

Thailand, a nation caught in the middle-income trap

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Thailand is caught in a middle-income trap of its own creation. How did this come about?

Are current policies making it better or worse, and what needs to be done to escape the trap?

The 'middle-income trap' is an empirical generalisation based mainly on East and Southeast Asian experience: once a country reaches middle-income levels the growth rate often declines and graduation from middle-income to higher-income levels stalls.

During the decade of economic boom ending in 1997 Thailand's average annual growth rate of real GDP per person was a remarkable 8.4 per cent. Like most booms, this one ended badly. It collapsed with the Asian Financial Crisis of 1997-99. Since 2000 the corresponding growth rate has been 4.1 per cent. The immediate culprit was a contraction of private investment, which declined as a proportion of GDP from an average of 30 per cent to 18 per cent over the same two periods. The effect of lower investment was twofold: it reduced aggregate demand, lowering income in the short run; and it reduced the rate of capital formation, lowering long-run growth prospects.

A decline in this investment ratio occurred in all of the crisis-affected Asian economies, including Indonesia, Malaysia, the Philippines and South Korea. The decline in Thailand was one of the largest. The contraction of investment occurred primarily among Thai-owned, rather than foreign-owned, firms. Put simply, after the crisis Thai firms became less confident about their prospects and hence less inclined to invest. An expectation of this kind is self-fulfilling. It reduces investment, which does indeed ensure that growth will be lower.

Beneath these short-term macroeconomic events lies a deeper and longer-term phenomenon. Between the 1960s and 1990s Thailand achieved the transition from a poor, heavily rural backwater to a middle-income, semi-industrialised and globalised economy. The transition was primarily market-driven and the central policy imperative was to avoid those policies that impeded absorption of low-cost labour into export-oriented labour-intensive manufacturing and services. This transition required some elementary market-supporting policy reforms: promoting a stable business environment (not necessarily meaning stable politics); open policies with respect to international trade and foreign investment; and public provision of basic physical infrastructure, including roads, ports, reliable electricity supplies, telecommunications and policing sufficient to protect the physical assets created by business investment.

This transition has now occurred in most of East and Southeast Asia and the pattern was similar in all countries that undertook the basic policy reforms listed above. During this transition average real incomes rose significantly, the share of the workforce employed in agriculture contracted and the incidence of absolute poverty fell.

The core of this growth process is expansion of the physical capital stock, resting overwhelmingly on private investment. The private financial system facilitates the link between private savings and business investment. But the process is self-limiting. As labour moves from low-productivity

agriculture to more rewarding alternatives elsewhere, wages are eventually driven up. As wages rise, the profitability of labour-intensive development declines. As the return to investment in physical capital falls, the rate of private investment slackens and growth slows.

The frontier for further expansion of labour-intensive export-oriented development soon moves to other, lower-wage countries. The result is the dreaded 'middle-income trap'. This describes Thailand and Malaysia today and China in the very near future.

Progress from middle-income to higher-income levels requires a different kind of policy reform, addressing a market failure that the private financial system cannot resolve: the undersupply of human capital. Human capital is a crucial input, created primarily by investment in education, broadly defined. But it differs from physical capital in that it does not provide the collateral that can ensure repayment of loans. Unlike physical assets, human beings can walk away. The private financial system is therefore unable to support investment in human capital. Individual families can and do invest heavily in the education of their own children, but because their resources are limited and because the recipient of the educational investment reaps only part of the returns it generates this is insufficient to prevent the overall underinvestment in human capital.

Increasing the supply of human capital is central to overcoming the middle-income trap. It raises labour productivity directly and raises the return to physical capital, encouraging greater investment in physical capital as well. In Thailand, as in many other middle-income countries, the problem lies in the quality of education and not just the bare numbers of total school enrolments. And the problem is primarily not at the tertiary level but at the primary and secondary levels. Massive public investment and reform of the education curriculum is needed to redress these problems, requiring the raising of sufficient tax revenue to finance it and combating the backward and self-serving practices of the ministry of Education and the teachers' unions. These are formidable obstacles.

During Thailand's boom almost everyone gained, including the poor, though not all at the same rate. Economic expectations rose, even among groups like lower-income rural people, who previously benefited only marginally from economic growth. But when the boom collapsed in July 1997, the new opportunities vanished and the newly-expanded expectations were crushed. A sense of economic and political injustice, latent for decades, then became more acute. For large numbers of people redistributive politics then became more appealing as a focus for their anger and as a vehicle for collective economic advancement. Opportunities arose for political entrepreneurs who could mobilise the frustration and use it to capture power.

Enter Thaksin Shinawatra. He had made a fortune by exploiting government-granted concessions in the telecommunications industry and had been a deputy prime minister under two conservative governments in the 1990s. But around the year 2000 Thaksin saw the political opportunity created by the frustrated expectations of many low- and middle-income people, especially those in the predominantly rural north and northeast regions. He articulated the discontent felt by these people and offered hope. According to his new rhetoric, Thailand's problem was not a flawed macroeconomic strategy that had strangled growth, but injustice inflicted on 'the people' by their fellow Thais, 'the elite'. Thaksin would look after them. This was standard Latin American-style populism and it worked. Thaksin's new party won an unprecedented election victory in 2001 and repeated the achievement in 2005.

What is wrong with that? At one level, it is simply democracy in action. But a problem remains, in that Thaksin's populism fails to address the sources of the middle-income trap and distracts attention from it. The policy platform successfully taken to the 2011 elections by the Pheu Thai Party, led by Thaksin's sister and in absentia by Thaksin himself, illustrates this point. There were two economic components: capital-intensive mega-projects and redistributive initiatives, each

designed to attract new sources of political support.

Each of the mega-projects appealed to a significant segment of the population and, like all large construction projects in Thailand, offered the prospect of huge kickbacks for politicians, bureaucrats and others. The redistributive initiatives were similarly designed to appeal to specifically targeted groups. They included a three- to five-year debt moratorium for people owing 500,000 to 1 million baht; a 10 million baht minimum revenue guarantee for local administrative organisations; a farmers' credit card project, backed by the government; a 15,000 baht per month minimum salary guarantee for bachelor's degree graduates; a 1 billion baht education fund for state and private universities; a tax-cut for first-home buyers and another for first-car buyers; free wi-fi in public areas; a guaranteed price of 15,000 baht per tonne for unmilled rice; and an increase in the minimum wage to 300 baht per day.

Aside from the problem of paying for these initiatives, the important point is what the policy did not contain: anything about reforming Thailand's antiquated systems of primary and secondary education, the single greatest impediment to long-term economic progress in the country; anything else about raising the long-term productivity of Thailand's masses of unskilled and semi-skilled workers; anything about reforming the country's regressive and inadequate tax system; or anything about reducing corruption.

Thailand's version of economic populism wastes public revenue, feeds corruption, ignores the sources of long-term improvements in human productivity and diverts attention from them. Until this changes the jaws of the middle-income trap will surely remain closed.

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P.S.

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