

Middle-Income Traps

Whether an absolute or relative definition of “middle income” is used makes a big difference in analyzing middle-income traps

The term “middle-income trap” has entered common parlance in the development policy community. But it often has not been precisely defined in the incipient literature. Im and Rosenblatt, in a new paper, present a conceptual and empirical survey of the issues. Much as in the poverty measurement literature, the middle range of country income levels can be discussed in either relative or absolute terms. The World Bank Group’s classification system, for example, is based on absolute thresholds that are fixed in time in real terms. Many recent papers implicitly follow a relative definition—often comparing the income per capita of middle-income countries with the U.S. level or some rich-country average.

Whether one takes a relative or absolute approach to thresholds matters for descriptive statistics. For example, from a relative perspective Latin America and the Caribbean is often cited as the classic case of a

middle-income trap: a review of either the regional aggregate or individual countries shows that relative to the U.S. level, income per capita did not progress during the 20th century (figure 1, left-hand panel). But using an absolute definition, one might reach the conclusion that today’s high-income countries themselves were stuck in a middle-income trap for much of the century. A comparison using 2008 income per capita (in constant dollars adjusted for purchasing power parity, or PPP) for Colombia and Poland shows that it was only in the late 1950s that the G7 economies surpassed Colombia’s recent income per capita and only in the 1970s that they all surpassed Poland’s (figure 1, right-hand panel).

The authors present empirical evidence in terms of both absolute and relative thresholds, using “old” techniques to examine the fairly “new” concept of middle-income traps. To get a better understanding of whether the performance of middle-income countries has differed from that of other income categories, they examine historical transition phases in the inter-country distribution of income based on previous work in the literature. The

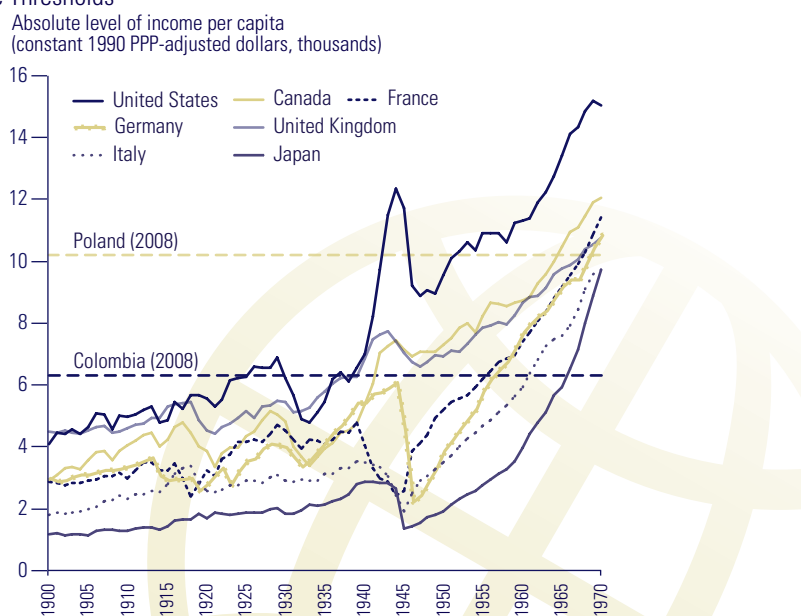
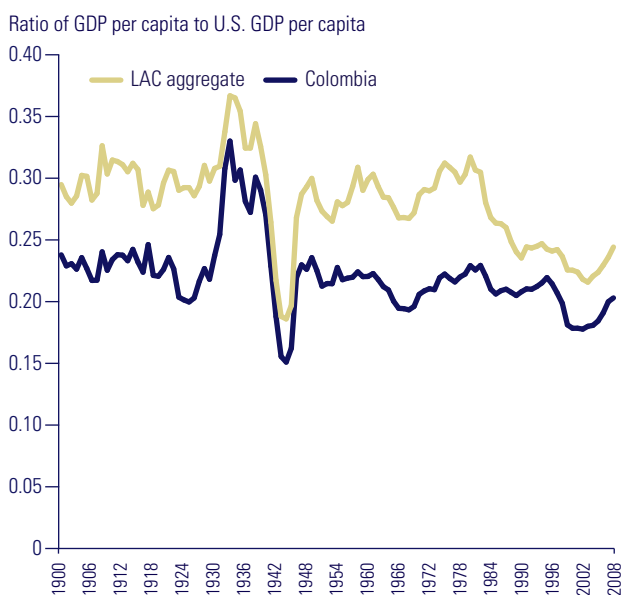
authors also use a patterns-of-growth analysis, reproducing earlier results by Lant Pritchett.

What are the conclusions of the transition matrix analysis? First, the probability of being a middle-income country and remaining one is lower than the probability of being a low- or high-income country and remaining in those relative income brackets. Moreover, in 14 of 48 occasions “middle-middle” income countries were able to move up to the upper-middle-income bracket, and three transitions from “middle-middle” income to high income were recorded over the period 1950–2008. “Middle-middle” income countries have also been subject to negative shocks and slowdowns in growth, resulting in “downgrades” in their relative income status. But these backward transitions were less frequent than the upward transitions. Being in the lower-middle-income group is more problematic—with more persistence—and countries in this group have only an equally likely chance of moving up or down the ladder.

Analysis of cross-country patterns of growth provides additional

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Figure 1. Two Views of the “Trap”—Relative and Absolute Middle-Income Thresholds



Source: Based on data from Angus Maddison, “Historical Statistics for the World Economy: 1–2009 AD,” 2010 (database available at <http://www.ggd.net>).
 Note: LAC = Latin America and the Caribbean.

When Competition Corrupts

Are there market conditions that cause corruption to increase? And what are the implications for the control of corruption?

Economists normally associate competition with healthy and desirable market outcomes: economic models typically show that competition increases efficiency and consumer surplus and reduces discrimination. But in a new paper Basu, McGavock, and Zhang show that under certain conditions, corruption will flourish as competition increases and may be less pervasive when competition is less fierce. Policy environments that make corrupt practices unprofitable can root out the corruption that arises from competition.

The standard economic model of corruption and crime is entirely amoral: the fact that an action entails corruption means nothing to the individual apart from its economic returns, which are considered in isolation when deciding whether or not to choose an action. The authors break from this tradition and assume that in addition to corrupt people there also exist honest people to whom corrupt actions are distasteful no matter what the returns to being corrupt are. If market conditions are such that firms managed by corrupt individuals enjoy lower costs and higher profits—if, for example, they pay a bribe to avoid installing an environmental safeguard—competition will serve to ensure that corruption is widespread in the industry. The honest entrepreneurs are driven out of the market as “bad money drives out good.”

Consider first the polar case in which there are two types of people: the honest and the corrupt. The corrupt people are like the standard description of human beings in economic models, and the honest people are those who, given a choice, will never choose the corrupt option. If firms are managed by these individuals and fixed costs are lower for the firms that engage in corrupt practices,

by standard competition firm profits will depend on the number of firms in the industry and, when that number is large enough, honest firms will find it economically undesirable to participate in the industry. Ultimately, beyond a certain threshold of competitiveness, all firms in the industry will be corrupt when firm profits are too low for an honest firm to survive.

If we assume instead that individuals vary in their attitudes toward corruption and honesty (as indeed is real), there is still a critical level of competitiveness in the industry (as indicated by the number of firms) such that once an industry becomes competitive beyond this level, corruption and bribery will be ubiquitous. In fact, interestingly, the authors’ theoretical model shows that even when individual propensity toward corrupt behavior varies finely from the incorruptible to the totally amoral, the incidence of corruption still rises abruptly beyond a certain level of competitiveness in the industry.

The paper points to an important reason why corruption is so rampant in some industries. But it does not show that corruption is inevitable in competitive industries. In fact, corruption may be significantly less pervasive in the developed world than in the developing world because institutional arrangements and enforcement make it less possible or less attractive. The way to root out corruption in society is to ensure that corrupt behavior is not worthwhile for amoral individuals, either by ensuring that hiring for police forces selects innately honest people or by enacting policies of punishment that make it not worthwhile for officers to accept bribes.

Some societies may even establish self-enforcement norms whereby bad behavior is collectively punished by all and people punish bad behavior because not to punish bad behavior is itself bad behavior. Moving away from the textbook assumption that all human beings are amoral not only helps to explain the incidence of corruption in some industries but also highlights

the important role of the distribution of morality in a society.

Kaushik Basu, Tamara McGavock, and Boyang Zhang. 2013. “When Competition Corrupts: A Theoretical Analysis of Market Structure and the Incidence of Corruption.” Policy Research Working Paper 6596, World Bank, Washington, DC.

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support for the conclusions in the paper: growth patterns for middle-income countries vary substantially from the “peaks,” “hills,” or “valleys” of Pritchett’s earlier work.

While the empirical results show that middle-income countries do not really fall systematically into a “trap,” the concept of the middle-income trap is useful for guiding policy discussions. It recognizes the particular challenges faced by countries at that stage of development. And it calls attention to the limited number of middle-income countries that have been fully successful in attaining developed country status. At the same time, a certain amount of realism might be added to the discussion. The identification of a small group of fast “escapees” can lead to a form of “outlier worship.” The attempt to grow at 7 or 10 percent could lead to unsustainable policies that eventually create the trap-like pattern of dismal growth that middle-income countries are trying to avoid in the first place. Gradualism may be more sustainable and less risky—especially for upper-middle-income countries.

Fernando Gabriel Im and David Rosenblatt. 2013. “Middle-Income Traps: A Conceptual and Empirical Survey.” Policy Research Working Paper 6594, World Bank, Washington, DC.