SPECIAL PROJECTS

Can Latin America Escape the Middle Income Trap? Lessons from a Trans-Regional Comparison

by Eva Paus | Mount Holyoke College MA | Project leader | epaus@mtholyoke.edu

In the fall of 2009, we received a Mellon-LASA grant to explore policy solutions for overcoming the middle income trap. Our working group met several times, and we presented preliminary findings at the LASA meetings in Toronto (fall 2010), at a conference in Costa Rica organized by José Cordero from the University of Costa Rica (spring 2011) and at the SASE meetings in Madrid (summer 2011). The final results of the project will be published in *Studies in Comparative International Development* this summer. The forthcoming special issue includes an introductory article that lays out the common analytical framework and summarizes the main results (Eva Paus, Mount Holyoke College), and five articles with individual country studies: Chile (Esteban Pérez Caldentey, ECLAC); the Dominican Republic (Diego Sanchez-Ancochea, Oxford University); Jordan (Luis Abugattas Majluf, international consultant); Ireland (Eva Paus); and Singapore (Penelope Prime, Mercer University). Below is a brief summary of the project and some of the main findings.

The high road to economic development involves a process of structural changein which production shifts increasingly towards activities with greater value added and knowledge-intensity. The failure of Washington Consensus policies to engender such structural transformation has become more apparent in recent years, as international competition has intensified and China has become a strong competitor in low as well as high-tech goods. Middle income countries find themselves between a rock and a hard place. On the one hand, they have not made headway in catching up with the high-income countries of the OECD, with a persisting income gap of more than 80 percent. On the other hand, they have lost ground vis-à-vis China at an astonishing rate. In 1980, their average GDP percapitawas seven times higher than that of China; by 2010, it had fallen below that of China (see accompanying chart).

Producers in Latin American countries increasingly find that they can no longer compete with producers in low wage countries in the export of standardized products, but that they have not developed the capabilities to compete, on a broad basis, in the exports of skill and knowledge-intensive goods and services. Middle income countries in Latin America and elsewhere now run the risk of being trapped, of being pushed onto the low road of change, where declining wages, not rising productivity, form the basis for competitiveness and growth.

To understand better how countries can achieve broad-based upgrading to confront the middle income trap, we developed an analytical framework that links the macroeconomic context with microeconomic behavior and mesoeconomic conditions. This capabilities-based approach advances the theoretical debate by merging structuralist, evolutionary and global value chain analysis. It deliberately shifts the focus from growth to upgrading, and thus to learning processes, policy interventions, and the interactions among social and firm-level capabilities in the context of path dependency and location and time-specific contingencies.

The country studies use the capabilities-based approach to analyze upgrading processes and outcomes in five small latecomers. We focused on small countries because most middle income countries are small and do not have the advantages of internal market size and bargaining power of large latecomers like Brazil, India, and China, and thus tend to be more open to trade and investment. We chose countries that narrowed the income gap with high-income countries under a liberal foreign trade and investment regime and have been considered success stories in their own regions, and sometimes beyond. Finally, we chose countries from different parts of the world to explore the importance of location and time in a comparison of upgrading experiences.

Each author examines the nature of structural change and productivity growth in one of the five countries. We analyze how the development and interaction of social and firm level capabilities, the nature of foreign direct investment (FDI), the role and impact of different government policies, and location and time-specificity account for the particular upgrading outcomes of the countries. Due to space constraints I limit the discussion of the project results to three lessons.

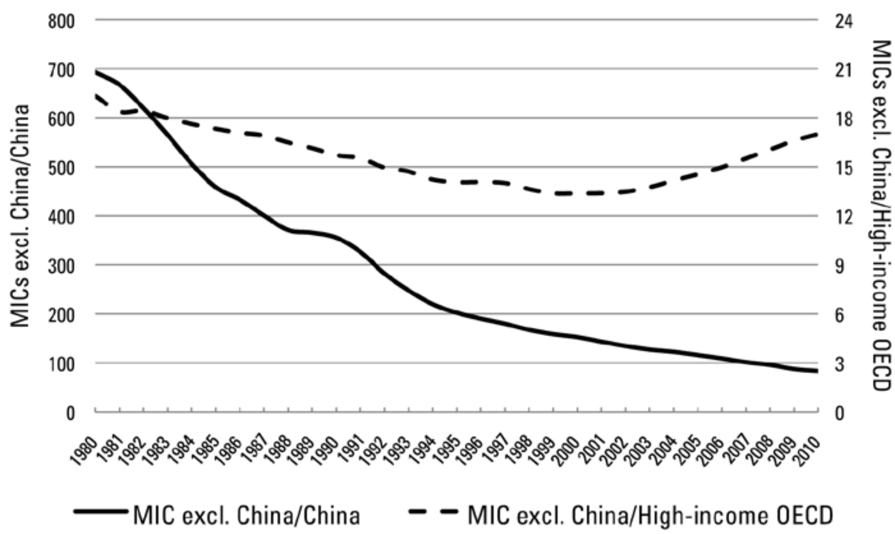
First, the case studies show that income convergence does not necessarily imply capability convergence and broad-based upgrading. In at least three of the cases, an assessment of development success based on growth differs considerably from an assessment based on capability advancement. Second, the country studies demonstrate that strategic, proactive and coherent government policies for the advancement of social and firm-level capabilities are a critical determinant of upgrading, both at the country level and in the development of "pockets of excellence." Thus, the project makes an important contribution to the ongoing discussion about the role of industrial policies in addressing pro-growth structural change and broad-based upgrading.

Third, the trans-regional comparison demonstrates the peril of neglecting the development of local firm capabilities Small countries are more prone to rely on FDI for upgrading. Indeed, in all five countries, governments envisioned FDI to play a key role in the country's development. But the case studies demonstrate that production by Transnational Corporation (TNC) affiliates in the host country does not automatically contribute to increasing local firm capabilities, and that, in the context of changing national and global conditions, reallocation ofTNC production may be more likely than upgrading of TNC production in the host country.

The comparative case studies suggest that the best shot at an escape from the middle income trap is a shift in the analytical focus from growth to capability-accumulation and a shift in the policy focus from the current faith in a market-led process of upgrading to an embrace of a proactive state to support the synergistic advancement of social and firm-level capabilities. Effective states may be hard to build, but they have become essential in the current process of China-dominated globalization.

GDP p.c. of Middle Income Countries excl. China
Relative to China and to High-Income OECD

(constant 2005 PPP)



Source: Calculations based on World Development Indicators.