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PROGRAM ON ESCAPING THE MIDDLE - INCOME TRAP: CHAINS FOR CHANGE

Still Trapped, at a Higher Income

Labor Export, Import Dependence, and the Philippine Middle-Income Trap

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Key Messages

- The Philippines' reclassification to upper-middle income in July 2026 reflects real gains in education, health, infrastructure, and poverty reduction, but the country has not escaped the middle-income trap: income has converged faster than the economy has transformed (World Bank 2024, 2026; Gill and Kharas 2015).
- The country produces and exports too little, and too narrow a range, because two forms of exit have hollowed out its domestic economy. Its most capable workers leave through migration, and its demand leaks abroad through imports, since sourcing from local suppliers is harder and costlier than importing through the harbor (De Dios and Williamson 2013; Balaoing-Pelkmans and Mendoza 2024a).
- The roots of this disconnection are weak agricultural productivity and thin inter-sectoral linkages, which leave the domestic economy poorly wired to itself and make importing easier than building local supply chains (Hirschman 1958; Usui 2012).
- The binding constraint on escape is the capacity of a fragmented state to coordinate and sustain implementation. Where no strong coordinating mechanism exists, firms and agencies act defensively in silos to protect themselves from the inefficiencies of the whole system; the problem is institutional, and appeals to collaborate change little (Doner and Schneider 2016; Evans 1995).
- The Tatak Pinoy Strategy is an attempt to build that coordinating capacity, through a statutory council, dedicated sector units, and local-content procurement. Its success will depend on whether its institutions are granted real authority, insulated from capture, and held accountable, so that solidarity has a mechanism and Filipinos can build a future at home (Tatak Pinoy Council 2025; Balaoing-Pelkmans 2025a).

An income milestone without structural escape

In July 2026 the World Bank reclassified the Philippines as an upper-middle-income economy, its gross national income per capita having crossed the threshold that had separated it from that group for more than three decades (World Bank 2026). By the income criterion this was progress. Yet for many Filipino families the reclassification changes little about the fact that shapes their lives most, that the surest path to a decent future still runs through an airport. The country's most reliable export remains its own labor.

The concept of a middle-income trap entered development economics with Gill and Kharas (2007), who described economies caught between low-wage competitors in labor-intensive goods and innovation-driven economies in knowledge-intensive ones; a decade later they recast it as a real and recurring difficulty that no mechanical law captures (Gill and Kharas 2015). Of 101 economies classified as middle-income in 1960, only 13 had reached high income by

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2008 (World Bank 2024), and by the criteria of the empirical literature the Philippines has long counted among the trapped, having remained in the lower-middle band for more than three decades before reclassification (Felipe, Kumar, and Abdon 2012). By structural criteria the position is starker: the country held one of Asia's highest per capita incomes in the 1950s and was progressively overtaken by its neighbors (Balisacan and Hill 2003), and it now carries the weakest manufacturing base among the ASEAN-6 (Balaoing-Pelkmans and Mendoza 2024a).

The country knows what escape requires; the requirements have been named repeatedly, in the academic literature and in its own strategies. The difficulty lies in translating that knowledge into sustained action, and the reasons are visible in the structure of its domestic economy. Where the standard diagnosis looks outward, at the country's position in global value chains, this paper looks inward, at value chains that function poorly at home.

Real gains, and the limits of a services-led path

The reclassification should not be dismissed as merely statistical. It reflects real gains accumulated over decades in education, health, infrastructure, macroeconomic stability, and poverty reduction, and many Filipinos are meaningfully better off than a generation ago. These gains are also a foundation. The country brings real assets to the next stage of development: a large, young, and adaptable labor force with high English proficiency; internationally competitive niches in tradable services; a substantial and growing domestic market; a diaspora with skills, capital, and networks; and a record of macroeconomic resilience through repeated external shocks. The country already possesses considerable capabilities, and the task ahead is to organize and connect them.

Rising living standards and a crossed income threshold are, however, not the same as structural transformation, and upper-middle-income status is a milestone; many economies have remained at this level for decades (Gill and Kharas 2015). The Philippines has shown it can grow; the unresolved question is whether it can transform.

A natural objection is that the premise is outdated. Manufacturing, it is argued, is no longer the only route to development; tradable services, digital industries, business-process management, logistics, and other knowledge-intensive activities can raise productivity and generate learning spillovers, and some recent work argues that labor-absorbing services will have to carry more of the burden of development than they once did (Rodrik and Stiglitz 2026). The Philippines is competitive in several such sectors. The objection has force. What matters is whether an economy can create high-productivity sectors that absorb labor, innovate, and generate spillovers, and manufacturing is one route to that among others.

The difficulty is that a services-led path cannot, on its own, absorb the workforce the Philippines actually has. The country's globally competitive services are a pocket: concentrated in a few cities, oriented toward export, and demanding skills that only a minority of the labor force possesses. For the lower-skilled majority, the services on offer are low-wage, low-productivity domestic activities, and the gap between the two is wide. A model resting on a high-skilled service enclave raises returns for the already advantaged while leaving the lower-skilled majority to choose between low-wage service work at home and emigration. This is the mechanism behind the labor leak examined below, and it is why the services model and the overseas-worker model have grown together.

Manufacturing matters here for what it does for that majority. Industrial employment, including its lower rungs, offers higher productivity and higher wages to workers without advanced skills than low-end services can; even construction, among the lowest-paid industrial occupations, pays more than the average low-skilled service job. A broad base of such employment allows an economy to raise ordinary workers' incomes at scale. Building capabilities through education depends on this base, since sustained public and private investment in schooling requires the broad-based incomes that mass productive employment generates. An economy that skips the stage of mass mid-productivity work forgoes the incomes that would fund capability-building, so the shortcut deepens the problem it was meant to avoid. The services debate strengthens the case for a functioning domestic productive economy.

Two forms of exit: labor and demand

Consider the choice facing a Philippine manufacturer that needs an input. It is cheaper and simpler to source it through the harbor, in a container from abroad, than to buy from a local consolidator, and harder still to buy from farmers and small producers directly. The imported input arrives on schedule, to a known standard, at a predictable price; the local supplier is smaller, less reliable, more costly, and often too far away across too many islands to reach economically. So the firm imports, and every firm facing the same incentives makes the same choice. The demand that might have sustained a domestic supplier leaks abroad as imports; the supplier, without steady buyers, remains small and unproductive and never becomes good enough to be chosen; and because it does not improve, importing continues to be rational. Domestic demand in the Philippines remains heavily skewed toward imports, and the absence of strong domestic suppliers has long kept local firms from advancing up the value chain (Balaoing-Pelkmans and Mendoza 2024a).

This has the same structure as the more familiar story of overseas employment. For four decades the Philippines has sent its most capable workers abroad, a choice that is individually rational given the wage gap and that has made remittances a pillar of the economy, even as it has quietly relieved the pressure to build the domestic economy that would give those workers a reason to stay (De Dios and Williamson 2013). The mechanism operates through human capital: the scarcity of high-skilled domestic employment discourages investment in domestic capabilities, which perpetuates that scarcity, in what Hausmann and Hidalgo (2010) term a quiescence trap that training expenditure alone cannot dissolve. The migration literature is careful here, since emigration need not deplete a country's human capital and can even raise it, though only where the domestic economy offers returns sufficient to retain and deploy the skills that are formed (Docquier and Rapoport 2012); in the Philippine case those returns have been weak. Remittance-driven real appreciation has compounded the problem by penalizing tradable production, a classic Dutch Disease dynamic (Corden and Neary 1982; De Dios and Williamson 2013).

Placed side by side, the two are one problem in two forms. The country lets two things leak away that it most needs to retain: it lets its ablest workers leave, which keeps good jobs scarce, and it lets its demand leak out through imports, which keeps local suppliers weak. Labor exits through migration; demand exits through the harbor. Both drain the economy of what would allow it to grow, and an economy that exports its workers and imports its supplies has, in effect, ceased building the productive core between them.

This diagnosis carries a more encouraging implication. The two resources the country allows to escape, its workers and its demand, are among its greatest assets, and both already exist. Closing the leaks therefore means retaining talent the country has already educated and capturing demand that at present flows abroad. The magnitude of the loss is a measure of the opportunity.

The disconnected domestic economy

Two structural weaknesses keep the domestic economy from cohering, and both tend to fall outside the headline debates on the trap.

The first is agriculture. Philippine agricultural productivity is low by regional standards, and this matters well beyond the farm, because much of the manufacturing a country at this stage can realistically build is agro-industrial: food processing, packaging, cold storage, and the everyday transformation of produce into marketable goods. When the agricultural base cannot supply enough, at steady quality and competitive cost, the activities meant to build on it lack a foundation. This helps explain why the productivity gains the country has recorded have come largely from within-sector improvement, and not from the reallocation of labor across sectors that defines genuine structural transformation (Usui 2012).

The second is the thinness of inter-sectoral linkages. In a well-functioning economy, growth in one sector pulls others along through the demand and knowledge it transmits forward and backward across the production structure, the dynamic Hirschman (1958) identified as central to development. In the Philippines these linkages are weak: the country has among the fewest manufacturing firms per capita in Southeast Asia, and those firms are weakly connected to one another (Balaoing-Pelkmans and Mendoza 2024a), so the economy lacks the internal wiring that carries an advance from one activity to the next. This is consistent with the finding that global value chain participation raises income mainly where it is matched by domestic capability and can otherwise leave a country locked in low-value activity; Philippine electronics illustrates the pattern, with high participation in assembly and little deepening of domestic capability (Gereffi, Humphrey, and Sturgeon 2005; Mendoza 2024).

Weak agriculture and thin linkages are why importing is so often easier than sourcing at home, and they are also why no single firm can solve the problem alone. A factory will not invest in developing a local supplier while competitors import more cheaply; a supplier will not upgrade without a committed buyer. Each waits for the other. This is a coordination failure, in which all parties would gain from moving together but none can afford to move first, and it recurs throughout the literature on why market-led strategies leave productive capabilities underdeveloped (Paus 2017).

The binding constraint: effectiveness, not knowledge

Here the Philippine case departs from the standard advice. The prescriptions for escaping the trap are well established and broadly agreed, capability-building, strategic integration, and industrial policy, and the Philippines does not lack them; it has produced them in successive strategies for decades. What it has lacked is the capacity to carry any of them through. This political economy of preservation, in which the arrangements that advantage incumbents resist the coordinated change transformation requires, is increasingly identified as the true locus of the trap (Doner and Schneider 2016; World Bank 2024).

The coordination problem is easily misread as a failure of willingness, as if firms and agencies preferred to work apart. The reality is a rational response to a dysfunctional environment. When systemic problems are pervasive and no strong coordinating mechanism exists, no clear leadership, no lead agency, no binding institutional instrument, acting in silos becomes the defensive strategy that protects each actor from the inefficiencies of the whole. A firm that cannot count on complementary investments by others, or an agency that would bear the cost of coordination while others capture the benefit, does better to withdraw into its own mandate. With no mechanism to make cooperation reliable, cooperating exposes each actor to the failures of the rest, so each retreats. The withdrawal is a rational defense, and goodwill has little to do with it. The constraint is institutional, and exhortation to collaborate, without a mechanism, changes little.

The binding constraint is thus the capacity to carry a policy through, and that capacity deserves a precise definition. A state may command considerable capacity, in competent personnel, fiscal reach, and administrative infrastructure, and still be ineffective if that capacity cannot be aligned behind a single purpose and held there. Effectiveness concerns the durable alignment of capacity behind a purpose; a state can own the resource and still fail to achieve the alignment. Where alignment must be built and cannot be assumed, the design of the coordinating institution becomes decisive (Evans 1995; Balaoing-Pelkmans 2025a).

Closing the two leaks

The implications are concrete. Making it worthwhile to stay and worthwhile to buy local reduces to identifiable, if difficult, tasks.

The first concerns logistics, above all the cost of moving goods between islands. In an archipelago, inter-island freight is decisive: it is often the reason a supplier on one island cannot compete with a container from abroad even when its product is otherwise adequate. Cheaper, more reliable domestic shipping, together with relief from the country's high energy costs, makes local sourcing economical, so that a firm buys local because it pays to.

The second concerns the behavior of large firms. The realistic route to capable local suppliers runs through the anchor firms that buy from them: large firms, especially in food and agriculture, that invest in bringing their suppliers up to standard instead of importing around them. This supplier-development practice was central to the economies that industrialized successfully (Amsden 2001; Wade 1990), and it turns the value chain from a ladder Filipino firms cannot climb into one they build together.

The third concerns public procurement, a substantial lever that has largely gone unused for development because contracts typically default to the lowest bidder, often a trader or importer instead of a domestic producer. Restructuring procurement so that public buyers favor goods made and sourced at home, and reward higher local content, gives domestic suppliers the predictable demand they need in order to invest and reach efficient scale, an instrument regional peers have used and the Philippine system has historically lacked (Balaoing-Pelkmans 2025a).

The Tatak Pinoy Strategy as coordinating instrument

The Philippines has adopted sound industrial strategies before, and most named the right priorities only to founder at implementation, undone by the coordination problem described above. It is reasonable to ask what distinguishes the present effort. Two features are new. First, the Tatak Pinoy Act gives the strategy a statutory basis, establishing a permanent coordinating council, dedicated units for priority sectors, and a requirement that plans be tied to budgets and monitored, so that the strategy carries an institutional spine and a legal obligation to persist beyond the tenure of its authors (Tatak Pinoy Council 2025). Second, its design principle recognizes that no single actor can upgrade a value chain and that government, firms, universities, and communities must be bound into sustained cooperation, each holding a distinct part. This is the coordinating mechanism whose absence, as argued above, makes defensive siloing rational.

A caveat is essential. The strategy asks a fragmented state to build the very capacity it has always lacked, and endowing a divided or captured government with stronger instruments does not guarantee better outcomes; in the wrong hands it can entrench the same interests more firmly (Evans 1995). Whether the strategy avoids this turns on whether its coordinating institutions are granted real authority, insulated from capture, and held accountable through transparent targets and independent review; the strength of its diagnosis will not be enough on its own (Balaoing-Pelkmans 2025a). The difficulty lies in building an institution that can carry the plan, and in keeping that institution honest. This is why the frontier of reform is effectiveness, the capacity to carry knowledge into sustained action, a lesson the country's own history has taught repeatedly (De Dios and Williamson 2013).

Malasakit, bayanihan, and the stakes

The argument can be, and to be rigorous must partly be, made in the language of coordination failures and transaction costs. But that language leaves out a dimension the Tatak Pinoy Strategy places at its center, that industrial development is a national undertaking as much as an economic one. The strategy is anchored in malasakit, compassion for the Filipino workers and producers striving to advance, and bayanihan, solidarity across institutions and communities, and it treats bayanihan as a practical mechanism for co-implementation, a working principle for how actors are to cooperate (Tatak Pinoy Council 2025).

The argument of this paper explains why that emphasis is right. The coordination problem at the center of the trap is a question of whether actors will bear a cost now so that others, and the country, are better off later, and that is what solidarity is. But the analysis of siloing shows that solidarity cannot be summoned by appeal. Actors withhold cooperation because, with no coordinating mechanism, cooperation is individually unsafe, and goodwill alone cannot change that. Malasakit and bayanihan name the disposition; the coordinating institutions supply the mechanism that makes acting on it rational. Values and institutions work together here, and neither substitutes for the other.

Behind the analysis is the human fact the numbers exist to serve. The overseas model has separated families for a generation and directed the country's talent to the building of other economies, and the strategy states plainly what it is for: livelihoods secure not abroad, but here, at home (Tatak Pinoy Council 2025). This is the true measure of escape, and an income classification cannot supply it. The elements of an answer are in place: a capable workforce, a large domestic market, a diaspora, and, for the first time, a national strategy with legal standing and a coordinating mandate. What remains is the demanding institutional work of aligning them, so that solidarity has a mechanism and staying has a rationale, and a Filipino need not leave in order to build a future at home.

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