

IT'S DEMOCRACY, STUPID: OVERCOMING THE MIDDLE-INCOME TRAP

Jan Rudengren & Lars Rylander

Why do many middle-income countries fail to sustain sufficient economic growth to become high-income countries? This policy brief argues that a political process leading to democracy and better governance is essential if such countries are to overcome the Middle-Income Trap.

Many countries experience high economic growth when getting out of the low-income country (LIC) category, but once they have become middle-income countries (MICs) rapid growth is often followed by economic stagnation. A key puzzle is therefore why many middle-income countries fail to sustain sufficient economic growth to become high-income countries. This has increasingly begun to be referred to as the Middle-Income Trap (MIT). While the economic dimensions of growth/stagnation are relatively well propounded, we argue that factors relating to governance, institutions, inclusive growth, and education, among others, can underline and play a determining role in explaining failure or success in sustaining economic growth, and that, furthermore, democratic governance can serve as a useful proxy for many of these factors.

Stuck in the Middle-Income Trap

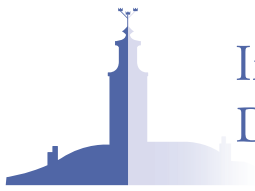
According to World Bank calculations, of altogether 101 countries that were MICs in 1960, only 13 of them had managed to become high-income countries (HICs) by 2008—among them the so-called “Asian Tigers” and OECD members such as Greece and Ireland. For the vast majority of countries, therefore—with notable exceptions such as oil producers—attaining high-income status (classified by the World Bank as a GNI per capita of US\$12,616 or more) appears to be somewhat of a “glass ceiling.” While it is too early to tell whether or not some countries, including China, India, and Vietnam, have fallen or will fall into the MIT, it is clear that many middle-income countries do face significant obstacles in sustaining economic growth.

The economic factors behind stagnation have been well-described by economic research. At a low-income lev-

el, 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. According to a 2012 World Bank Report, “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.” In order to thwart the risk of falling into a trap, it is necessary for countries to upgrade the labor market regime, better enforce property and patent rights, invest in innovation and infrastructure, develop firm-level capabilities, and benefit from technology transfers through joint ventures. This entails prudent economic management and policies. However, as is examined below, this is not enough by itself.

Beyond Economic Factors

There is a growing body of research to demonstrate that broader issues of human and social capital development are sine qua non conditions for successful economic development and avoidance of growth slowdowns. Furthermore, that societal and institutional factors undergird successful economic reforms. This addresses the need for structural changes in five broad categories: (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. These are briefly examined in turn.

Education

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. Pursuing the correct educational policies is thus critical in building human capital to facilitate the transformation from labor-intensive to skill-intensive industries.

“Soft” Infrastructure

Besides “hard” infrastructure like roads and railways, “soft” infrastructure must be developed to facilitate communication and information flows. In the race to become a knowledge-based economy, Information Communication Technology (ICT)-related infrastructure is of crucial significance. This serves to foster innovation and connectivity.

Institutions and Role of Government

The broader political and economic institutional framework of a country needs to be inclusive, i.e. political and economic institutions need to be open, transparent, accessible, and encourage the population to participate in society without fear of sanctions. Moreover, a certain degree of state centralization is necessary to fend off separate interests. In other words, institutional and policy barriers 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 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, ensuring land and property rights, and so on.

It is incumbent upon governments at this stage to guide governance 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 and new types of skills and capacity

among civil servants.

Corruption

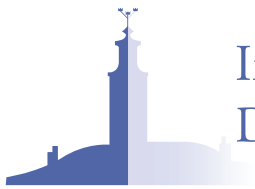
In order to successfully transition from the so-called “rule of man” to the rule of law, government and institutions need to be open and accessible to citizens, there needs to be measurable independency between the different organizational bodies of the state as well as from the producing sectors, and 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.

Inclusive Growth Policy

A further factor—contrary to conventional economic wisdom—that imperils the sustainability of the growth process is rising income (and regional) 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. 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). This involves 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, and provision of social welfare for vulnerable groups such as children, women, elderly, single-parent families, and victims of natural disasters or civil conflicts.

Toward Democratic Governance

It is argued here that the degree of democratic governance can serve generally as a useful proxy for many of the above factors. A country which displays a high level of democratic governance in the form of inclusive political and economic institutions is more likely to have a relatively low level of corruption, more equal income distribution, a judiciary system relatively free from politics and government influence, while freedom and rights are established with a more open



ction 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, also referred to as “creative destruction.” While democracy per se is not a panacea—indeed, democracies are found at all income levels from LIC to HIC, and among LICs and Lower MICs there are roughly the same number of democratic as non-democratic countries—Upper MICs 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.

Conclusion

While prudent economic management is a prerequisite for middle-income countries to avoid growth slowdowns, this also needs to be combined with a political process leading to democracy and better governance. Failure to do so may lead to growing income inequality, among other risk factors, which have the potential to harbour social and political consequences, as witnessed in the revolutions across the Arab world. This analysis accordingly concludes that implementing broad and inclusive democratic reforms is a prerequisite to become a HIC. From this perspective, the trajectory of China is an interesting case to follow. Can China continue its rapid growth rate and become a HIC without such democratic reforms?

This policy brief is a shortened version of an ISDP Stockholm Paper published earlier this year. See ISDP's website to access the full paper.

Dr. Jan Rudengren and Mr. Lars Rylander are Associated Senior Fellows at ISDP with long experience in issues of international development.

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