

THE POLITICAL ECONOMY OF MIDDLE-INCOME TRAPS: IS SOUTH AFRICA IN A LONG-RUN GROWTH TRAP? THE PATH TO “BOUNDED POPULISM”

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Abstract

The current literature on middle-income traps has been dominated by economists who have relied on economic explanations mainly around stages of development and the structural transformation of economies. But there is an equally vigorous literature from political science which speaks to the political economy of transitions. We look at the dynamics of how economic modernisation triggers structural changes with winners and losers and how this is reflected in the polarisation of the political sphere amongst middle-income countries. This paper asks the question of whether South Africa is an archetypical example of a country stuck in a trap and how this has affected the policy choices that it has made. South Africa needs to move up the value chain with a viable value proposition, and this requires a very different policy set and human capital plan.

JEL Classification: O10, O40, P48

Keywords: Middle-income traps, emerging markets, South Africa, long-run growth

1. INTRODUCTION

The past decade has seen the proliferation of research attempting to explain middle-income traps (MITs) both conceptually and empirically. This work exists alongside an even larger body of papers which suggests a changing geo-economic momentum with middle-income countries (MICs) becoming future engines of economic growth. Various scenarios have been modelled to illustrate what the future composition of world gross domestic product (GDP) will look like and almost all of these capture a very different world order with today's MICs soaring up GDP rankings. How do we reconcile these diverging narratives? It is of course possible for both of these to be realised. The momentum being experienced by today's emerging markets may push them into the top echelons of size while future growth slowdowns may prevent them from reaching the high-income per capita range. This implies that while they may see significant changes in GDP that the GDP per capita may still find it hard to transcend the range implied by the traps. The current literature on MITs has been dominated by economists who have relied on economic explanations mainly

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around stages of development and the structural transformation of economies. But there is an equally robust literature from the other social sciences, particularly political science, which does not necessarily use the same nomenclature but nonetheless speaks to it in a language of the political economy of transitions. This is appropriate because a characteristic of MICs, which is often underplayed, is the fact that a large proportion of them have been undergoing simultaneous political and economic transitions and liberalisation. In very broad terms (with exceptions), we saw the start of these transitions in East Asia and Latin America in the mid-1980s and early-1990s, in Eastern Europe with the fall of the Berlin wall in 1989, in parts of South East Asia and Sub-Saharan Africa in the 1990s and 2000s, and then more recently in North Africa with the tumultuous Arab Spring uprisings. These transitions are in various states of consolidation and stable systems are yet to arise in some of these cases.

Surprisingly, relative to other emerging markets, we have seen very little analysis addressing the issue of whether South Africa's anaemic economic performance (which stretches back to the mid-1970s with a few exceptional outlining years) can be explained within the parameters of the MIT literature. This paper asks the question of whether South Africa is, in fact, an archetypical example of a country stuck in a MIT. What can South Africa learn from other countries marooned in these zones of stagnation? How does this work affect our understanding of the long-term phases of economic stagnation in South Africa, and what are the policy implications which arise? It adopts a comparative political economy perspective and positions the South African experience within that middle-income literature.

2. AN ECONOMIST'S PERSPECTIVE ON MIDDLE-INCOME TRAPS

MICs, by definition, are countries in transition between low and high-income status. As of July 2014, the World Bank's analytical classification of the world's economies based on estimates of gross national income (GNI) per capita is as follows: low-income economies are defined as those with a GNI per capita, calculated using the World Bank Atlas method, of \$1,045 or less; middle-income economies are those with a GNI per capita of more than \$1,045 but less than \$12,746; high-income economies are those with a GNI per capita of \$12,746 or more. Lower middle-income and upper-middle-income economies are separated at a GNI per capita of \$4,125. Using this classification, 79 countries qualify as high income, 102 as middle income and 34 as low income. Within the middle income group, it is equally split at 51 each within the upper and lower middle categories.

MITs refer to the experience of countries which achieved high economic growth rates in the past but which have become marooned in this middle-income zone that has seen their growth rates decline and them struggle to transition to high income status. Eichengreen *et al.* (2013:2) analyse the incidence of growth slowdowns in fast-growing MICs, and find dispersion in the per capita income at which slowdowns occur. They find two modes, one in the \$10,000-\$11,000 range and another at \$15,000-\$16,000 in 2005 purchasing power parity dollars. At these points, the growth rate of GDP per capita slows from 5.6% to 2.1%. They argue these growth slowdowns are essentially productivity growth slowdowns – with a drop in total factor productivity growth accounting for about 85% of the absolute reduction in the growth rate (Agenor and Canuto, 2012:5-6). Felipe *et al.* (2012:45) argue that a country is in an MIT if it has been longer in the middle-income group than other countries have on average. They calculate

this to be “more than 28 years in the lower-middle-income group and more than 14 years in the upper-middle-income group. These imply that a country that becomes lower-middle-income has to attain an average growth rate of at least 4.7 percent to avoid falling into the lower-MIT and that a country that becomes upper-middle-income has to attain an average growth rate of at least 3.5 percent to avoid falling into the upper-MIT.” Using these parameters they find that 35 out of the 52 MICs in 2010 were in the MIT. By region, 13 are in Latin America, 11 are in the Middle East and North Africa, six are in Sub-Saharan Africa, and three are in Asia. South Africa finds itself squarely in this category. Van der Hout (2014) calculates how long it would take upper middle income countries (UMICs) to graduate to high income (HIC) status and finds that it would take South Africa 28 years if it maintains the per capita growth rate of 2.52% per annum which it did in the latter half of the Mbeki years – certainly not currently in sight with per capita GDP growth languishing at close to 0% in recent years.

The large number of countries in MITs suggests that there is something structural about the nature of MICs which results in them becoming marooned in this zone. They are able to generate high growth to transition into middle-income status but then are unable to jump to the next phase. There is the now infamous statement attributed to Charles de Gaulle about Brazil when he stated that “Brazil is the country of the future . . . and always will be.” This comment may well ring true for many currently much vaunted emerging markets that may find themselves in the process of “emerging” well beyond what might be considered a reasonable time period to transition into high income adulthood.

Alternative explanations have been proposed as to why MITs arise. But the basic idea is that they find themselves struggling to compete with the low wages of low-income countries and the technological aptitude of advanced countries. Because wages and incomes have risen in MICs, they are increasingly unable to compete in lower skilled, labour-intensive activities but have not acquired enough human capital (and perhaps physical capital) or the necessary national innovation systems to compete with HICs in more sophisticated products (Im and Rosenblatt, 2013:2). They are therefore squeezed from below and above and find themselves increasingly with less economic space to perform. The result is the increasing deindustrialisation of MICs and a growth slowdown as countries are unable to transition to higher value activities. Kharas and Kohli (2011) state that moving up the value chain requires three fundamental transitions: “(i) from diversification to specialisation, in moving away from only producing a wide range of mass products that require little skill, technology and know-how; (ii) from the physical accumulation of factors to raise overall productivity to productivity-led growth; and (iii) from centralised to decentralised economic management, so that government and institutions can respond faster to new information” (Van der Hout, 2014:7).

Understanding this phenomenon requires us to go back to early development economists who spoke about the structural changes which economies need to go through to progress. They maintained that the problem facing Third World countries lay in the apparent vicious circle they found themselves in, whereby underdevelopment perpetuated itself. Chenery *et al.* (1986), Rostow (1959) and Kuznets (1971) all saw the development taking place in phases and entailing structural changes to the economy. Kuznets (1971:243) wrote about a stage theory of long-term development which implied “distinct time segments, characterised by different sources and patterns of economic changes.” The focus of these early development economists on structural changes and phases of

economic development have direct bearing on our analysis on MITs. This literature suggests that these countries have become stuck in a trap and are struggling to adapt to the demands of the next phase which requires new institutions and new sources of competitive advantage. A more recent strand of literature by Hausmann and Klinger (2006), Hidalgo and Hausmann (2009), and Felipe *et al.* (2012) build on this and identify the structural transformations and patterns of comparative advantage in the context of a country's product space and we examine this further in the South African case below. Tying this up with the MIT literature, one could argue that these traps are a function of the inability of countries to successfully manoeuvre through the complex product value chains necessitated by changing patterns of development and new competitive pressures.

3. A POLITICAL ECONOMY PERSPECTIVE ON TRANSITIONS AND MIDDLE-INCOME TRAPS: A MORE DYNAMIC APPROACH

The political science literature comes at this discussion from a different angle. The focus here is less on structural changes within an economy as it develops and more on the political consequences and drivers of economic processes. Modernisation theory emerged in the 1950s as the dominant school of thought on political development until the early 1970s. This theory derived from the evolutionary ideas of Darwin and Spencer, whereby it postulated a form of Social Darwinism in which societies, much like their biological equivalents, went through stages of birth, maturation and decay (Bauzon, 1992:36). The modernisation theory was subsequently refined and entrenched through the works of Rostow, Lerner, Deutsch and Lipset.

The theory's basic tenet is that an overall economic expansion (measured in GNP per capita, the degree of industrialisation and urbanisation and level of education) would lead to the complete transformation of society which, in turn, would give rise to modern political institutions and a democratic dispensation. It was believed that a general social mobilisation would ensue, which Deutsch (1961:78) defined as "the process in which major clusters of old social, economic, and psychological commitments are eroded or broken and people become available for new patterns of socialization and behaviour . . . away from a life of isolation, traditionalism and political apathy, and . . . into a different life of broader and deeper involvement in the vast complexities of modern life, including potential and actual involvement in mass politics." In other words, it was expected that socio-economic progress would promote educational attainment, which would further understanding of political issues and increase expectations for political participation and civil liberties. Increasing prosperity would also lead to the expansion and mobilisation of the working class. All these factors would culminate in a revolt against the political status quo controlled by the traditional elites, in favour of competition for political power and the development of more modern sets of institutions. While Deutsch did not specify the form of this relationship, it would appear from his work that he regarded political modernisation as a linear positive function of economic growth. History, however, does not vindicate such a linear correlation. Neubauer (1967:1007) refined this theory by arguing that democratic political development may be a "threshold phenomenon":

Certain levels of 'basic' socio-economic development appear to be necessary to elevate countries to a level at which they begin to support complex, nationwide patterns of political interaction, one of which may be

democracy. Once above this threshold, however, the degree to which a country will 'maximise' certain forms of democratic performance is no longer a function of continued socio-economic development.

Arat (1991) argues that developing countries do not display a linear relationship between democracy and development, but instead more complex patterns exist. Historically, most MICs experienced higher levels of instability, and saw a continuous back-and-forth shift on the scale of democracy. In this zone of transition, it appears as if socio-political factors supersede economic influences, and the position of the modernisation school, whereby economic progress would automatically activate other positive social and institutional changes, is not guaranteed. These disruptions may trigger pressure for reform but the outcome is by no means guaranteed.

This literature on the relationship between economic and political outcomes has a direct bearing on the analysis of MITs. It proposes that economic progress may elicit socio-political change; and that political systems themselves have consequences for overall stability and the capacity of countries to grow economically. Given that MICs are moving between low and high-income status, they are especially appropriate as a unit of analysis. It is then of little surprise to witness the ongoing political and economic travails of this group and the fact that so many appear to find themselves marooned in this zone of transition.

Samuel Huntington (1970:319) argues very strongly against the tenets of modernisation. He maintains that: "It is not the absence of modernity but the efforts to achieve it which produce political disorder. If poor countries appear to be unstable, it is not because they are poor, but because they are trying to become rich." He suggests that the poorest nations tend to be less prone to violence and instability than those countries just above them, but that wealthy countries tend to be the most stable. In other words, you either want to be poor and content in a low-level equilibrium, or rich and content in a high-level equilibrium. But trying to move between these two equilibria triggers processes of social mobilisation which can result in political and economic extremism. This ties in with our MIT literature as it suggests that countries between low and high-income status are subject to extraordinary pressures of social and institutional change which result in high-levels of volatility – the outcome of which is uncertain. Fukuyama (2014:7, 531) relates Huntington's thesis to the case of emerging markets (our MICs) and says that the problem that many face is one of social change outstripping existing institutions. As economies grow, different social structures emerge and new technologies disrupt the status quo. How institutions are able to accommodate these new actors influences the ability of a country to transition from low income (LIC) to HIC status. Where institutions are unable to accommodate the new scenario, it can lead to either political decay or a stable system of clientelism and elite coalitions built around the distribution of rents. Politics then centre on state capture and zero-sum games over rent distribution rather than productive activities.

Mancur Olson (1982:75) writing on the complexities of collective action and how this affects bargaining by interest groups especially during periods in which new orders are attempted says that new institutional frameworks are difficult to establish: "The interest of organisational leaders insures that few organizations for collective action in stable societies will dissolve, so these societies accumulate special interest organizations and collusions over time. . . . These organizations . . . have little incentive to make their societies more productive, but they have powerful incentives to seek a larger share of the

national income even when this greatly reduces social output. . . . The barriers to entry established by these distributional coalitions and their slowness in making decisions and mutually efficient bargains reduces an economy's dynamism and rate of growth." There is therefore no guarantee that good institutions drive out the bad in an automatic, evolutionary process through modernisation. At these critical dislocative junctures there is a need to leap (a big push – a critical effort) beyond evolutionary dynamics. In recent history, we have seen only a few MICs make this leap to a new equilibrium state. Often, this leap itself is a function of some form of massive social upheaval. Charles Tilly makes the point concerning Europe and why it was the first to industrialise when he wrote: "War made the state and the state made the war." Or Thomas Jefferson's once observed that "the tree of liberty must be refreshed from time to time with the blood of patriots and tyrants" (quoted in Olson, 1982:141). Extreme violence is not the only way and the four countries which have in recent years escaped the MIT did so without a revolution (South Korea, Taiwan, Hong Kong and Singapore). Their authoritarian states were able to manoeuvre and accommodate a new political dispensation but which built on the existing economic model. The reason for this is that they were able to gain legitimacy by continuing to generate high levels of economic growth. For MICs facing slowdowns there is the prospect of aspirations running ahead of capability and generating high volatility. Another important characteristic of our four successes is that they all had relatively equitable income and wealth distributions at the outset of their take-off phase which allowed for a focus on economic growth.

How is the pressure for distribution affected by economic and political systems and how is this related to MICs? Huntington (1970:326) states that "some measure of economic development is necessary to provide the means for instability." It is this economic dynamic which triggers the effects of instability. In MICs with high levels of inequality, there are questions about the appropriate level of redistribution, and this creates tensions between those who are net contributors to state revenue and those who are the recipients of public goods, between those who are in favour of the status quo (the current insiders) and those who call for radical change (the outsiders) and between macroeconomic conservatism and macroeconomic populism. Economic growth brings these challenges to the fore as it highlights the winners and losers as a result of this structural change. As societies change, so politicians also redirect their political positioning so as to capture the emerging median voter.

Benhabib and Przeworski (2006:271) raise the possibility that if redistribution is insufficient for the poor or excessive for the rich, they may turn against democracy. Thus, if no redistribution simultaneously satisfies both groups then democracy cannot be sustained. They find that democracies survive in wealthy societies but in poor, unequal societies there exist no redistribution which would be acceptable to both the poor and wealthy. We see this polarisation in politics and economic policy in various MICs. In Thailand, the uprisings of the recent past have partly been a function of this. But as the capital stock grows, beyond a certain threshold, the wealthy tolerate more and the poor less redistribution so that the feasible redistribution options become larger: "Since the median voter prefer one such scheme to the dictatorship of either group, democracy survives."

What this all points to is the importance of the interplay between the political and economic dimensions which are always at play but where the consequences are particularly pivotal as countries transition from one stage to another. Thus, trying to

untangle the causes and consequences of MITs necessitates a closer examination of the underlying processes of social mobilisation and how this connects with existing institutions. We return to this theme at the end of the paper.

4. SOUTH AFRICA: IN A MIDDLE INCOME TRAP?

4.1 South Africa's Long-Run Growth Performance

South Africa's growth underperformance is not only a recent phenomenon and even during the country's high growth era, its performance relative to other comparable countries had been lacklustre and uneven. Using the Maddison data set we examine per capita GDP for various countries starting in 1700 (or the most recent year for which data exist) (Fig. 1). The South African data prior to 1910 is based upon the Cape Colony data and is incomplete but nonetheless provides us with some indication of the trends. It becomes more consistent from 1850 onwards. A snapshot in 1870 shows the Cape Colony's GDP per capita (1990 Int. GK\$) at \$807, Chile at \$129, South Korea at \$337, Thailand \$608, Malaysia at \$663, Brazil at \$713, Sweden at \$1345, Argentina \$1468, USA at \$2445, England at \$3190 and Australia at \$3273. Over the next 140-year time period, we see South Africa's GDP per capita underperform relative to our entire sample – lower than the Latin American countries although they underperform too given the relatively low base that they commence with, and sharply less than the Asian countries. The industrialised world starts to pull away from the rest during the nineteenth century, and the Asian economies do so from the 1960s. While South Africa is firmly in the middle of the pack in 1870 with five countries in our sample with lower per capita GDPs, by 2010 it stands alone at the bottom.

We can explore this further by examining different phases of this performance (Fig. 2). It shows that South Africa has experienced relative decline vis-a-vis our sample over a protracted period (not just since the mid-1970s). If we focus only on South Africa and

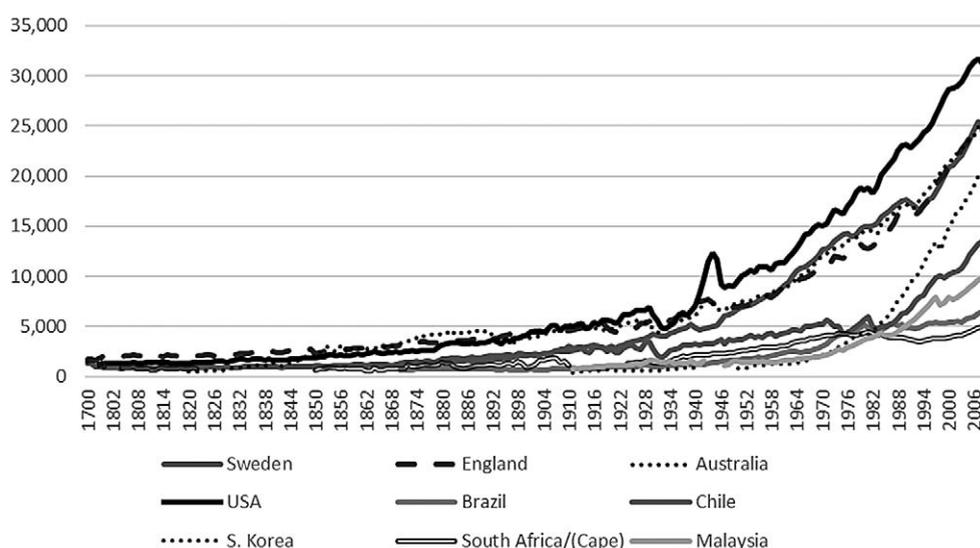


Figure 1. Per capita GDP for various countries from 1700 till 2010 (in 1990 Int. GK\$)
Source: Maddison data.

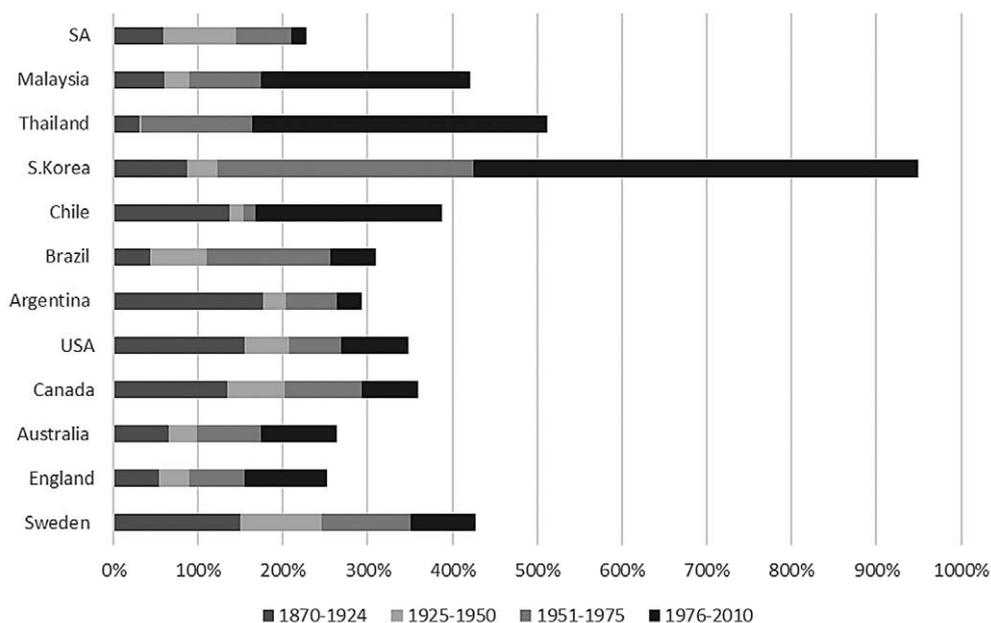


Figure 2. Percentage growth in per capita GDP for selected countries, 1870-2010

Source: Own calculations from Maddison data.

Brazil, an interesting picture emerges during the course of the twentieth century and beyond. South Africa outperforms Brazil through until the end of World War II but then starts the process of relative slowdown. Even during South Africa's high-growth phase of the 1950s and 1960s, South Africa actually underperforms, and this is a point that has been made previously by others including Moll (1991). For example, South Africa's GDP per capita increases cumulatively by 65% between 1951 and 1975, while Brazil's increases by 146% over the same time period. South Africa's growth rate then plummets in the 1970s and 1980s, only to begin the recovery in the 1990s, and we see GDP per capita rising by 19% between 1976 and 2010, while in Brazil (which also undergoes a significant political and economic transition during this time), it rises by 54% (even Argentina outperforms South Africa).

We can slice and dice the numbers in many different ways but the picture which emerges continues to be the same. Fig. 3 illustrates per capita GDP of Latin American and Asian countries and South Africa relative to the USA (in 1990 Int. GK\$) from 1924. For Latin America, the story is one of relative stagnation. We see the spectacular collapse of Argentina throughout the twentieth century which is well documented. Brazil and South Africa trade places but stagnate. For Asia, we see the rise of Japan, followed by South Korea, then Malaysia, and finally more recently India.

5. STRUCTURAL CHANGES IN THE SOUTH AFRICAN ECONOMY: CONSTRAINTS ON INNOVATION

Very simply, companies, and hence countries, compete on the basis of price/cost, quality and the level of innovation associated with their product space. The level of productivity

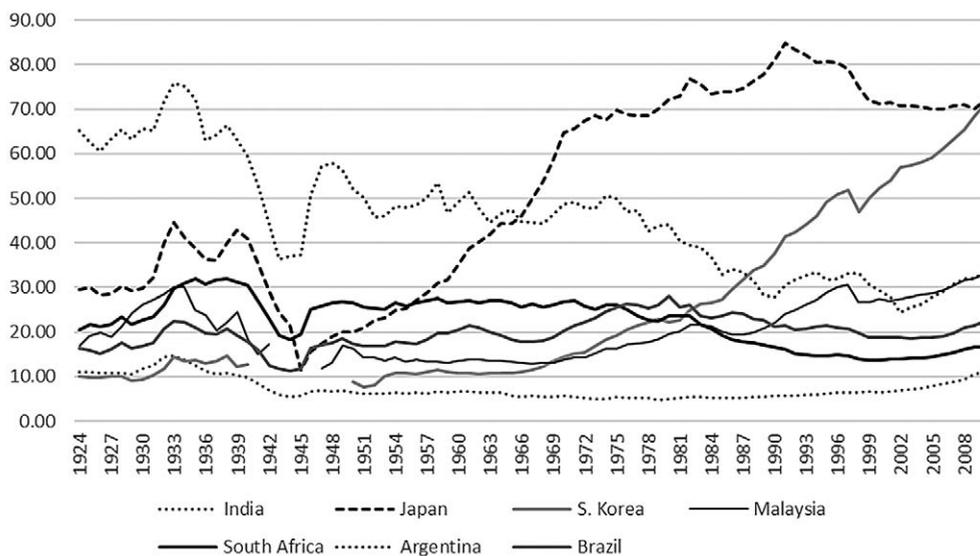


Figure 3. Per capita GDP of Asian and Latin American Countries and South Africa relative to the USA (in 1990 Int. GK\$)

Source: Maddison data.

affects the efficiency with which resources are employed to produce and compete on the basis of those three criteria. At lower levels of development, countries generally compete on the basis of low-cost structures, especially related to wage costs. This stage relies heavily on low-skilled workers and relatively low levels of product sophistication. As countries develop and wage structures start to rise, they need to transition to compete more effectively on the basis of quality and innovation which requires more sophisticated skills set with higher levels of human capital. Moving up the value chain allows countries to absorb the higher cost structure by gaining a premium for greater levels of quality and, in time, a more sophisticated and innovative product portfolio. This is the challenge facing MICs.

Hidalgo and Hausmann (2009) use network theory methods to illustrate that a country's trajectory is influenced by its capacity to develop capabilities that are required to produce more sophisticated products. Thus, they see development not only as a process of producing the existing product set more effectively but also acquiring new complex capabilities to develop new products with higher levels of productivity. What this literature argues is that not all products matter equally for growth. Hidalgo and Hausmann (2009), Hausmann and Klinger (2006), Felipe *et al.* (2012) all develop this idea that MITs are associated with the product space and the export profile of these countries. Countries which have successfully transitioned out of middle-income status are those which had more diversified, sophisticated export baskets which allowed them to leap to higher levels. Felipe *et al.* (2012:39) use a probabilistic measure of how close a product is to others and whether it is likely that the country can acquire the revealed comparative advantage in them through the transferability of capabilities. Out of the 779 products that they analysed, 352 are in the mid or high proximity ("good" products) and 427 are in the "bad" product space (pp. 41-42). They find that countries in MITs

(especially lower income) export a substantial share of products that are both unsophisticated and not well connected to other products. South Africa is squarely in this category with 66.4% of our exports being located within the “bad” product space. Thus, their explanation of what is affecting some MICs is that they never fully industrialised the way most developed countries did (due to their lower levels of sophistication and product connectedness), and now are undergoing some early deindustrialisation. They link this to Baumol’s *et al.*’s (1989) argument that deindustrialisation is the result of the differential of labour productivity between manufacturing and services: “economies end up in a situation of ‘asymptotic stagnancy’, where the long-run growth is essentially determined by the growth of productivity in the service sector, lower than that in manufacturing” (p. 43).

Examining the long-term structural changes in terms of contribution towards GDP reveals a definite pattern for South Africa. For the sake of space, we do not provide the time series data here, but using World Bank numbers we find the following (see Table 1). Manufacturing, value added as a percentage of GDP remains fairly stagnant at between 20% and 24% throughout the 1960s, 1970s and 1980s before starting its decline during the 1990s and more so during the 2000s to the point where in 2013 it contributed only 11.56%. This is the lowest proportion for any country in our sample. Brazil, Turkey and Malaysia have likewise seen a sharp fall in the same time period. These four also happen to be the countries most closely associated with the MITs. This decline in manufacturing in South Africa has been accompanied by a rising contribution of the services sector from 45.4% in 1980 to 70% in 2013, the largest proportion of our sample closely followed by Brazil and then Turkey. The picture which emerges for South Africa is thus one in which the manufacturing sector is growing relatively smaller pointing to a process of deindustrialisation which might well be argued to be premature given our level of development. High-technology exports make up only 4.5% of South Africa’s manufactured exports, compared to 10.5% for Brazil, 20.5% for Thailand, 26.2% for Korea and 43.7% for Malaysia. Also recall our earlier point that 66.4% of South Africa’s exports are located within the “bad” product space of being unsophisticated and unconnected.

MITs are partly explained by countries struggling to move up the value chain and produce more sophisticated products, less reliant on low-cost structures. To make this leap requires a more effective use of inputs and an improvement in the quality of these inputs. South Africa performs poorly on both counts as is reflected in Table 1. On the

Table 1. Selected proxies for technology readiness of various countries, 2013

	Brazil	China	S.Korea	Malaysia	Thailand	Turkey	SA
Public spending on education, total (% of GDP)	5.82	NA	5.25	5.94	5.79	2.86	6.60
Gross domestic savings (% of GDP)	15.41	51.85	34.05	35.37	32.53	14.07	16.55
Gross fixed capital formation (% of GDP)	18.18	47.30	29.66	26.86	26.73	20.32	19.33
Manufacturing, value added (% of GDP)	13.13	31.83	31.10	23.92	32.94	17.63	11.56
Industry, value added (% of GDP)	24.98	43.89	38.55	40.51	42.55	27.07	27.58
Services, value added (% of GDP)	69.32	46.09	59.11	50.18	45.47	64.44	70.03
Exports of goods and services (% of GDP)	12.55	26.41	53.92	81.68	73.57	25.65	31.14
Foreign direct investment, net inflows (% of GDP)	3.60	3.76	0.94	3.70	3.27	1.57	2.32
High-technology exports (% of manufactured exports)	10.49	26.27	26.17	43.71	20.54	1.83	4.55
Patent applications, residents	4,804	535,313	148,136	1,114	1,020	4,434	608
Research and development expenditure (% of GDP)	1.21	1.98	4.04	1.07	0.25	0.86	0.76

Source: World Bank Data.

human capital side, South Africa spends more on public education as a percentage of GDP than any other country in our sample and yet its performance is dismal on almost any measure. Fedderke *et al.* (2000, 2003) and Fedderke and Luiz (2002) show that this education crisis has long-standing roots and that the efficiency with which inputs in the educational production function are converted into quality outputs have been questionable for a long period – we cover the 1910-1993 era. At tertiary level, the performance was equally worrisome. We show that in the natural and engineering sciences, which have been shown to be central to the process of economic growth, that the output was limited and that this had implications for competition and innovation and access to new ideas. Post-apartheid education has similarly performed with a focus on quantity rather than quality, and this has implications for a country trying to escape the MIT through innovation and movements up the value chain. We see South Africa underperforming on various technological readiness measures. Outside of Thailand, South Africa's R&D spending as a proportion of GDP at 0.76% is the lowest among our sample. A country like South Korea which is one of the few which has successfully negotiated the treacherous transition beyond middle-income status in recent decades has an R&D spend of 4.04%, and China which is acutely aware of the pressure to innovate for further success is spending almost 2% of GDP. South Africa has the lowest number of patent applications. Turkey with a population 50% larger than South Africa has over seven times the number of patent applications, Malaysia with a population half our size has almost double the number, while Korea has roughly the same population but has over 243 times the number of patents. The key dimensions which facilitate transitions from middle-income to high-income status are precisely the dimensions where South Africa fares poorest – namely those related to technological innovation and human capital.

A key component of modernisation is the ability to translate more efficiently inputs into output and more effectively harness technological forces to accomplish this. Fig. 4 illustrates total factor productivity (TFP) levels for several countries at current purchasing power parity (PPPs) relative to the USA (which equals 1) between 1950 and 2011. While measuring TFP presents particular problems especially across countries, it is nonetheless instructive. Within our sample, Turkey and South Africa in the 1960s and 1970s are the clear leaders in terms of TFP levels (approximating US levels), but while Turkey remains steady through until the end period, South Africa experiences the sharpest decline of our sample during the 1980s and 1990s, and then a slight improvement during the Mbeki years. During the past two decades, South Africa's TFP growth placed it around the levels of Greece and Argentina (not shown here). We see the familiar picture of low TFP growth for China and India with growth being very much input driven, although both see improvements since 2000. Brazil's, so called, economic miracle under Lula is questionable looking at the country's falling TFP and may explain some of the difficulties being experienced in that country presently, once one strips out the rising commodity prices of the early 2000s.

5.1 Bringing Politics Back in: The Lack of a Social Contract, a Middle Ground and the Implications on Policymaking

The prospects for a long-term revival in the growth fortunes of South Africa look slim on the basis of the evidence provided above. MITs are not inevitable but are the result of policy failures to recognise the malaise and to implement appropriate strategies to move countries through successive value chains. This brings us back to the political economy of

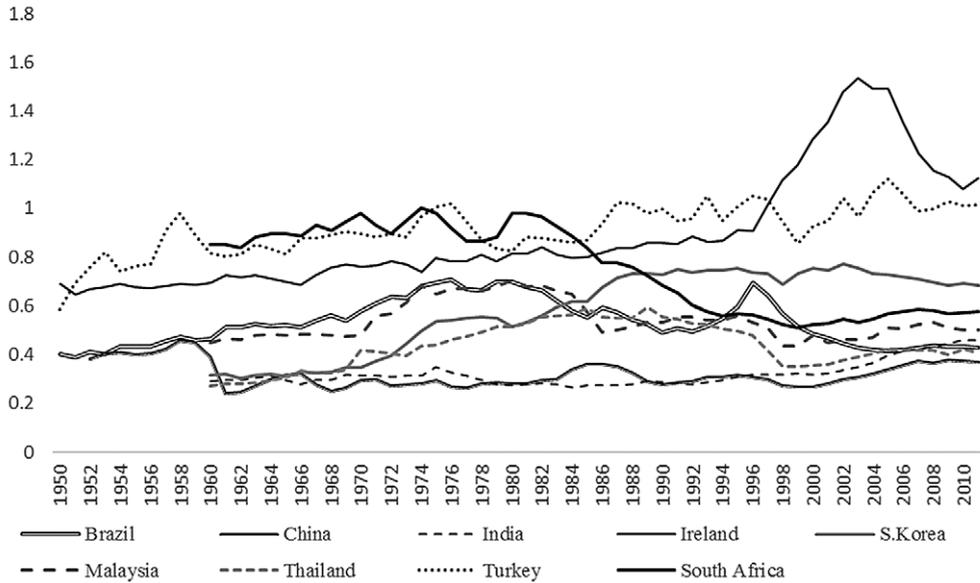


Figure 4. TFP level at current PPPs (USA = 1), 1950-2011

Source: Feenstra *et al.* (2013).

MITs – why are states unable or unwilling to formulate and execute appropriate strategies to catapult countries between different stages of development? In South Africa, there is a broad understanding of what the issues are that are holding the country back. The National Planning Commission undertook a comprehensive diagnosis of the development challenges and developed an arguably reasonable plan for the way forward. But it has remained stuck in a limbo and contested within the very party that claims it as its overall framework. Ministers and departments that are meant to implement it often openly disagree with it or ignore it. Given that government itself is divided, there is little wonder that there is no general consensus on its implementation between the main players in the economy.

South Africa's economic inequality shows up repeatedly as among the worst in the world. This is not sustainable and increasingly puts pressure on decision makers as they struggle to mediate the tensions between a focus on production versus distribution. Business, government and labour have not been able to formulate a social contract to govern a way forward, and the result is increasing policy paralysis and indecision. In Luiz (2014:240-241), I argue that the South African post-apartheid dispensation was a negotiated settlement between elite groups that left the majority of the population without "voice": "They were pacified through the introduction of an elaborate welfare system which does not seek to address their dispossession but rather seeks their silence. The black establishment was bought through the promise of black economic empowerment (BEE) which gave a small black elite the chance for rapid economic mobility, and big white capital was co-opted in return for the drop of nationalisation and radical redistribution as a policy option." Recall our earlier discussion of Olson (1982:75) on the difficulties of collective action especially when new orders are attempted. He suggests that during these transitions few organisational interests will dissolve and instead

countries fudge a consensus by accumulating more special interests and collusions. This was the reality of the 1994 transition, and he warns that these accumulated interests have little incentive to make their societies more productive but strong incentives to seek a larger share of the national income for themselves. This accommodation of elites in 1994 established barriers to entry, and this bargain makes it difficult to pursue economic dynamism when the interest groups have to be pacified at every turn. Huntington (1970:325) almost seems to be referring to post-apartheid South Africa when he writes about how economic progress can be highly destabilising as it disrupts traditional social groupings, produces nouveaux riches who are imperfectly assimilated by the existing order, increases the incomes of some people absolutely but not relatively and hence increases their dissatisfaction, and intensifies group demands on government, which the government is unable to satisfy. It may also explain why vested interests may opt for a low-level equilibrium which is stable and guarantees existing interests over one which increases social output. He concludes by saying that to the extent that these relationships hold, economic growth increases material well-being at one rate but social frustration at a faster rate. Thus in the case of South Africa, the lack of a consensus on a growth strategy might well be explained through a political economy explanation of interest groups protecting the status quo out of which they benefit. When challenged, they may gradually accede to greater inclusion either by expanding the small pool of the elite (as we see with BBBEE) or through a tokenistic redistribution to pacify the masses (through social grants) but never an undermining of the overall equilibrium outcome. High growth cannot guarantee that the existing social order will not be unsettled. A cynic would argue that this may also explain the perpetuation of poor quality education as education increases aspirations (and is good for growth) which could be disruptive.

South Africa's political economy dynamics are dominated by the effects of the highly skewed income distribution which affects the nature of the middle class. Levy *et al.* (2014:26) illustrate that in South Africa about 12.5% of the jobs of primary household earners fall within the "middle range" of earnings. This is in contrast with the equivalent share for Mexico of about 22.5% and in Turkey more than 25%. They argue that this has implications for the proportion of the population that gains directly from economic growth and that unless South Africa is able to move to a more inclusive model and expand employment in the middle range of the earnings distribution, that "the sustainability of its landmark political settlement will remain worryingly uncertain." Recall also our earlier discussion on the importance of the middle class more generally and Barrington Moore's (1966) warning that no bourgeoisie, no democracy. It is the middle class that provides the underlying stability of a country's political economy model. The middle class have the most to lose through economic disintegration as the wealthy have mobile capital which is often transnational, and the poor lack an asset base to protect. The middle class act as the social glue that can transcend fractious divides (including those related to ethno-linguistic fractionalisation) through their cross-cutting cleavages (see Luiz, 2015). There is a common "language" of the middle class which allows for this facilitation. These inherent concerns make them ideal custodians of future stability. Where the middle class is lacking, society becomes more vulnerable to instability and policy vacillation. This can be tied into our earlier discussion of the median voter theory.

South Africa's high inequality results in highly contested public policy interests between insiders and outsiders and taxpayers versus transfer recipients. The lack of a strong middle class makes holding the policy centre difficult. The burden of personal

income tax is borne overwhelmingly by the richer deciles. The two richest deciles (the richest decile) of individuals generated over 97% (87%) of total collections while their share in market income was equal to 81.4% (63.7%) (World Bank, 2014: 28). On the transfer side, the cash transfers are highly progressive. The World Bank (2014:34-35) argues that the impact of these transfers in raising the income of the poor in South Africa is far larger than in other MICs in their sample, including Brazil. Sixty-nine per cent of all cash transfers go to the poorest four deciles. They state that the programme which stands out as being the most progressive is the child support grant. The consequence of South Africa's fiscal policy is that the Gini coefficient on income falls from 0.77, where it lies before various taxes and social spending programmes are applied, to 0.59 after these fiscal interventions are incorporated, and the rate of extreme poverty is cut by half (World Bank, 2014:3). Nonetheless, even after this, the country retains the highest inequality of that sample *before they* apply fiscal policies. Designing public policy thus entails trying to pacify the economically marginalised without alienating the tax base – no mean feat in any society but more so in the case of South Africa given its history and extraordinary inequality. One way to do this is by “procuring” acquiescence through a complex web of implicit deals. The lowest deciles through social spending and cash transfers, the highest decile by guaranteeing no radical change in the underlying economic system and allowing for the continuation of the status quo. The upper middle and middle classes end up slightly worse for wear but are known for their forbearance. For good measure, the state furthermore co-opts the vast civil service (a middle-class constituency) through above inflationary pay increases and through an expansion of the sector. The Budget Review (RSA, 2015:8) states that over the past decade, “public-sector unit labour costs have increased by more than 80 per cent in real terms, with an average annual growth rate of more than 6 per cent above inflation. Compensation of employees has contributed in large measure to the structural fiscal deficit.” Furthermore, public sector employees have grown from 1 million in 2005 to 1,251,325 in 2013 – an increase of 25.1% (RSA, 2013:28).

This system of appeasement may result in stability but comes at the price of a low level equilibrium trap. The casualty of this is the lack of focus on expanding the productive capacity of the economy. This would require innovation and moving up the value chain which will result in a process of creative destruction and of new winners and losers. The elite rather bet on a sure thing, namely an existing share of the national income and negotiate between themselves how that is distributed, rather than the uncertain outcome which displaces the existing means of production. Labour, likewise, has an interest in the perpetuation of the status quo as long as they remain the insiders. Shifting to a new productive economy will displace some insiders even as it creates opportunities for current outsiders. This would also explain the fact that labour market reforms are left untouched. While easing labour market restrictions may expand the class of the employed, it may distress the existing insiders – witness the recent opposition to a youth wage income subsidy as further evidence. It would also account for the ongoing paralysis in the education sector.

The one advantage of the current system is that the state escapes absolute capture as it appeases both ends of the spectrum. This prevents a shift to absolute policy populism – it is a form of “bounded populism”. Unbounded populism would entail ignoring the macroeconomic constraints and see a debt and inflationary spiral, but bounded populism sacrifices innovation with an elaborate rent-granting system while retaining economic

stability, be it at a low level. Goran Hyden's (1983) work springs to mind in this regard. Is South Africa gradually moving back to a more sophisticated version of Hyden's "economy of affection." He was referring to the African development experience and the fact that it contained a substantial pre-capitalist component which resulted in a network of support among defined groups connected by some form of kinship. An ornate system of client-patron relationships develop between leaders who have access to public resources and the kin who do not. Instead of institutional development that enhances the capabilities of the economy, it institutionalises this patronage and leads to the misappropriation of public resources. In a country like South Africa which has transitioned out of a pre-capitalist mode, what would such an "economy of affection" look like? Would it resemble the modern Russian system of an oligarchy of interconnected re-patriomonalism? Instead of clan leaders, we have well connected elites behaving badly (e.g. BEE, without the broad based, which institutionalises distribution between the elites), and the kin relying on the largesse of their patrons. Kin may, or may no longer, be defined by blood or ethnic ties but by who you know and how many degrees of distance between you and the ultimate patron. In this sort of milieu, pursuing economic policy which puts the productive capacity upfront is extremely difficult. Tough choices are not made, and the result is stasis and policy indecision – conditions very conducive to MITs. The thesis of this paper is that MITs need to be understood as a combination of not just economic factors but political factors which explain policy choices.

6. CONCLUSION

Teece (2014:345) warns that "economists have been very slow to recognise that much organising is necessary before there are goods and services to exchange in markets" – *before* Adam Smith's pin-making comes into play. He explains that firms require dynamic capabilities to compete and generate superior profits by developing differentiated products and services by reconfiguring the "internal and external resources to maintain leadership in continually shifting business environments" (p. 329). This moves beyond the realm of efficiencies and towards the production of something that is idiosyncratic and difficult to imitate. It is these capabilities that allow "firms to stay congruent with market and technological developments." Increasingly for organisations to compete they need to be able to link, leverage and learn to ensure that they develop resources that can support durable competitive advantage that are valuable, rare, imperfectly imitable, and non-substitutable (as cited by Teece, 2014:332-333). In a rapidly changing global economy, MICs need to create systems, whereby their organisations are able to move up the value chains through innovation. This requires a very different set of capabilities that moves beyond the ordinary to the dynamic and that integrates the role of organisational action and resources with countrywide systems of competitive advantage. The latter includes national innovation systems, appropriate human capital strategies and industrial policies. Agenor *et al.* (2012:4) further highlight the importance of developing advanced infrastructure in the form of high-speed communications networks, attracting more high-ability workers into the design sector, and improving productivity which not only enhances innovation but also allows for higher wages.

This transition from one economy to the next creates winners and losers, and the disruption unleashes uncertainty and new interest groups. Managing this in a way that enhances international competitiveness and creates enough opportunities to compensate

the losers is not a trivial exercise. This is the challenge facing MICs. There has been a proliferation of research by economists predicting the linear progression of emerging markets (MICs) in the future and that these countries will soon come to dominate among the largest economies in the world. I do not dispute the fact that we have seen a slowdown in many major economies of the industrialised world and the demographic transition does not bode well for parts of the industrialised world, but what this paper seeks to do is to highlight that these studies have largely ignored the vast difficulties associated with economies transitioning between political and economic systems and equilibrium thresholds. The path forward for emerging markets is by no means a smooth, linear one, and to assume it to be is problematic, and many investors are likely to find themselves on the wrong side of a bet on a “sure thing.” The future does lie with MICs and the next tier of developing countries that will move into middle-income status. But it is going to be a period of high volatility with winners and losers and with many MICs vacillating between progress and collapse. Social and political unrest is likely to be a strong feature associated with this transition as countries do not fulfil the high expectations that have been generated about their future prospects.

For South Africa, unless there is a dramatic policy shift which recognises the realities of the political and economic causes of stagnation and the appropriate investments and choices are made, we are unlikely to move beyond middle-income status any time soon. We are already among the longest serving countries in this MIT. South Africa needs to move up the value chain with a viable value proposition, and this requires a very different policy set and human capital plan. Tough choices need to be made to avoid the road to nowhere or a default into a policy set of “bounded populism.”

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