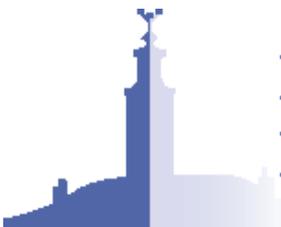


It's Democracy, Stupid: Reappraising the Middle-Income Trap



Jan Rudengren
Lars Rylander
Claudia Rives Casanova

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Jan Rudengren

Lars Rylander

Claudia Rives Casanova

Institute for Security and Development Policy
Västra Finnbodavägen 2, 131 30 Stockholm-Nacka, Sweden
www.isdp.eu

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Institute for Security and Development Policy
Västra Finnbodavägen 2, 131 30 Stockholm-Nacka, Sweden
Tel. +46-841056953; Fax. +46-86403370
Email: info@isd.eu

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The Central Asia-Caucasus Institute
Paul H. Nitze School of Advanced International Studies
1619 Massachusetts Ave. NW, Washington, D.C. 20036
Tel. +1-202-663-7723; Fax. +1-202-663-7785
E-mail: caci2@jhuadmin.jhu.edu

Editorial correspondence should be addressed to Alec Forss at: forss@isd.eu

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Abbreviations

ADB	Asian Development Bank
FDI	Foreign Direct Investment
HIC	High Income Country
ICT	Information and Communication Technology
LIC	Low Income Country
LMIC	Lower Middle Income Country
MIC	Middle Income Country
MIT	Middle Income Trap
OBM	Original Brand Manufacturer
OECD	Organization for Economic Cooperation and Development
OEM	Original Equipment Manufacturer
PPP	Purchasing Power Parity
R&D	Research and Development
SOE	State Owned Enterprise
TNC	Transnational Corporation
UMIC	Upper Middle Income Country
WTO	World Trade Organization

Executive Summary

The causes and reasons for countries' economic growth and development have long been a challenging subject for research and debate. It is observed that while many countries experience high growth when they are low-income countries, once they become middle-income countries rapid growth is often followed by economic stagnation, with the potential for increasing social unrest as a result. A key puzzle is therefore why many middle-income countries fail to sustain sufficient economic growth to become high-income countries. A relatively recent concept in this debate is that of the Middle Income Trap (MIT), which argues that countries encounter a series of obstacles when trying to adapt their economies and comparative advantages to become more specialized market economies. In other words, the very same factors that fueled growth in the early stages act as a hindrance at the middle-income level, slowing down and eventually causing a stagnation of the growth process, if the correct policies are not implemented. This study seeks to reappraise the MIT concept by going beyond a mainstream analysis, which focuses mainly on economic aspects of growth/stagnation. Accordingly, while prudent economic management and policies are vital to avoid the MIT, factors relating to governance, institutions, inclusive growth, and education, among others, can underlie and play a determining role in explaining failure or success in sustaining economic growth. Therefore, non-economic dimensions are fundamental for any reform or structural change, and, as is argued in this paper, democratic governance can serve as a useful proxy for many of these factors.

Introduction

The issue of so-called “developing countries” and how they can benefit from the previous experiences of economic growth of “developed countries” has been discussed ever since the school of development economics rose to prominence in the 1950s, as former colonies gained independence and strived for national social and economic development, with development aid becoming an integral part of that process. However, the findings that economic growth is not easily sustained have, over time, acquired much attention in the literature on development. Indeed, there may be a previously unobserved hurdle in the economic growth process, one that has only relatively recently been studied, and was firstly identified as the “Middle Income Trap” in a 2007 study by Gill and Kharas, who contrasted the slow growth of Middle East and Latin American countries with Asian middle-income countries—the so-called “Tiger Economies.”¹

The Middle Income Trap (MIT), it is argued, is the result of a series of failures in the process of sustained economic growth that thwarts the progression of middle-income countries into high-income countries. This paper aims at recapturing the main arguments—largely economic in nature—in the current debate on the MIT,² before going on to introduce a *broadened* analysis that incorporates other factors, which, we assert here, have been largely overlooked in the debate and yet may underlie many of the economic failures. Therefore, this study seeks to move the discussion from a macroeconomic analysis of the concept of MIT to a broader political-economic analysis, including governance, so-

¹ I. Gill and H. Kharas, et al., *An East Asian Renaissance. Ideas for Economic Growth* (The International Bank for Reconstruction and Development/The World Bank, 2007).

² This paper draws upon four major research studies regarding the MIT, which are: H. Kharas and H. Kholi, “What is the middle-income trap? Why do countries fall into it, and how can it be avoided?” *Global Journal of Emerging Market Economies*, vol. 3, no. 3, September 2011, pp. 281-289; J. Felipe, “Tracking the middle-income trap: What is it, who’s in it and why,” *ABD Economics Working Paper*, no. 306 (Asian Development Bank, March 2012); P. Agénor and O. Canuto, “Middle-income growth traps,” *Policy Research Working Paper 6210* (The World Bank, September 2012); and S. Aiyar and R. Duval, et al., “Growth slowdowns and the middle-income trap,” *IMF Working Paper 13/71* (International Monetary Fund, 2013).

cial, and institutional dimensions. In thus doing, it sheds light on the importance of issues such as education, transparency, inclusive growth, and the rule of law, among others. These largely non-economic dimensions also set the stage for economic policy development and implementation. The final section of this paper draws conclusions on the utility of the MIT concept and the need to incorporate a broader dimension in order to provide for a more adequate explanation as to why some countries have not been able to escape the Middle-Income Trap.

A backdrop for this paper is the fact that while an increasing number of countries have crossed and are crossing the poverty threshold to become middle-income countries, few of them have managed to continue the climb into the group of high-income countries. Argentina represents a salient example in this regard. One of the world's richest countries at the end of the nineteenth century, a constellation of mainly non-economic factors in the following century precipitated Argentina's steady decline. These included military coups, populist policies, and protectionism. The country therefore failed to build the necessary institutions to protect its young democracy. Hence, the base for effective macro-economy policies was not created, as institution building was slow and ineffective. The political and economic elite also failed to invest in improvements of the education of the labor force, thereby also hindering efforts to increase productivity.

Furthermore, issues such as growing income inequality—a hallmark of the MIT—may cause marginalization and eventually trigger social unrest, as witnessed in the revolutions across the Arab world. The political and security implications of the MIT are therefore also apparent.

It should be emphasized that the present paper aims to more generally explore the features and utility of a broadened MIT concept. It is intended that this paper will lay the foundation for future ISDP policy research on the issue, for example by conducting comparative case-studies of Asian countries. Rigorous empirical analysis will help to further clarify the causes of MIT and test the arguments made in this paper.

Explaining the Middle-Income Trap: Concept, Criteria, Causes

The Middle Income Trap, below referred to as MIT, builds upon observations that many middle-income countries (MICs) tend to be confronted by a slow-down of the steady economic growth they experienced to reach MIC level. A review of the literature suggests that the MIT is a result of a series of failures in the process of sustained economic growth that prevents the transformation of MICs into high-income countries (HICs). In other words, the research points at the inability of a given country to change its growth strategy and progress further after having reached the middle-income threshold.

According to Gill and Kharas,³ countries that reach middle-income status⁴ will encounter a series of obstacles when trying to adapt their economies and export production-driven models to become more specialized market economies, which is deemed as necessary to escape the MIT.⁵ At a low-income level, growth takes place as a consequence of the surpluses generated from production factors such as cheap labor, the transformation of the labor force from an agricultural workforce into an industrial one, as well as a natural increase in the size of the labor force, among other factors. However, at the middle-income level, the very same factors that fueled growth in the early stages act as a hindrance of sorts, slowing down and eventually reversing the growth process.

As a World Bank report in 2012 contended, once countries reach middle-income status, “productivity growth from sector reallocation and technology catch-up are eventually exhausted, while rising wages make labor-intensive exports less competitive on world markets [...] output and growth slow, and economies become trapped, unable to transcend to high-income status.”⁶ In other words, as the source of cheap labor is exhausted, wages rise, and the costs of

³ Gill and Kharas, *An East Asian Renaissance. Ideas for Economic Growth*.

⁴ Middle-income countries are sometimes divided into two groups: lower and upper middle-income; see footnote 8 below.

⁵ Countries endowed with rich natural resources such as oil and gas producing states may be considered exceptions in regard to this analysis.

⁶ P. Agénor, O. Canuto, M. Jelenic, “Avoiding Middle-Income Growth Traps,” Poverty Reduction and Economic Management Network (PREM), *Economic Premise Series*, No. 98 (The World Bank, November 2012), pp. 2-3.

manufacturing and exporting mass-produced goods exceed the initial added value gains, MICs become trapped between the low-cost production economies of low-income countries (LICs) and the highly-skilled economies of HICs.

In an econometric analysis published by the International Monetary Fund (IMF), it was found that economic slowdowns are “disproportionately likely to occur in MICs, thereby providing empirical justification for policy concerns about the middle-income trap.”⁷ This analysis established a series of thresholds for low-income, middle-income, and high-income countries, respectively. Further, this classification reveals that attaining the higher threshold appears to be somewhat of a “glass ceiling” for MICs, and, moreover, that most of the MICs included in the IMF study are well behind a trajectory that would bring them up to the HIC level; indeed, some of them are still “stuck” as long as 50 or 60 years after they first attained MIC status.

According to World Bank calculations,⁸ of altogether 101 countries that were MICs in 1960, only 13 of them had managed to become high-income countries by 2008⁹—among them the so-called “Asian Tigers” and OECD members such as Greece and Ireland, but notably no Latin American country.

A study published by the Asian Development Bank¹⁰ provides an operational definition of the Middle-Income Trap. Based on an analysis of the development path of 124 countries between 1950 and 2010, the study concludes that it takes 28 years at an annual average growth of 4.7 percent for a country to pass from a lower-middle income country (LMIC) to an upper-middle-income country (UMIC) and another 14 years at an annual growth rate of 3.5 percent to graduate from an UMIC to a HIC.¹¹ The study uses the GDP per capita in 1990 (purchasing power parity, ppp) to define US\$2000 as the threshold for LICs, \$7,250 as the ceiling for LMICs, and \$11,750 as the ceiling for UMICs.¹² According to their analysis, 35 out of altogether 52 countries in the MIC category (as of 2010) are caught in the MIT, with over 80 percent of them being found in the LMIC group. In terms of regional distribution, 13 are in Latin America, 11 in Middle

⁷ Aiyar and Duval, “Growth Slowdowns and the Middle-Income Trap,” p. 3.

⁸ The World Bank classifies its member countries into the following categories, based on the GNI per capita (ppp in 2012): low income, \$1,035 or less; lower middle income, \$1,036 - \$4,085; upper middle income, \$4,086 - \$12,615; high income, \$12,616 or more. Note that figures are in U.S. dollars.

⁹ See Agenor, Canuto, and Jelenic, “Avoiding Middle Income Growth Traps.”

¹⁰ J. Felipe, “Tracking the Middle-Income Trap: What it is, Who is in it and Why?”

¹¹ Based on those countries that have graduated from MICs to HICs.

¹² Note that the ADB’s thresholds differ slightly to those of the World Bank (see footnote 8).

East/North Africa, 6 in Sub-Saharan Africa, 3 in Asia, and 2 in Europe, respectively. It should be noted in this regard that several newcomers in the MIC category, such as China, Vietnam, and India, have not been long enough in the category—in accordance with the above study definition—to be defined as having fallen into the MIT.

MIT: Recapturing the “Standard” Arguments

The Middle-Income Trap is frequently described as a squeeze between conditions characterizing LICs under transformation to MICs through low wage competition that dominate mature industries and conditions of HICs that dominate industries undergoing rapid technological change.¹³ A common explanation of growth slowdowns is based on a Lewis-type development process of unlimited supply of cheap labor in the subsistence sector which can be more productively engaged in the private sector without the need to raise wages, thereby creating high growth during the initial phase of rapid development. What are advantages in LICs—low-cost labor and import of foreign technology in the capitalist sector—gradually become less so, however, when middle-income levels are reached, thereby requiring new sources of growth to maintain sustained increases in per capita income. Indeed, during the initial phase, LICs can compete in international markets by producing labor-intensive, low-cost products using technologies imported from abroad. These countries can achieve large productivity gains initially through a reallocation of labor from low-productivity agriculture to high-productivity manufacturing.

In a narrow economic sense, MIT equals “imitation,” that is, an economy that has transcended a low-income rural economy and, with help from foreign direct investment, managed to achieve industrialization in the form of imported and mature technology, often at the lower levels of the value chain of a Transnational Corporation (TNC). The imitated technology could take the form of inputs into more composed and complex final products, but also assembly of products of mass production such as computers, motor vehicles, and so on. However, the ownership and control of innovation or design, as well as the main revenues, of the final product or service are still managed by TNCs with headquarters in a HIC. Also, after rapid growth when low-labour costs boost export earnings from sales of finished or semi-finished goods, falling global competitiveness from increasing labour costs tend to slow down production

¹³ Gill and Kharas, *An East Asian Renaissance. Ideas for Economic Growth*.

and, eventually, economic growth of the MIC. In such a case, a country can be said to have entered the MIT.

The literature reviewed of what can be termed the standard arguments of why many MICs have not been able to escape falling into the trap points to a number of explanatory factors, which are outlined below.

- *The Youth Dividend and the Labor Market*

As Eichengren¹⁴ has noted, most developing countries are experiencing falling fertility rates with a corresponding youth dividend or bulge. A population dominated by young people is eventually transformed into a growing labor force and higher employment, resulting in increasing per capita growth. This process often takes place in a labor regime of long working hours in worker-unfriendly conditions, low wages, and low hiring and firing costs—the garment industry in Bangladesh and Cambodia being an example of such.

Once the middle-income level has been reached, however, an inconsistency will emerge between the market and labor structures. Previously applied policies aimed at fostering economic development through a growing labor force and a rise in productivity through the introduction of low-cost manufacturing processes¹⁵ cannot be perpetuated over time at middle-income level to further increase per capita income. As the inflow of workers willing to work long hours for low wages dries up, wages tend to rise in accordance with productivity gains, and it thus becomes more expensive to compete in global markets while maintaining a low-income country productivity rate.¹⁶ In other words, a country's "per capita output growth can soon be diluted by the growth of the population."¹⁷ It is at this point that a middle-income country needs to upgrade its labor market regime to meet the demands of a population that will not settle for lower-income country conditions and the realities of a market paradigm that no longer increases growth. The driving force behind this growth that hitherto was reliant upon low cost production must be upgraded to what researchers

¹⁴ B. Eichengren, "Escaping the Middle Income Trap," in *Achieving Maximum Long Run Growth* (Federal Reserve Bank of Kansas City, 2011 Economic Policy Symposium), pp. 409-419.

¹⁵ *Ibid.*

¹⁶ F. Cai. "Is There a 'Middle-Income Trap'? Theories, Experiences and Relevance to China," *China & World Economy*, Vol. 20, Issue 1, January-February 2012, pp. 49–61.

¹⁷ *Ibid.*

have come to define as “capabilities accumulation.”¹⁸

As discussed in a World Bank paper on Poverty Reduction and Economic Management (PREM)¹⁹ for LMIC countries, productivity and wages are relatively low in the imitation sector, which mitigates the incentives to invest in higher level skills and education. The lack of highly educated workers constrains production in design activities and further prevents the establishment of knowledge networks. Countries may remain caught in a situation of low or moderate growth because they are unable to get enough potential highly skilled workers into innovation activities; and due to low wages, fewer individuals of high potential are willing to make the investment necessary to acquire the skills needed to be employed in the innovation sector. The composition of the labor force depends, therefore, on the interaction between supply and demand of skilled workers. Therefore, the misallocation of talent, i.e. when distortions in the labor market do not provide incentives for workers to engage in higher education, serves as one explanation of MIT.

On the one hand, as the economy moves out of the LIC bracket and low-skilled workers start to organize themselves, in order to reap better benefits from the growing economic output, working conditions improve and the labor market generally becomes more effective and efficient. On the other hand, some types of labor market restrictions, especially those on firing costs, may be particularly detrimental to design or innovation activities. As Agénor²⁰ describes, it is often more difficult to evaluate the productivity of a worker before hiring in an innovative activity than in routine tasks in manufacturing, where such assessments are both less necessary and costly. Thus, the risk of hiring a worker who turns out to be a poor performer is higher in activities where a college degree does not necessarily provide a reliable indicator of future performance. In such conditions, the high cost of firing acts as a disincentive to develop innovative and high-tech companies, which require human capital with an advanced education. The labor restrictions then have adverse consequences for innovation and growth.

¹⁸ E. Paus, “Confronting the Middle Income Trap: Insights from Small Latecomers,” *Studies in Comparative International Development*, Vol. 47, Issue 2 (2012), p. 120; Felipe, “Tracking the Middle-Income Trap: What it is, Who is in it and Why?” p. 2.

¹⁹ Agenor, Canuto, and Jelenic, “Avoiding Middle Income Growth Traps.”

²⁰ *Ibid.*

- *Poor enforcement of property and patent rights*

There is a consistent lack of innovation and investment in specialized production in most MICs. Many MICs seem to be unable to detach themselves from lower technology patterns, which ultimately serve to constrain the economy at a level where competition with other LICs and LMICs defines the economic environment for the business sector. One crucial factor in overcoming this situation is stable property rights, particularly with reference to land ownership, which is the building block in any efficient real estate management system and a cornerstone in the development of an effective credit system.²¹ Without such a system land assets are “dead” — that is, they cannot be used as collaterals to finance investments.

Equally important is the existence of a stable regime for patent rights. The enforcement of patents is essential in order to create incentives for individuals and firms to engage in innovation and design activities. However, in most LMICs, this is often lacking. A poorly functioning system to administrate patents and enforce property rights results in a lost momentum and will effectively jeopardize a country’s trajectory to UMIC and eventually HIC levels.

- *Economies of Scale and Innovation*

In a context of economies characterized by mass production, as previously argued, it is widely observed that export revenues are the main source of economic growth for LICs. The globalized market entails a universal demand for manufactured goods and, in order meet this demand, developing countries save production costs by borrowing manufacturing technology from more advanced producers.

However, there is a consistent lack of innovation and investment in specialized production witnessed in most MICs, as they seem to be unable to detach themselves from low-income patterns. Such a situation is ultimately detrimental when the country, having reached middle-income status, is faced with other LICs that can take advantage of benefits deriving from economies of scale. Therefore, innovation and investment are crucial, for example, in efforts to modernize agriculture and to scale up the development of rural economies.

Accordingly, the need to specialize in more skill-based products emerges when a country is no longer able to profit only from its mass production and

²¹ See, for example, H. de Soto, *The Mystery of Capital* (Basic Books, 2000).

must, instead, increasingly rely on “indigenous innovation.”²² This reliance in turn depends on investment in national and local firms as well as the creation of a competitive environment for companies to develop products for a domestic market—that is, creating a pattern of consumption within the population, which, again, goes back to the point of the need for labor restructuring by raising salaries and empowering society economically. In other words, the national economy is boosted if the population is encouraged to consume domestically produced goods, which, in turn, will only happen if the population in question has the economic surplus to do so.²³ Additionally, the lack of a technology-boosting environment deters foreign direct investment which would be extremely valuable for MICs in the process of building a network of functioning partnerships with neighboring producing countries.

Another bottleneck faced by MICs is the high investment cost linked to high-speed communication networks, which are closely related to a more innovative industry. Moreover, in most cases these costs will have to be borne by the public sector, at least initially, and notably by the state budget. On a similar note, the willingness by the political elite to trust and permit open, non-censured communications between citizens in and outside of the country often serves as another obstacle which can hamper the development of an innovation and design-based economy, where the level of high-tech and branded products and services serves as a growth engine.

Furthermore, the experience derived from the South Korean example (see Appendix 1) dictates that infrastructure plays a key role in the connectivity of the economy, for instance, in the reduction of transportation and logistical costs. In other words, the enhancement of transport infrastructure is a crucial cornerstone for the successful development of the trade performance of a MIT. According to an OECD paper published in 2012,²⁴ part of South Korea’s successful trade remodeling is grounded in the profound development of infrastructure that the country underwent according to market-led needs, both in terms of improvements in transport and communications infrastructure as well as “soft infrastructure” such as ICT access. Additionally, Kohli and Mukherjee have laid

²² *Ibid.*, p. 119.

²³ Kharas and Kohli, “What Is the Middle Income Trap, Why do Countries Fall into It, and How can It Be Avoided?”

²⁴ A. Jankowska, A. Nagengast, J.R. Perea, “The Product Space and the Middle-Income Trap: Comparing Asian and Latin American Experiences,” *OECD Development Centre Working Paper*, No. 311 (OECD Development Centre, 2012).

out the positive implications for investing in road infrastructure, such as decreasing transportation time, increasing proximity and safety of population travelling, reducing alienation of local communities, increasing food availability, and greatly improving secondary and primary education completion rates in rural or semi-urban areas where children are forced to travel a long way to attend school.²⁵

- *State-led Transformation and Capability Development*

In the early 1980s, Singapore and Taiwan succeeded in advancing their industrialization through clear policies that derived lessons from Japan's experience of industrialization, which, to a large extent, was led by the state, particularly in terms of the acquisition of foreign technology and protection from external competition while building up the capability of Japanese firms. South Korea, possessing a similar economic policy and structure to Japan, adopted the Japanese experience of enabling high-tech industries and accelerating its economic growth while receiving a great amount of investment from Japan. However, the so-called "convoy system"²⁶ contained protectionist policies and did not work well in an open economy; Japan was able to take this approach in the 1960s because of the non-openness of its market. By contrast, the current Asian UMICs have realized their rapid economic development by opening their markets and linking closely with other economies with huge volumes of trade and inflows of FDI.

MICs, as all other members of the World Trade Organization (WTO), cannot pursue protectionist policies but have to seek another path, compatible with a more open economy, to advance their economic structures. However, implementation may be difficult politically, because sunset industries, i.e. very mature industries working under oligopolistic regimes, sometimes have strong lobbying powers. Moreover, state-owned enterprises (SOEs) tend to be resistant to change. And yet, according to Egawa, an "effort to maintain these industries by providing subsidies will result in weaker economic growth and may lead countries to fall into the middle-income trap."²⁷ For example, although Vietnam

²⁵ H. Kohli and N. Mukherjee, "Potential Costs to Asia of the Middle Income Trap," *Global Journal of Emerging Market Economies*, vol. 3, no. 3, September 2011, pp. 291-311.

²⁶ The convoy system was a practice employed by the Japanese government in the 1980s that consisted of all banks offering the same interest rates and performance with cooperative lending under the concealed monitoring of the Ministry of Finance.

²⁷ A. Egawa, "Will Income Inequality Cause a Middle-Income Trap in Asia?" *Bruegel*

has just entered the LMIC level, the political elites' inability to reform the huge SOE sector is causing major macro-economic imbalances that prevent sustainable growth. Consequently, there are signs that Vietnam may have already entered the MIT.

The pervasiveness of coordination failures and market inadequacies as well as the need for non-marginal change, demand a proactive state for the achievement of broad-based upgrading. Horizontal and vertical policies may be needed in order to advance social capabilities, support the development of local firm capabilities and establish a critical level of absorptive capacity, enable Transnational Corporation (TNC) affiliates to upgrade production in the host country toward more sophisticated activities, and provide a set of economic incentives conducive to broad-based capability accumulation.

MIC government policies have to expand education and infrastructure in a way that is in sync with, and sometimes in anticipation of, the advancement of firm-level capabilities. The government must play a key role in shifting economic activities toward greater knowledge intensity, by establishing, enabling, and promoting networks among public sector institutions, academia, and firms, and by funding research and by providing incentives to private sector firms. Historically, the government has taken the lead in funding in advancement of R&D activities, directly through its own institutions or by supporting research in public universities; only later does the business sector become the driving force.

The government of a MIC also needs to play an active role in supporting the development of firm-level capabilities. Different policies are needed at different stages of the ladder of technological capabilities. Given the heterogeneity of the productive sector in many MICs, support for capability advancement has to be multipronged, as different firms are on different steps of the technological capability ladder. One set of policies has to be directed toward the many micro- and small enterprises so that they can become better integrated at the low end of the value chains. Deliberate policies may be needed to support the formation of linkages with TNCs to enable leapfrogging in local firm capabilities. And finally, policies to support research and inter-sector upgrading toward high-technology activities have to provide incentives for R&D and start-up funding for inventors who want to turn their ideas into profit-generating production.

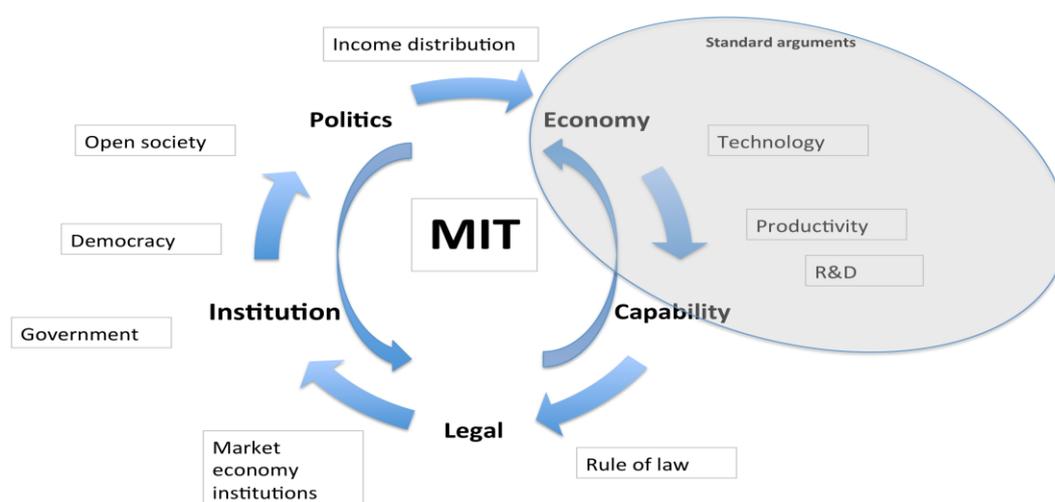
These policies are very far from a quick fix and require a long-term government commitment over and above bipartisan policies. This represents, no doubt, a challenge for many MICs.

Broadening the MIT Concept: Non-Economic Dimensions

After having reviewed and analyzed the essentially economic dimensions of the MIT as per what can be termed “standard” arguments, we argue that insufficient attention in the MIT debate has been given to non-economic aspects. There is therefore a need to also turn to other aspects of the endogenous processes of the transformation of countries: namely, human and social capital development.²⁸ This necessary analysis of other non-economic dimensions rises out of the certainty that the concept of MIT—and therefore its causes and consequences—are not exclusive to the economic transformation of a country.

Figure 1 below summarizes the more complex picture of the MIT. The factors in the grey (shaded) ellipse—as examined in the previous section—are those that are generally referred to and analysed when explaining the causes and ways out of the MIT. The factors and issues outside of this ellipse are not generally included in the mainstream analysis, even though, as will be argued here, they are interlinked and even constitute key underlying causes for many of the economic failings of MICs.

Figure 1: Holistic view of MIT



²⁸ E. Paus, “Confronting the Middle Income Trap: Insights from Small Latecomers,” *Studies in Comparative International Development*, vol. 47, issue 2 (2012), p. 120.

According to Kuznets,²⁹ economic development at middle-income level is an increasingly complex process that requires human and capital accumulation and development, industrialization, and innovation in products and process designs. More specifically, it requires changes in state structures and dimensions such as in the political and institutional sphere.

Accordingly, much research reveals that the broader issues of human and social capital development are *sine qua non* conditions for the successful development and avoidance of growth slowdowns. Human and social capital development addresses the need for structural changes in areas such as education, health care (as well as other primary welfare services), social inclusion, gender equality, governmental transparency, a free press, and the creation of a participative democracy by state institutions. In the latter context, for instance, Eva Paus³⁰ specifies the need for a proactive state that provides opportunities for the lower-income population to participate in the decision-making processes related to democratic institutions, as well as their empowerment when it comes to promoting the creation of new businesses and community-based groups at local and regional levels. Further, primary welfare services should focus on the protection of those strata of the population particularly vulnerable to illness, disability, natural disasters, economic crises, civil conflict, and so on.³¹ The issue of gender equality is also viewed by scholars as part of the necessary development of society. Empowering women with equal opportunities to men not only increases human capital productivity but also deeply influences the fabric of society and improves general life conditions. To this effect, a basis for functioning welfare states needs to be established.

In sum, a vast majority of research conducted in countries currently afflicted by poverty and slow growth concludes that there are five crucial pillars to be addressed to fully comprehend the extent of these phenomena, and to be able to provide policy reactions to counter it. These are: (i) education, (ii) "soft" infrastructure, (iii) institutions and the role of government, (iv) corruption and the rule of law, and (v) an inclusive growth policy.

²⁹ S. Kuznets, *Economic Growth of Nations: Total Output and Production Structure* (Belknap Press of Harvard University Press, 1971), p. 348.

³⁰ Paus, "Confronting the Middle Income Trap: Insights from Small Latecomers."

³¹ *Framework of Inclusive Growth Indicators 2013, Key Indicators for Asia and the Pacific*, 3rd edition (Asian Development Bank, September 2013).

- *Education*

As explained above, human capital development is vital for a country's evolution from a labor-intensive economy to skill-intensive industries. When "copying" or "borrowing" technology or knowledge is no longer profitable, advanced techniques and skills are required to induce the necessary shift in market structures. Comparative advantages for countries in a global market arise from innovation and investment in R&D policies, which ultimately can only be achieved by the prior strengthening of educational and capability-providing networks.

Education and capability network strengthening serves the purpose of providing for primary compulsory education for the overall population³² and facilitating access to good quality secondary education as well as vocational training. Both secondary and tertiary education provide for an academic environment that fosters specialization and capability building. The accumulation and diffusion of knowledge and capabilities is vital for countries to make a sustained progression up the value chain. In this regard, indicators collected in an ADB report suggest that countries with weak education (and health) programs struggle for longer to sustain growth and overcome traps.³³ There is therefore an urgent need for policy makers to tackle this lack of a highly educated and skilled population because structural change will require capacity building for entire generations.

If education is not made accessible for the lower-income population, human capital development will be delayed, hence slowing productivity and resulting in permanent stagnation. Moreover, the risk of the monopolization of secondary and tertiary education by elites has proven to result in social alienation which has the potential to lead to social unrest, thus feeding social inequality and perpetuating divisions among the populace—all of which characterize countries that have fallen into the MIT.³⁴

- *"Soft" Infrastructure and Social Welfare*

The importance of infrastructure, including the development of services and networks as well as the necessity of hard infrastructure for energy and transport,

³² Agenor, Canuto, and Jelenic, "Avoiding Middle Income Growth Traps."

³³ Felipe, "Tracking the Middle-Income Trap: What it is, Who is in it and Why?" Part 2.

³⁴ *Ibid.*

has already been highlighted in the preceding analysis. A broadened view focuses on “soft” infrastructure and access to information and communications. In the race to become a knowledge-based economy, Information Communication Technology (ICT)-related infrastructure, as well as connectivity of urban and rural areas, are all of crucial significance. According to Gill and Kharas: “The availability of good-quality information and communications infrastructure plays an important role in fostering innovation both by facilitating the cheap circulation of disembodied knowledge flows across and within national boundaries, as well as by reducing the transaction costs of international trade and foreign investment flows.”³⁵ As reported by the aforementioned authors,³⁶ the governments of MICs must acknowledge the importance of reducing intra-industry trade and transport costs, as well as the need to invest in research and development according to the country’s specific market prospects, while focusing on diversifying capital markets.

Another very relevant dimension of infrastructure concerns social safety nets and the welfare state. As presented in an ADB report in 2012,³⁷ basic infrastructure services regarding health, energy supply, and access to clean water and sanitation, are one of the main failures in MICs. Inequality of opportunity and access to these services increases alienation and polarization of productivity and negatively affects overall well-being. In addition to this, research has shown that the failure to address these issues can result in the deepening of poverty levels, especially in rural areas that are yet to experience the technology catch-up.³⁸ Tackling these failures in basic infrastructure development should be one of the priorities for countries seeking to avoid the MIT.

- *Institutions and the New Role of Government*

The institutional pillar refers to the capabilities management and organizational structures of the state; that is, the governmental or state-led entities that are in charge of promoting and ensuring the correct implementation of the previous two pillars. Hence, educational and infrastructural measures need to be

³⁵ Gill and Kharas, *An East Asian Renaissance. Ideas for Economic Growth*.

³⁶ *Ibid.*

³⁷ Felipe, “Tracking the Middle-Income Trap: What it is, Who is in it and Why?”

³⁸ S. Fan, L. Zhang, X. Zhang, *Growth, inequality, and poverty in rural China: The role of public investment*, Research Report 125 (Washington D.C.: International Food Policy Research Institute, 2002).

supported by the necessary actors in order to nurture a holistic and comprehensive change in society. This translates into government and institutional enforcement of social networks as well resource-gathering. Institutions need to be open, transparent, and accessible to the population. In other words, institutional and policy barriers³⁹ should be removed in order to legitimize governmental authority and to strengthen ties between political elites and civil society and, thus, foster social inclusion and participation in democracy.

The role of institutions and the government is vital for the implementation of policies seeking to expand education and infrastructure according to the country's needs and in synchronization with the evolution of firm-level capabilities. There is thus a demand in countries experiencing economic stagnation for a proactive institutional and political sphere,⁴⁰ the responsibilities of which range from establishing and fostering networks of knowledge (capabilities), supporting the creation of public sector institutions, encouraging and funding production and innovation in the private sector, and so on.

Indeed, it is precisely at the middle-income level that the government's role becomes even more important in terms of meeting social demands and reducing inequality (both in terms of income and access to opportunities). The extreme polarization of resources between elites and disadvantaged strata of society necessitates governmental support in providing efficient social protection programs and social safety nets, which take the form of judicious labor market policies, human capital development, regulation of taxation systems adjusted according to population income, provision of social welfare for vulnerable groups such as children, women, elderly, single-parent families, and victims of natural disasters or civil conflicts.

It is incumbent upon governments at this stage to guide governance, ensure the correct allowance and functioning of these programs, and to supervise the funding, capacities, infrastructure, and policy frameworks at local and regional levels. As the income and development of a country increases, considerable reforms and changes must be implemented concerning governments' roles, functions, and tasks. Policy development and monitoring become paramount functions rather than implementing projects. In turn this calls for structural reforms

³⁹ G. Rauniyara and R. Kanbur, "Inclusive growth and inclusive development: a review and synthesis of Asian Development Bank literature," *Journal of the Asia Pacific Economy*, November 2010, vol. 15, issue 4, 2010, pp. 455–469.

⁴⁰ A. Booth, "Initial Conditions and Miraculous Growth: Why Is South East Asia Different From Taiwan and South Korea?" *World Development*, February 1999, vol. 27, no. 2, pp. 301–321.

and new types of skills and capacity among civil servants.

Anne Booth⁴¹ further illuminates the issue of the role of governments in the building of functioning institutions and fostering democracy. In their role as growth promoters, government officials must have a high degree of competence and autonomy, that is: independence from lobbyists or other powerful groups, as well as from politicians. What is therefore demanded here of the institutional and political spheres of the state is a certain degree of insulation from one another and from the producing sectors, a separation that is measurable in terms of transparency and the rule of law.

- *Corruption, Transparency, and the Rule of Law*

In addressing institutional and governmental legitimacy—linked also to improving democratic governance in those countries suffering a growth slowdown—a large body of research as spearheaded by the previously cited 2007 World Bank report⁴² exposes very clearly two of the main issues at hand: corruption and transparency. The report makes the finding that “overly discretionary incentive regimes create uncertainty for investors and foster corruption.”⁴³ Research undertaken⁴⁴ in several countries in East Asia has shown that corruption has increasingly diminished growth, proving that the absence of transparency and accountability at a local level, as well as other levels, continues to endanger the development process through the middle-income stage, so deepening recession and incapacitating the rule of law as a functioning ally of democracy.

In order to successfully transition from the so-called “rule of man” to the rule of law, government and institutions need to be open and accessible to citizens, there needs to be measurable independency between the different organizational bodies of the state, and society needs to have access to state-based information through public means such as an independent press. Accordingly, freedom of press and speech needs to be established in order to expose corruption together with democratic institutions and a functioning and independent judiciary system, which are the tools to remove corrupt entities or persons.

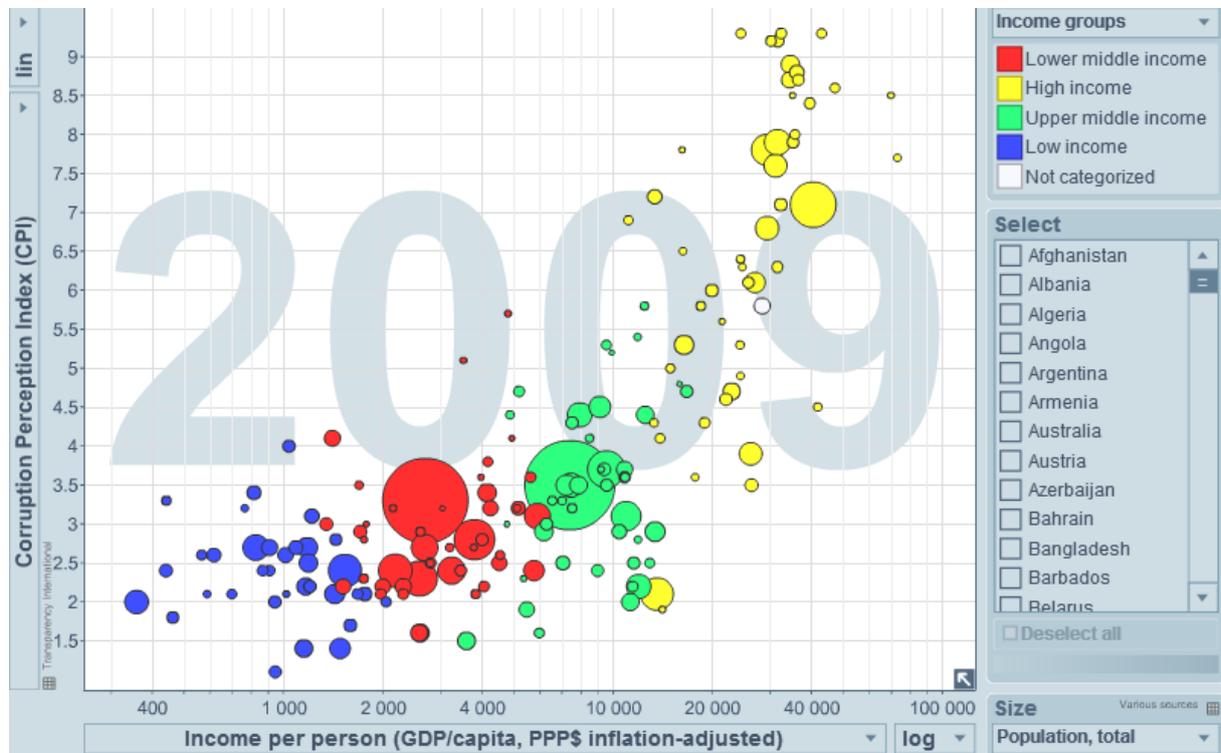
⁴¹ Ibid.

⁴² Gill and Kharas, *An East Asian Renaissance. Ideas for Economic Growth*.

⁴³ Ibid..

⁴⁴ See e.g. Gill and Kharas, *An East Asian Renaissance. Ideas for Economic Growth*.

Figure 2: Corruption index by country per capita income, per income group (2009)



(Source: gapminder.org)

Figure 2⁴⁵ above illustrates the trend that as corruption decreases (the higher the CPI, the less corrupt a country) per capita income accordingly increases. The distribution over the four income groups is distinctly visible: LICs with the highest corruption levels followed by LMICs and then UMICs, whereas HICs record the lowest corruption scores.

- *Inclusive Growth Policy*

A further factor that imperils the sustainability of the growth process is rising income inequality. This can lead to inefficient resource allocation and the waste of human and physical capital as well as the undermining of social cohesion leading to social conflict – which thus erode the possibilities of sustaining economic growth.

Several analyses⁴⁶ have found that income *inequality* increases as a result of

⁴⁵ Size of circle denotes a country's population size (the larger the circle, the larger the population). The year (2009) is the most recent available.

⁴⁶ See, for example, *Asian Development Outlook 2012: Confronting Rising Inequality in Asia*

rapid economic development, the main driving forces being technological change, globalization, and market reform, which altogether increase income from technology and capital as well as from investments in high-skilled industries. Regional inequalities may also increase as growth often tends to be concentrated in urban and coastal areas where high-tech skills and trade predominate. Conventional economic wisdom contends that growing inequalities foster economic growth. However, this wisdom is being increasingly questioned, as long-term and sustainable growth is not compatible with strong social and economic inequalities. Studies have shown, for instance, that a high degree of inequality in Latin America has served to slow down growth there; and, furthermore, cutting Latin America's Gini gap by half might see its growth spurt last twice as long.⁴⁷ Inclusive growth policies, aimed at reducing Gini and ensuring more equitable growth benefits, are therefore not only socially justified but also carry a growth dividend.

The main cornerstones for inclusive growth policies, as fleshed out in *Asia Development Outlook for 2012*,⁴⁸ are as follows: (i) fiscal policies that are based on broader tax bases and more effective collection being spent on health and education; (ii) improved regional connectivity and more equitable access to social services; and (iii) employment-friendly growth, improving household capacity to earn a sustainable living.

(Asian Development Bank, April 2012).

⁴⁷ See "Inequality v growth," *The Economist*, March 1, 2014.

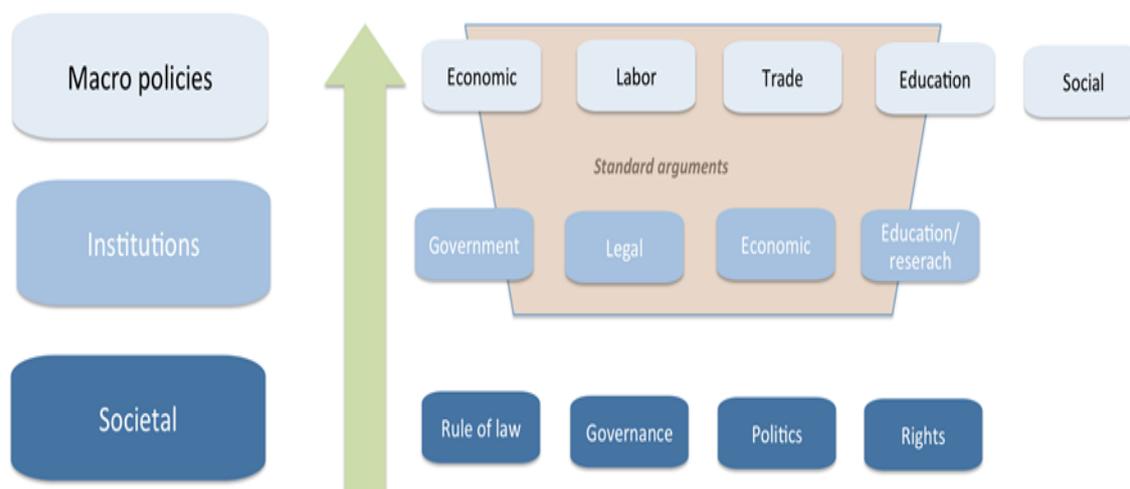
⁴⁸ *Asian Development Outlook 2012*.

Reappraising the Middle-Income Trap

Our analysis shows that the MIT concept is generally well described and useful, as previously examined, but also that mainstream arguments, which focus mainly on economic aspects of growth/stagnation, are not sufficient to capture all dimensions. Thus, while prudent economic management and policies are vital to avoid the MIT, other societal and institutional factors may be more important and play a determining role in explaining failure or success in sustaining economic growth. Therefore, non-economic dimensions are fundamental for any reform or structural change.

It follows therefore that the analysis has to be broadened so as to make the concept of MIT more fully understood and useful as a policy instrument. In so doing, the concept necessarily becomes more complex and multi-dimensional as depicted in figure 3 below.

Figure 3: The broadened MIT



In the table on the following page, we summarize the key factors, as elaborated on in this study, which have to be addressed in order to avoid the MIT.

Table 1: Summary of Key Factors

Factors/ dimensions	Measures to avoid MIT
<i>Mainstream analysis</i>	
Labor market	Consistencies between market and labor structures. Labor costs match productivity. Need to increase labour productivity through increased skills.
Property and patent rights	Ensure stable property rights, particularly land ownership as cornerstone for credit system (land effectively managed as “living capital” resource) as well as stable regime for patent rights.
Infrastructure	High level of communications infrastructure important to foster innovations and reducing transaction costs.
Capability	Government commitment to develop national education system and development of firm-level capability.
International trade	Export revenues main source for economic growth. International competition fosters efficiency in domestic firms—creating higher productivity. Globalization raises important questions on TNC role in upgrading processes and capability of domestic firms.
Technology and R&D	Technology development and allocation to R&D are critical when moving from imitation to innovation.
Foreign Direct Investment	Joint ventures and TNCs are important sources for technological transfer, with potential for spill-over effects on domestic firms.
State-led transformation	Policy of open market economy. Subsidizing of state-owned enterprises difficult under WTO regime; establish level-playing field with private firms.
<i>Broadened analysis</i>	
Open Society and Governance	Open society and good governance are essential to ensure freedom, transparency, and accountability, thereby minimizing corruption and increasing innovation.
Rule of law	Legal institutions need to be independent from government. All public institutions need to be open and information accessible by civil society.

Government	Roles, functions, and tasks of the government must be reformed and changed – from project implementation to policy development and results monitoring.
Social, income distribution	Social development by building a welfare state is important. Income inequalities become obstacles to economic growth. Inclusive growth is imperative.
Institutions	Suitable institutions are a must for realizing economic reforms and growth. This is a long-term process.
Corruption	Corruption is a major factor that will cause countries to fall into the MIT and makes it harder to implement necessary reforms.
Soft Infrastructure	Beside “hard infrastructure” like roads, soft infrastructure must be developed to facilitate communication and information flows.
Education	Education is critical in building human capital to transform from labor-intensive to skill-intensive industries. Also key in building social capital.

It's Democracy, Stupid

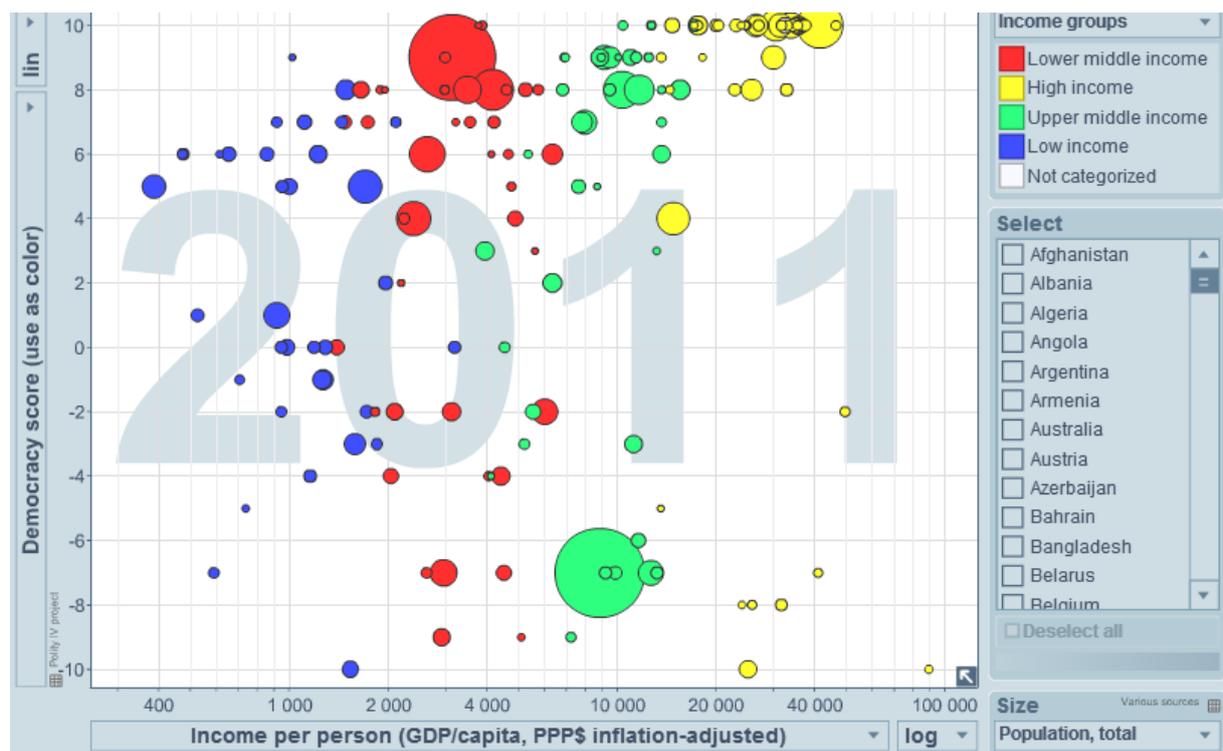
In illuminating the importance of the other factors as part of a broadened analysis, it is argued here that the degree of democratic governance can serve generally as a useful proxy for all these factors. A country which displays a high level of democratic governance typically has a relatively low level of corruption, income distribution is more equal, the judiciary system is relatively free from politics and government influence, while freedom and rights are established with a more open society and free press. In turn, such an environment fosters innovation and reforms, the government's role and function changes, and functioning public sector services and the private sector are encouraged by a more leveled field between the two—all of which lead to security of ownership, high capability, and more conducive economic policies for increasing growth and welfare.

Toward the beginning of this study it was highlighted that (according to World Bank calculations) only 13 countries had become HICs by 2008 out of the 101 countries that were MICs in 1960. A notable observation is that out of these 13 countries, 10 were at that time or have become democracies: Greece, Ireland, Israel, Japan, Mauritius, Portugal, Puerto Rico, South Korea, Spain, and Taiwan.

The remaining three are city-states (Hong Kong and Singapore) whereas the remaining country is an oil-exporting country, Equatorial Guinea.

And while the evidence suggests, as illustrated in Figure 4 below, that democracies are found at *all* income levels from LIC to HIC—indeed, among the LICs and LMICs there are roughly the same number of democratic as non-democratic countries—UMICs are nonetheless dominated by democratic countries, and HICs are solely democratic countries (excepting oil-exporting and city-states). It can be observed therefore that as the national income increases, the smaller the number of non-democratic countries and higher the share of democratic countries will be. Notwithstanding, this fact does not exclude the need for sound economic management.

Figure 4: Democracy index by country per capita income per income group



(Source: gapminder.org)

Conclusion

In conclusion we have found that MIT is a useful concept for diagnosing a stagnating economy, but that the remedy to a large extent also has to be found outside a macro-economic analysis. Indeed, the prescription and the cures to prevent falling into the MIT are not simple and need to be seen holistically, that is, economic and other factors are closely intertwined. We have shown therefore in this paper that both long-term social and economic policy reforms are necessary for MICs to avoid falling into the MIT. A long-term perspective is required not least to build and make effective the institutions that must be in place to ensure that reform policies are translated into laws and regulations and that these become respected and safeguarded from undue commercial and political interference. Hence, the reform agenda is most likely to become effective when underpinned by a social contract that is respected by the majority of the population, for instance under a regime of democratic governance.

Accordingly, it would appear that democratic governance serves as a good proxy that captures many of the dimensions and factors of the broadened analysis that determine the way out of the trap. Therefore, the main conclusion and recommendation advanced here is that a political process leading toward democracy, coupled with prudent economic management, is a necessary condition for nations to avoid falling into the MIT, and thus to avoid its negative social and political consequences. Further research, however, is required to more rigorously test the validity of the arguments presented in this paper.

Annex: The Case of South Korea

South Korea is often held up as an example to illustrate the case of a country that managed to avoid the middle-income trap and is now one of the best functioning economies in the world. The majority of analyses of South Korea focus on the country's rapid growth from the 1960s to the 1980s from an economic perspective.⁴⁹ However, all of them mention the specifics of governmental decision-making and the importance of the policies applied during those years. According to Lee, one of the factors leading to South Korea's success was the government's emphasis on capability and technological development by publicly funding and conducting R&D, which led to increasing private exporting and the upgrading of Korea's manufacturing structures from OEM to OBM,⁵⁰ thus allowing for national firms to expand in foreign markets and ultimately launching Korea's electronics manufacturing sector into a leading position in the global market.

The rapid economic development of South Korea has certainly not been a harmonious process. In fact, growth took off under harsh authoritarian rule, with the introduction of Five Year Economic planning after a military coup led by Major General Park Chung-hee. Within this framework investments in heavy industry—basic and chemical—took place in large companies, which benefited from government support in the form of low-interest bank loans and tax relief. These companies were later to become “chaebols,” the flagship of Korea's transformation. Whereas workers with high education were handsomely rewarded by these companies, laborers in the export sector and farmers were initially left behind. Despite some reform, protests against the regime increased, particularly after a constitutional amendment was forced through the National Assembly to allow Park to be appointed President for a third time. The political grip hardened further and was underpinned by emergency laws and the jailing of a large number of dissidents. In 1979 nationwide demonstrations demonstration eventually led to the assassination of Park.

During the fifth republic, 1979–1987, the rapid economic growth continued but also widened the gap between rich and poor and between regions. In 1987,

⁴⁹ K. Lee, “How can Korea be a Role Model for Catch-up Development?” *UNU-WIDER Research Paper*, No. 34 (World Institute for Development Economics Research, United Nations University, April 2013).

⁵⁰ See list of abbreviations.

however, a revised constitution was approved, civil rights were restored, and direct presidential elections were held. South Korea became a member of the OECD. The Asian financial crisis hit the country hard, but the reform package that was launched to address the crisis was one of most comprehensive and decisively implemented. It de facto made South Korea an almost totally open economy in every respect. The simultaneous democratization process has been on-going ever since during the so-called "Sixth Republic," including the launch of more inclusive economic growth reforms such as a national pension system, educational reforms, and strong support of the IT sector. These reforms have spread the benefits of the rapid growth to larger sections of the population, and increased the role of domestic demand as a driver for growth. The chaebols have continued their restructuring process and have become world leaders and exporters in shipbuilding, LCD screens, mobile handsets, and memory chips. South Korea has also become the fifth largest automaker.

However, a recent analysis⁵¹ has also concluded that even though the chaebols have continued to increase productivity, they have also become more globalized, employing fewer workers in South Korea. The national economy has started to "decouple" from the lives of many South Koreans. The low-productive service sector and the small- and medium-sized enterprises are not able to offer jobs at a rate that is sufficient, and certainly not the high-paying and long-term employment that the chaebols have been able to provide over the last 30 years. According to the analysis, South Korea therefore needs a new growth model with even further attention to the non-tradable sectors, essential for domestic demand and job creation.

⁵¹ W. Choi et al., "Beyond Korean Style: Shaping a New Growth Formula," McKinsey Global Institute, April 2013.

About the Authors

Dr. Jan Rudengren holds a Ph.D. in international economic geography from the Stockholm School of Economics. He has more than 40 years of experience in international development in his capacity as Sida expert, staff member at the Asian Development Bank, researcher, and as a consultant. He has worked globally with many organizations and published extensively. He is an Associated Senior Fellow at ISDP.

Mr. Lars Rylander holds a Master's degree in Political Science from Stockholm University. He has many years of experience in international development and development cooperation. He has worked for Sida, the Swedish Ministry of Foreign Trade, the International Labour Organization, and as an independent consultant. He is an Associated Senior Fellow at ISDP.

Claudia Rives Casanova holds a Master's degree in International Relations, Security and Development from the Autonomous University of Barcelona, Spain. She is a former intern at ISDP.