When you read the pro-regime media, you will get the impression either that the economic situation is great or that we will get better very soon because we have had high rates of economic growth for years. However, high rates of economic growth are not a general rule, and if we record them today, it does not necessarily mean that it will be the same tomorrow. One of the reasons for such a thing is the phenomenon that is defined as a middle income trap.

About 20 years ago, it was realized that there are a number of countries that after the Second World War managed to rise from low-income to middle-income levels (measured in relation to developed countries). But only a handful of them managed to climb even higher after that and reach a high level of income.

Of the 101 middle-income countries in 1960, only 13 managed to reach the high-income group by 2008. This phenomenon that a large number of countries cannot break above the limit of the mentioned level of development, but when it reaches it, is a middle-income trap. The transition to the category of high-income countries is hampered by barriers that many countries do not recognize at all. What is the main challenge with these barriers, the middle-income trap?

Lack of technological change as one of the reasons for the interruption of progress

At a lower level of income, economic growth occurs primarily through physical investments that use underutilized resources and that increase productivity by applying existing technology. Electrification and the use of electricity and appliances in industrial production after the Second World War in the Yugoslav economy is such an example of the use of existing technologies.

In these phases of economic growth, development can be very fast because there are large resources that are not used: productivity increases significantly when the masses of workers from primarily natural agricultural production move to work in factories, so during those years there is high economic growth.

The problem, however, arises when the workforce is exhausted, in other words when the villages are emptied and there is no one to come to work anymore. Reducing labor supply raises wages and old labor-intensive industries are no longer profitable, so their further development is halted. If the conditions for the development of other new industries are not created, the economy remains stuck at a given level. Economic growth rates are declining and becoming several times lower than before.

In contrast, high-income countries already use the best available technologies in production. Their development is based on technological changes and innovations. Of course, it is much harder to find new technologies instead of applying those that are already developed and used, so the growth rates in developed countries are generally low, much lower than in low- and middle-income countries.

Is Serbia approaching the middle-income trap?

The slowdown in economic growth due to the middle income trap does not come all at once, but it is a gradual process – therefore, there is no situation in which one year we have a high rate of economic growth, and the next it is low. Instead, growth rates are gradually declining. From the initial ones, for example, 5% go down to 4%, 3% and lower. This does not mean that the economy will not be able to continue to develop, but it will stop catching up with developed countries because they will continue to develop, even at slower rates.
Empirical research (Eichengreen, Park, Shin, 2011) shows that the effects of the middle-income trap are beginning to be seen in countries with an industrial employment share of 23%, or in countries with income levels above $ 16,700 in the 2005 PPP. If this is taken as a relevant threshold, it turns out that we are one step closer to entering this problem: the number of employees in the manufacturing industry in Serbia in 2020 was 476,000, which is 22% of the total number of employees in the country; and we cross this threshold if we include in this number the employees in the mining and electricity production sector, which are branches closely related to industry. Also, during 2020, GDP per capita was about $ 14,000 in international dollars from 2005, which is quite close to the second threshold. In other words, we have not yet entered this trap, but it seems that we have come quite close to it and that this will be a problem for us very soon.
What can we do?
Unfortunately, there is no easy and universal recipe here that we can apply quickly and solve the upcoming problems with it. Although much reliance is placed on the existence of industrial policy as a mechanism that can help in this, by encouraging industries that have a comparative advantage in various instruments such as tax breaks or subsidies (from hard instruments), or creating technology clusters and scientific research parks (one of the soft instruments of this policy), there are a lot of problems here.
The first is that the state administration has rarely proven to be someone who can identify such propulsive industries and then help them in an adequate way. For each example of Japan, Korea and Taiwan, which are considered to have successful industrial policies, there are identical examples of countries that have gone into economic ruin with this policy, from Argentina, Brazil, South Africa to India, but also countries that have managed to develop without the application of industrial policies, such as Hong Kong or Singapore.
Also, there are disputes among the proponents of industrial policy whether it should deal only with industries in which there are discovered comparative advantages or should go beyond that, to discover new branches in which such advantages are yet to appear.
Therefore, industrial policy may or may not help to overcome this problem. What else is available to us? An empirical study (Lee, 2018) explains that these are the factors that have a great impact on the emergence of high rates of economic growth, namely: demographic structure, human capital, level of investment, international trade and quality of institutions. And these are all areas in which Serbia unfortunately stands badly. As far as institutions are

concerned, we have a very high rate of corruption and it is not separated from the state but an integral part of it; corruption is centralized and it does not depend on the will of the officials who apply it, but on high-ranking civil servants and politicians who are an integral part of such a system and not its aberration.

The capacities of the state administration are rather weak, and employment and later advancement in the system does not depend only on the knowledge, skills and commitment of an individual employee, but also on his informal connections within clientelistic networks. This is accompanied by a low legal order, high business uncertainty because the laws change relatively often, and their application is not consistent.

The level of investment in the country is low, and domestic private investment, which is approximately half the amount in more successful countries in transition, fails the most. In international trade, most of the exports, but also industrial production, are products with a low level of added value, while only about 5% of industrial production in the country are high-tech sectors.

As far as the demographic structure is concerned, low fertility means a reduction in the labor force as the older generations withdraw from the labor market and the new generations join it. This was due to the high rate of emigration, mostly of young people, which further accelerates these processes. Human capital in Serbia is another problem – although the number of students and graduates in the younger generations is close to the average of CEE countries in the EU, an important issue is the quality of study programs and their connection with the labor market. Perhaps even more important is the issue of competencies at lower levels of education: almost 40% of students in Serbia cannot reach level II on the PISA test, so they are considered functionally illiterate.

The biggest problem is pushing your head into the sand

Perhaps the biggest obstacle is that these problems have not been recognized for years, but are being pushed under the rug. Great hope is directed towards foreign investments, because they also bring new technologies in addition to capital and new jobs. But most of these investments go to labor-intensive sectors with low added value – and are attracted by subsidies or tax breaks. It is understandable that in countries with low wages, investments will primarily go to labor-intensive activities, but then it is a pretty bad idea to have more such investments that would come on their own and attract in such a way. FDI will dry up at some point: wages will rise so much that it is not worth investing in such sectors more in Serbia, although wages will remain low in Europe.

On the other hand, reforms of the business environment that should encourage new investments in technologically demanding sectors are either not implemented, or are done half-heartedly, insofar as they will not actually disrupt the strength of influential social groups that support the government. Of course, such cosmetic changes, if there are any, will not change things too much.

When you look at the major systemic reforms from 2012 until today, the only ones that stand out are the flexibility of labor legislation, facilitation of the process of issuing construction permits and increasing the availability of electronic services; which is all pretty skinny for almost a decade of governing the current political coalition. With such an approach, it is quite clear that we are ready to expect the middle-income trap just as much as EPS was greeted by snow this winter. Accordingly, our results will be similar to theirs.
Source: talas.rs