might make growth slower and/or less inclusive.

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