

## The Middle-Income Trap: Myth or Reality?

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*The “middle-income trap” may be a myth. Nonetheless, it provides impetus for policymakers to reassess their strategies based on productivity improvement once the traditional sources of economic growth have lost their strength.*

### Introduction

The story of economic growth is one of many narratives. Over the last 70 years, growth has occurred in all regions of the world, many low-income countries have developed rapidly, and millions of people have been lifted out of poverty. Standard growth theory predicts that poorer countries will tend to grow faster and “catch up” to rich countries. However, relatively few countries have reached high-income status, and income growth across many countries has been variable and volatile. In recent years, policymakers in slower-growing middle-income countries have become preoccupied with the notion that they are stuck in a “middle-income trap.” Much has been debated about this so-called trap—from whether it actually exists to the types of policies that might help countries escape it.

This note considers the most relevant literature and contends that, even if the “middle-income trap” is myth, it provides impetus for policymakers to reassess their strategies once the traditional sources of economic growth have diminished. Middle-income countries must find drivers of productivity, innovation, and competitiveness while strengthening the economic fundamentals that foster and stabilize growth. Reaching high-income levels is challenging, with a strong likelihood of growth slowdowns along the way. But stagnation is not inevitable, and middle-income countries must have patience to manage the transition responsibly, avoid pitfalls, and promote new opportunities.

### What is a middle-income trap?

The concept of a middle-income trap was first coined by Indermit Gill and Homi Kharas, comparing a general phenomenon observed in regions like Latin America and the Middle East to the possibility of slowdowns in East Asia’s emerging economies (Gill and Kharas 2007). Their account describes how rapid growth from low-income to middle-income levels—fueled by cheap labor, basic technology catch-up, and the reallocation of labor and capital from low-productivity sectors like traditional agriculture to export-driven, high-productivity manufacturing—is often followed by lower growth. As the rural labor force shrinks and wages rise, the factor accumulation that once propelled high growth eventually loses strength. Unless new sources of economic growth are found, a country may find itself unable to compete with

either low-wage countries that dominate mature industries or high-income countries that dominate innovative, high-technology industries.

This narrative grew popular as a useful shorthand to describe the preoccupations of policymakers in middle-income countries, particularly in the fallout of the global financial crisis. In 2009, for example, Malaysian Prime Minister Najib Razak announced in a speech: “We have become a successful middle-income economy, but we cannot and will not be caught in the middle-income trap; we need to make the shift to a high-income economy or we risk losing growth momentum in our economies and vibrancy in our markets.” In the years since, the nature and risks of the trap have been hotly debated by economists, business leaders, media pundits, and those in high-level policy circles.

### What does the empirical evidence suggest?

Latin America and the Middle East seem to provide compelling empirical support for the phenomenon of a middle-income trap, as many economies in both regions have remained at middle-income levels for four or five decades. Indeed, out of 101 middle-income countries in 1960, approximately 13 became high-income by 2008 based on per capita income level relative to the United States: Equatorial Guinea; Greece; Hong Kong SAR, China; Ireland; Israel; Japan; Mauritius; Portugal; Puerto Rico; Republic of Korea; Singapore; Spain; and Taiwan, China. (Figure 1 tells a more optimistic story, as discussed below.) A growing body of research and analysis has sought to examine why so few middle-income countries have transitioned to high-income status and the policy approaches that can be pursued to enable more of them to do so. Analyses vary considerably, however, and in many cases come to opposite conclusions.

Some studies support the existence of a middle-income trap by finding empirical evidence that growth slowdowns are more likely at middle-income levels. An analysis of all growth slowdowns between 1960 and 2005, for example, suggests that they are more likely to occur in middle-income countries than in low- or high-income countries (Aiyar et al. 2013). There is also evidence that rapidly growing economies tend to slow down significantly when they reach middle-income levels, often near the per capita income levels of \$10,000-11,000 and \$15,000-16,000 in 2005 PPP-adjusted dollars (Eichengreen, Park, and Shin 2014). To explain this evidence,

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some growth models suggest the existence of low-productivity equilibria in middle-income countries, characterized by low shares of capable workers in highly-skilled activities (Agénor and Canuto 2015).

Meanwhile, other evidence questions the existence of a trap altogether. Close examination of countries' transitions between income levels, for example, finds that per capita incomes have grown steadily in the majority of countries, both since 1960 and in recent times (figure 1). This does not suggest a trap-like pattern and casts doubt on the notion that high growth was a temporary phenomenon of any particular era. While the process of convergence is often painfully slow, the transition from middle- to high-income does not on average take longer than other transitions (Im and Rosenblatt 2014). Likewise, comparing today's middle-income stagnators with countries that have reached high-income status suggests that "escapees" have simply always grown faster, even at lower income levels (Bulman, Eden, and Nguyen 2014). These countries' higher growth patterns may be explained by other underlying factors, such as rapid industrial transformation, low inflation, stronger exports, better quality education, or reduced inequality.

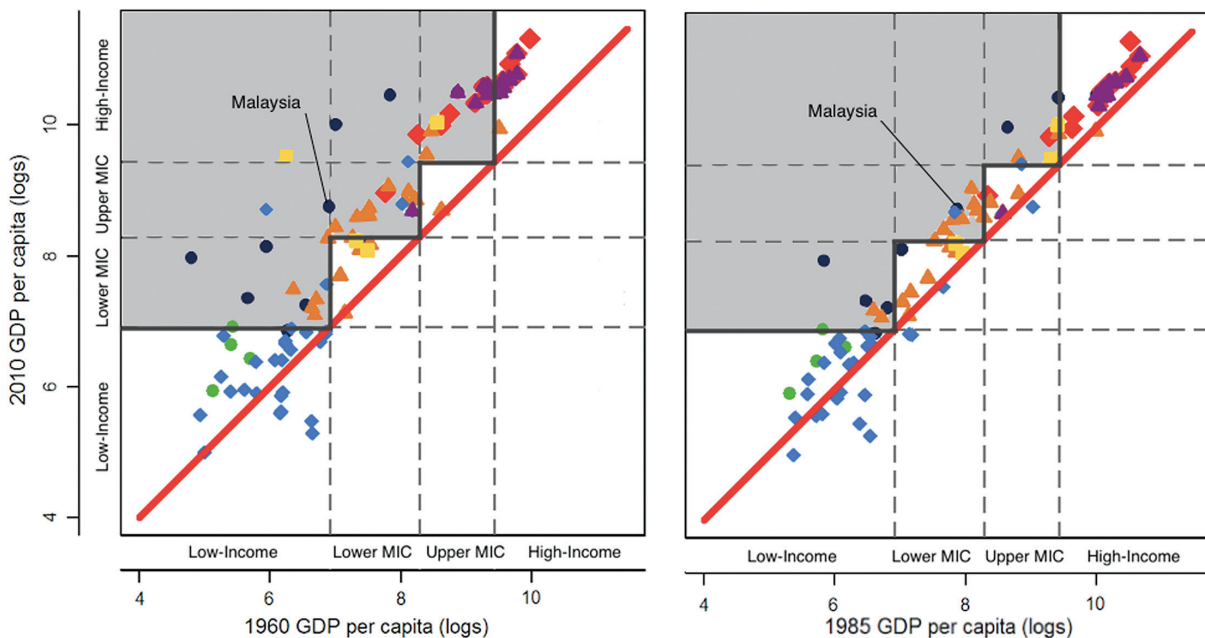
The "trap" literature is further complicated by lack of any methodological or definitional consensus. As of yet there is no established definition for what the middle-income trap is or how it should be explored. Most studies define it based on income levels—but the choice of using relative versus absolute income, or of setting specific income thresholds to identify the upper and lower bounds of middle-income status, can often produce divergent conclusions. Similarly, there is no consensus on what length of time would constitute a trap. Most studies rely on cross-country growth regressions using data typically limited to the postwar period of roughly 1960-2005, which may limit the literature's historical relevance (see box 1). Some studies seek to address these issues with enhanced rigor, but there is often a degree of arbitrariness in the parameters used, and at times it seems that methodological and definitional choices are driven by the goals of the research or the characteristics of the countries or regions being assessed.

**Does the concept of a "trap" help or hinder effective policy?**

The debate around the middle-income trap offers no quick or

**Figure 1: Little evidence of a trap**

The graph on the left compares countries' absolute GDP per capita in 1960 to that of 2010, showing that the majority of countries across all regions (though fewer in sub-Saharan Africa) experienced growth during this period, as they are above the 45-degree line representing zero growth. The graph on the right finds a similar pattern in recent times, comparing 1985 and 2010 absolute GDP per capita levels. The shaded area, indicating upward transitions from lower to higher income levels, dispels the notion of a trap. From a sample of 91 countries for which data is available, 41 transitioned to higher income levels during the 1960-2010 period. Of these transitions, 27 were middle-income (e.g., countries that transitioned from lower middle- to upper middle-income status or from upper middle- to high-income status). Additionally, many of these transitions occurred relatively recently, during the 1985-2010 period.



- East Asia & Pacific
- ◆ Europe & Central Asia
- ▲ Latin America & Caribbean
- Middle East & North Africa
- South Asia
- ◆ Sub-Saharan Africa
- ▲ Industrialized, WDR-1978

GDP per capita in constant 2005 USD \$. Regions are based on the WB classifications considering all income levels. The income threshold definitions are the following ones: (1) Low-income: GDP per capita of less than \$1,000; (2) Lower middle-income: GDP per capita between \$1,000 and \$4,000; (3) Upper middle-income: GDP per capita between \$4,000 and \$12,500; (4) High-income: GDP per capita above \$12,500.

Source: WDI, March 2016. Fabian Mendez-Ramos collaborated on producing these graphs.

### Box 1: History's income trap

The debate on growth stagnation in middle-income countries relies on analysis of a relatively short span of economic history. In the very long run, growth stagnation has been the historical norm (Kremer 1993, Maddison 2007). Income growth prior to the Industrial Revolution was almost nonexistent, driven primarily by world population growth. Beginning around 1800 there was a “great divergence” as growth from productivity exploded, first in European countries and their offshoots and then in Japan. The end of the 20th century saw the beginning of a “great convergence,” as growth in industrialized nations steadily slowed and countries like China and

India began to rise (Spence 2011). A long-run historical standard for explosive per capita GDP growth has been estimated at 4.2 percent, as at this rate a country would have gone from the lower bound in 1870 to the U.S. level in 1960 (Pritchett 1997). Since 1960, many lower-income and middle-income countries have achieved this pace—but many others have not, and worldwide income growth has been heterogeneous and volatile. In seeking to answer what accounts for economic growth and technological progress in the contemporary era, it is useful to remember that the world remains in a period of historically unprecedented economic growth.

easy solutions to the problem of slow growth. However, as one of the most salient issues in middle-income countries today, the concept has undeniable power to influence policy-makers. This can be both productive and unproductive.

On one hand, the specter of being mired in a trap can encourage desperate policymaking. Focusing on a small number of escapees may inspire efforts to maintain unrealistically high growth rates. When growth wavers, there may be immediate pressure to revise policies, and during periods of growth, important reforms may be postponed or dismissed. The classic example is large public expenditure in pursuit of short-run growth performance, as seen in some Latin American countries where subsidies to ineffective projects led to increased corruption and eventual economic slowdown. It remains to be seen whether China faces similar dangers, though the relative dynamism of its private sector may help it avoid a similar fate.

On the other hand, the middle-income trap notion may be useful for shaping policy discussions on the particular challenges faced by middle-income countries. Transitioning to high-income status is rare and difficult, and requires different growth strategies than the ones that propel countries out of low-income levels. When growth related to factor accumulation declines, countries must find new sources of growth based on productivity improvement.

Despite inconsistencies, the literature agrees that growth slowdowns are primarily productivity slowdowns, and suggests a range of policies and country characteristics associated with increased productivity and innovation. These include prudent macroeconomic regulation, strong institutions to encourage private sector development, investment in infrastructure, and regional integration (Aiyar et al. 2013); larger shares of exports in high-technology products and strong secondary and tertiary education systems (Eichengreen, Park, and Shin 2014); and investment in R&D and advanced infrastructure to accelerate innovation while enforcing property rights and removing labor market rigidities (Agénor and Canuto 2015). Other studies prescribe controlling inflation and debt, reducing income inequality, investing in human capital development, promoting entrepreneurship and knowledge diffusion, or supporting the growth of the middle class.

No matter what policy options a country selects, however, it still faces the challenge of implementing them—and the kinds of implementation challenges confronting middle-

income countries (e.g., improving the quality of education, enhancing regulatory effectiveness) may require rather different capabilities than those that got them to middle-income status in the first place (e.g., sound macroeconomic management, provision of basic infrastructure).

### Lessons from the larger literature on long-run growth

These findings echo the wider literature on the determinants of economic growth, in particular the view that growth does not occur randomly; rather, it responds to the quality of public policies and institutions, as well as the effort and entrepreneurship of the private sector. Despite debate over which policies are most important, there is agreement that government action (or inaction) can and does affect growth (Solow 1956, Romer 1990, Barro and Sala-i-Martin 2004). The literature finds at least four fundamental ingredients of long-run growth, which are especially relevant to countries in middle-income transition. When these ingredients are absent, slow growth or growth reversals should not be surprising.

First, it is difficult to achieve high growth without strong macroeconomic stabilization policies. Sound fiscal, monetary, and financial policymaking supports long-run economic growth by helping countries control inflation, avoid crises, and strengthen resilience to cyclical volatility.

Second, strong institutions and rule of law are essential to growth. The quality of governance—including public sector efficiency, control of corruption, effective legal systems and enforcement of contracts, and civil and political rights—are all strongly correlated with economic growth (North 1990; Mauro 1995; Barro 1996; Acemoglu, Johnson, and Robinson 2005). Likewise, an overburdening government that imposes high taxes, distorts markets, or interferes ineffectively in the economy weakens the private sector and leads to lower growth (Fischer 1993, Engen and Skinner 1999).

Third, investment in education and human capital development are crucial to growth. As the returns to physical capital accumulation diminish, the rate of productivity improvement and technological innovations depend largely on the presence of highly skilled human capital (Lucas 1988, Aghion and Howitt 1998).

Fourth, open and competitive markets support economic growth by promoting increased specialization, efficient resource allocation based on comparative advantage, improved productivity, and diffusion of knowledge and technology. Most economists agree that there is a virtuous

**Box 2: A brief case study of Malaysia**

Are concerns that Malaysia is (or may soon find itself) stuck in the trap warranted? Despite having higher income than Singapore or the Republic of Korea a few decades ago, Malaysia has struggled to maintain comparable growth rates, especially in the aftermath of East Asia's late-1990s financial crisis and the 2008 global recession. Compared to most other countries, however, Malaysia has been gaining in relative status, with respect to both developed and developing economies.

Malaysia is not stuck in a trap. This does not imply, however, that it can afford to disregard renewed sources of growth. Several recent papers have considered Malaysia's experience and offered specific policy recommendations. Researchers suggest that Malaysia should deepen its industrial and innovation capabilities through localization economies

cycle where trade leads to productivity enhancement, which leads to further increased trade (Dollar 1992, Frankel and Romer 1999).

Of course, achieving and maintaining the fundamentals of economic growth is easier said than done, and many countries are making sincere efforts. External conditions and cyclical fluctuations in international trade and capital flows can weaken the impact of countries' growth efforts and policy reforms. The considerable debate around the middle-income trap underscores that countries should tailor these fundamental ingredients to fit their economic and political realities and constraints (see box 2).

**Conclusion**

The middle-income trap is a narrative of growth stagnation that reflects (and exacerbates) current and long-standing anxieties about slow economic growth. This anxiety is

(Yusuf and Nabeshima 2009). Others advise that it should promote entrepreneurship, rapidly expand secondary and tertiary education, and grow the country's tech-based, globally-traded services sector by attracting highly productive foreign firms to locate production in Malaysia (Flaen, Ghani, and Mishra 2013). Yet other researchers recommend that Malaysia could achieve productivity gains by encouraging local firms to innovate through technology adoption, diffusion, and eventual creation—similar, in many ways, to the growth strategies of the Republic of Korea or Taiwan, China (Cherie and Hasanov 2015). This often contrasting advice must be taken with caution: removing obstacles to productivity growth is often a better policy than intervening directly in favor of particular sectors in the economy.

perhaps only growing more acute amid the prevailing notion of a global growth slowdown. This includes even China, the growth star in recent decades.

Historical experience and empirical evidence show that the transition from middle-income to high-income levels takes time, and requires countries to pursue consistently sound but evolving policies to maintain the fundamental drivers of economic growth. Different stages of growth call for different strategies and policies, and the right reforms often take time to impact economic growth.

Ultimately, each country's growth story is unique but the general prescription remains the same. Policymakers should critically examine their growth strategies to find the most effective ways to boost productivity improvement, which is the key to supporting, nourishing, and preserving long-run economic growth.

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