

2010). Indeed, 85 percent of growth slowdowns at the middle-income levels can be explained by TFP slowdowns (Eichengreen, Park, and Shin 2013).

For middle-income escapees, evidence suggests that one source of sustained TFP growth is an increasingly efficient allocation of resources. On a broad level, escaping countries experience much more rapid transitions out of agriculture and more rapid increases in manufacturing/industry (Bulman, Eden, and Nguyen 2014). Perhaps more important is the allocation of resources across subsectors and across firms within sectors. Because the productivity levels of firms in the same subsector can be markedly unequal, the entry of new firms and exit of unproductive firms (creative destruction), and the extent to which productive firms are able to gain a bigger market share by reallocating inputs between firms, are important for TFP growth (Hsieh and Klenow 2009; Bartelsman, Haltiwanger, and Scarpetta 2013; Melitz and Polanec 2015). For example, when capital and labor in Indian and Chinese manufacturing firms are hypothetically “reallocated” to match the level of efficient allocation observed in the United States, the two countries experience TFP gains of 40–60 percent and 30–50 percent, respectively (Hsieh and Klenow 2009).

Other analyses of the middle-income trap have focused on the lack of industrial upgrading (Ohno 2009; Doner and Schneider 2016). Evidence suggests that middle-income escapees have more diversified and sophisticated exports than those that remain stuck (Felipe, Abdon, and Kumar 2012). Such upgrading requires proactive government policies and coordination between domestic firms. A related view is that market failures may occur in many countries when private incentives to enter new sectors are less than social returns, necessitating a process of economic development as “self-discovery” (Hausmann and Rodrik 2003).

Efficient resource allocation and industrial upgrading require a set of institutions that differs from those that enable growth through resource accumulation. Efficient allocation requires new institutions to manage competition and creative destruction. Industrial upgrading requires the institutional capacity for greater intersector and government coordination, possibly through a strategic alliance between government and business (Doner and Schneider 2016). Product differentiation to succeed in new export markets requires “modern and more agile” property rights institutions and capital markets (Kharas and Kohli 2011).

Political economy traps

The creation of these institutions may be stymied by vested interests. Creative destruction and competition create losers—and in particular may create losers of currently powerful business and political elites. This is a more politically challenging problem than spurring productivity growth through the adoption of foreign technologies, which tends to favor economic incumbents (Acemoglu, Aghion, and Zilibotti 2006). These political challenges may be particularly great in middle-income countries because actors that gained during the transition from low to middle income may now be powerful enough to block changes that threaten their position.

In this sense, the challenges that middle-income countries face go beyond policy choice to the challenge of power imbalances. Yet, with few exceptions, discussions of the middle-income trap have generally focused on the *proximate causes* of transition difficulties and on selecting the right policies rather than the *underlying determinants* of these transitions. Understanding the policy arena in which elites bargain is essential for explaining the political economy traps faced by middle-income countries.

One such political economy trap is a persistent deals-based relationship between government and business. Deals-based, sometimes corrupt, interactions between firms and the state may not prevent growth at low income levels; indeed, such ties may actually be the “glue” necessary to ensure commitment and coordination among state and business actors (see spotlight 1 on corruption). But they become more problematic for upper-middle-income countries. For example, theory suggests that as markets expand and supply networks become more complex, deals-based relationships can no longer act as a substitute for impersonal, rules-based contract enforcement (Dixit 2004). Consistent with this hypothesis, upper-middle-income escapees lower their levels of corruption significantly before becoming high-income economies, whereas “non-escapees” do not see an improvement in corruption (figure S6.2, panel a). In non-escapees, corruption may prop up the status quo, undermining competition and the creation of new growth coalitions.

Combating entrenched corruption and creating a level playing field for firms imply a need for accountable institutions. At upper-middle-income levels, legislative, judicial, media, and civil society checks become increasingly important. Indeed, escapees tend to see much larger improvements in these institutional checks when they are at upper-middle-income

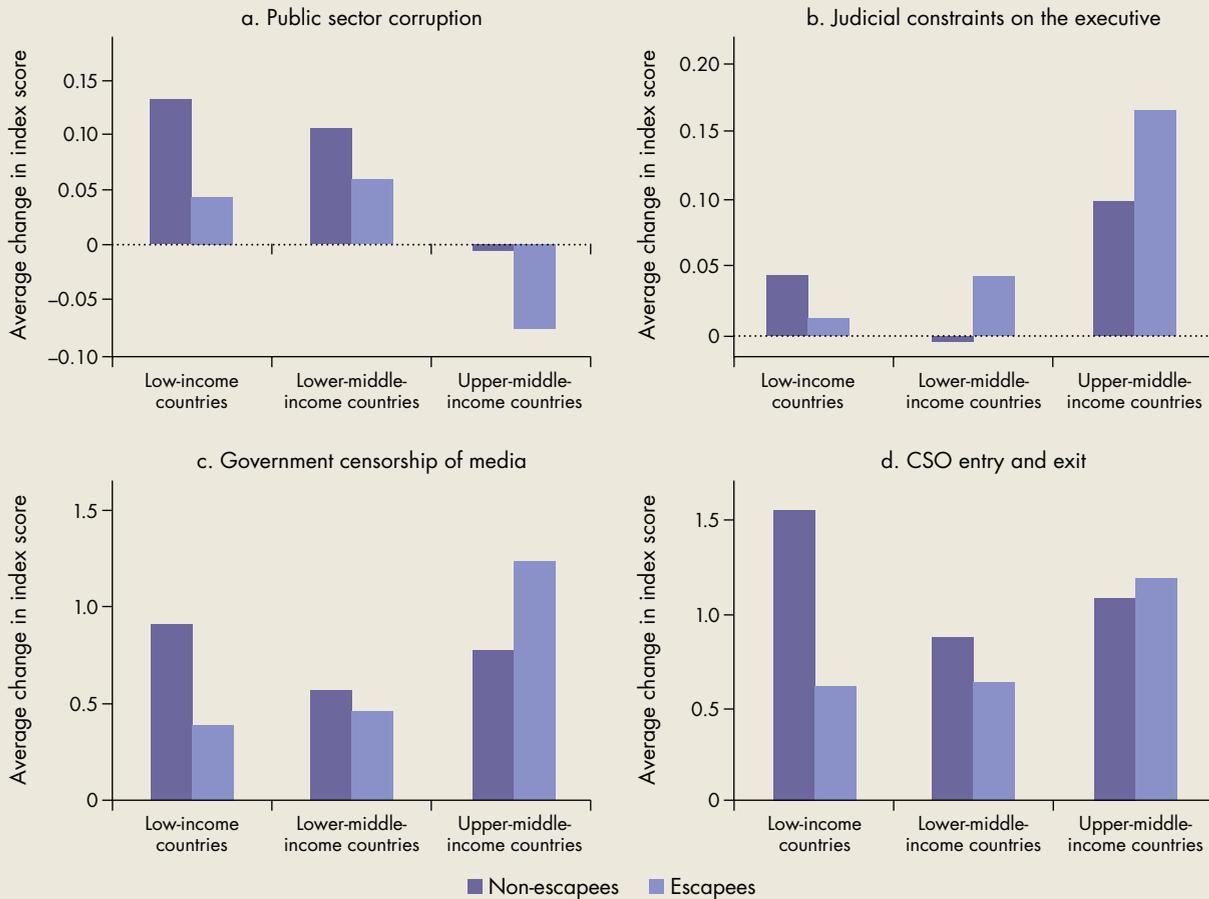
levels than non-escapees, although the differences between successful and unsuccessful countries are less distinct at the low- and lower-middle-income levels (figure S6.2, panels b, c, d).

The sources of these rules-based institutions for contestation and accountability are discussed in part III of this Report, but comparing escapees and non-escapees helps identify several conditions that make institutional reforms and thus successful transitions more likely. Recently, many countries that have transitioned, including East Asian economies and Chile, have had strong, representative business groups. Well-represented business groups

helped lead to pro-growth coalitions that could push for “nonparticularistic” policies benefiting broad interests to enable broad-based growth. Other recent transitioning countries have had a source of external support/pressure for reform: nearly half of the countries that grew recently from middle to high income are in Europe, where the external commitment provided by European Union accession and membership has made institutional development credible.

Lower levels of inequality may also help prevent institutional sclerosis at middle-income levels. High levels of inequality can generate societal cleavages that prevent the emergence of the growth coalitions

Figure S6.2 Checks on corruption and accountability institutions improve more in countries that escape upper-middle-income status to achieve high-income status than in countries that are “non-escapees”



Source: WDR 2017 team, using data from V-Dem, 2015.

Note: The bars represent the average change in the relevant category for all “non-escapees” (dark blue) and “escapees” (light blue) during the time a country is at the income level specified. Escapees are defined as those countries that reach the subsequent income levels during the sample period (1950–2011). Non-escapees are those that remain trapped at the same income level or move to a lower income level. All four panels use the same methodology. In panel a, public sector corruption ($v2x_pubcorr$) is an index ranging from 0 to 1, with 1 representing the most corruption. In panel b, judicial constraints on the executive ($v2x_jucon$) is an index ranging from 0 to 1, with 1 representing the greatest constraints. Government censorship of media ($v2mecenefm$) in panel c and CSO entry and exit ($v2cseeorgs$) in panel d are ordinal variables ranging from 0 to 4, with 4 representing the most accountability (that is, the least media censorship and the most CSO entry and exit). CSO = civil society organization.

necessary for reform (Doner and Schneider 2016). According to the data, escapees not only have lower levels of inequality when they become middle income, but also do not experience the large increases in inequality that characterize non-escapees on average (Bulman, Eden, and Nguyen 2014). Middle-income countries should therefore value equity not just as an aim in itself, but also as a precondition that increases the likelihood of escaping the middle-income growth trap.

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