
How China Can Avoid the Middle Income Trap



By Michael A. Witt , INSEAD

Without further institutional development, China is headed for the middle-income trap.

Optimists see China's slowing growth as a temporary slowdown as the country reconfigures itself for sustainable future growth. Pessimists see this as the beginning of the end of the Chinese miracle. These divergent views have vastly different implications for the future of business in and with China.

There are good reasons to be optimistic, and [the article](#) by my colleague Hellmut Schütte a few weeks back did an excellent job of putting things into perspective.

At the same time, there are serious reasons for concern; environmental degradation, corruption, high debt levels, to name just a few. These are real issues, and yet they are essentially all expressions of the same overarching problem: governance. Unless China can address its governance challenge, I fear that the pessimists will prove right.

The ingredients of wealth

To see why I am concerned, it is useful to start with the question of how economies get rich. Standard neoclassical economics says little about this (see Beinhocker's [The Origin of Wealth](#)). More helpful insights come from complexity economics. This approach suggests that economies need three ingredients to get rich: physical technologies, such as manufacturing know-how; social technologies, such as management tools; and businesses bringing the two types of technologies together to create value.

China has historically had no trouble with physical technology, as its numerous inventions illustrate. Yet as Joseph Needham famously noted, China's prowess in physical technology did not lead to an industrial revolution and thus also not to the higher levels of wealth (and power) Western nations began to enjoy from the eighteenth century onward. This suggests historical limitations either with social technologies or with the business landscape needed to harness it.

China today is very different from its former dynastic self. Yet the challenge on its way to rich country status bears some resemblance with the past. While the country has made great strides with respect to physical technologies and features a vibrant population of businesses, it remains unclear whether China has developed, or can develop, suitable social technologies that will permit it to evolve into a truly rich society. Institutions are a key aspect of such social technologies.

Wealth and institutions

This question is key for the future of China. Among others, it speaks to the puzzle whether and how it can avoid the so-called middle-income trap – the tendency to get stuck at middle income levels of development.

Institutional economists have drawn a causal connection between the quality of institutions – defined as [“humanly devised constraints that pattern human interaction”](#) – and economic wealth. Figure 1 illustrates this relationship by plotting levels of GDP per capita against a simplistic measure of institutional quality: the average score for each country on the six World Bank Governance Indicators, which are voice and accountability, political stability, government effectiveness, regulatory quality, rule of law, and control of corruption.^[1] Countries deriving their wealth mostly from oil are omitted.

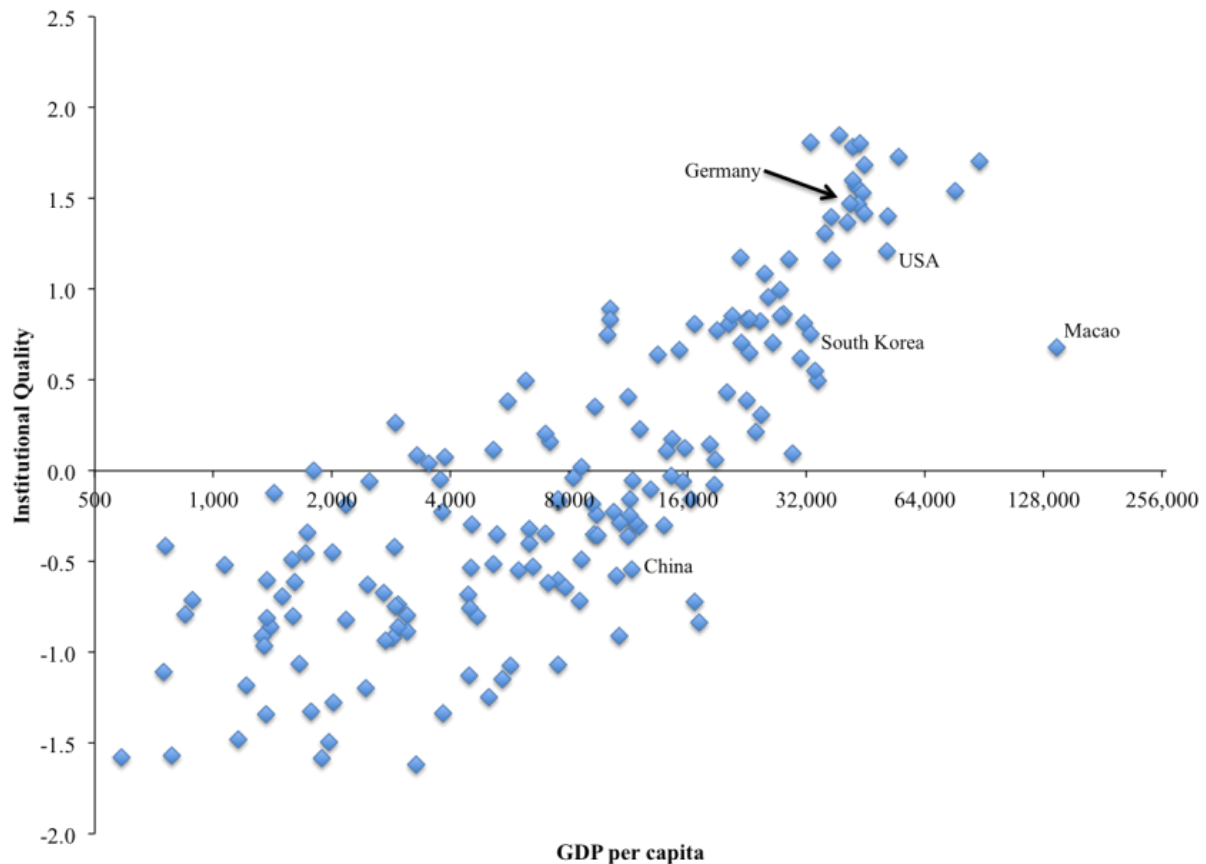


Figure 1: Per Capita GDP and Institutional Quality for 166 Economies, 2013. Per capita GDP expressed in purchasing power parity at 2011 prices. Oil-based economies and economies for which the indicators are unavailable omitted. Sources: World Development Indicators, Worldwide Governance Indicators

The figure suggests a close connection between institutional quality and per capita GDP.

China, as indicated, finds itself closing in on middle-income trap levels – estimated to be at around USD 15,000–16,000 – while featuring relatively poor institutional quality. Without further institutional development, it risks getting stuck in the middle-income trap.

This is not a new argument. For instance, [my colleagues Antonio Fatas and Ilian Mihov have made this point](#) and have been showing a similar figure in their core classes for years, and my colleague and co-author Gordon Redding and I explored institutional limits on China’s growth in our 2007

book [*The Future of Chinese Capitalism*](#).

What has become clearer over time, however, is the nature of the challenge. Economies with similar institutional structures often follow similar trajectories over time – a phenomenon known as path dependency. If one could find an economy that used to look similar to China today and managed to get past the middle-income trap, one could attempt to draw conclusions about the future of China.

Democracy and institutional quality

South Korea around 1980 had a great deal of structural similarity with China today. Korea has since avoided the middle-income trap and has become rich on the back of wide-ranging institutional changes.

[**More detailed analysis**](#) suggests that a key component in this seems to have been transformations in political governance. In 1980, Korea was a highly centralised, authoritarian dictatorship. Democratisation, starting in the 1980s, has since transformed it into a full democracy as defined by the Economist Intelligence Unit (EIU), though it still remains highly centred on the presidency.

This connection between democratisation and wealth seems to be present not only in this specific case, but also more generally. Figure 2 shows a scatter plot of per capita GDP against the Economist Intelligence Unit (EIU)

[**Democracy Index**](#).

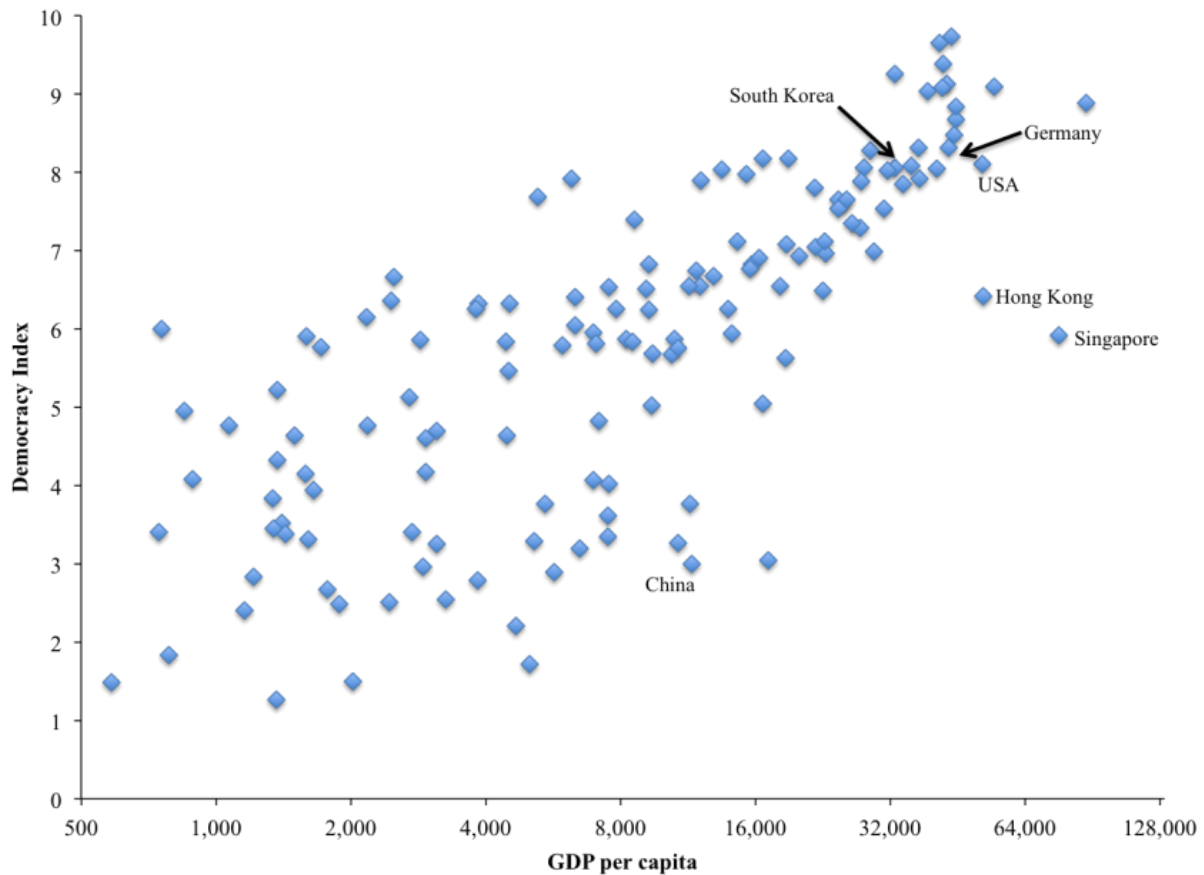


Figure 2: Per Capita GDP and Democracy for 141 Economies, 2013. Per capita GDP expressed in purchasing power parity at 2011 prices. Oil-based economies and economies for which the indicators are unavailable omitted. Sources: EIU Democracy Index, World Development Indicators

The parallels with Figure 1 are obvious. Democracy and GDP levels seem to be linked, with higher levels of democracy implying better institutions.

Indeed, the only non-resource-based nation that, for a while, succeeded in resisting this relationship was Singapore. Communist Party functionaries hopeful of emulating the Singapore experience should note, though, that given the urban nature of the Singapore economy, per capita GDP has tended to overstate levels of development relative to nations with rural hinterlands – Singapore is economically best compared with cities, not countries. In addition, Singapore has seen an upward trend in the EIU Democracy Index, reaching "flawed democracy" status in 2014.

Correlation is not causation, and neither the comparative analysis nor the figure can tell us which comes first: democracy, or further growth in GDP. But the consistency of the pattern in Figure 2 and the linkages between form of governance, institutions, and GDP it implies is remarkable.

Chinese policymakers at this point seem to be trying to sever the link. It is possible that they will succeed. However, given the overall picture in Figure 2, the most likely outcomes would seem to be either that they fail to prevent democratisation, in which case path dependency would suggest a similar trajectory as in Korea, or that they succeed, in which case Figure 2 would suggest that China would be unlikely to escape the middle-income trap.

Put differently, for China to get rich, the Chinese Communist Party needs to accept the risk of losing power through elections. The alternative would be for the Party to continue to monopolise power in a stagnant middle-income China.

Interesting times ahead.

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[1] These measures generally do not, in themselves, imply any specific form of governance. Nor are they culturally contingent. Most people, no matter where, would prefer to live in politically stable environments with effective governments and well-regulated economies in which laws can be relied on and corruption is low. Even those who make their fortunes in environments scoring low on these dimensions have a tendency to move their wealth, and often also themselves, to high-scoring locations. Voice and accountability may be the exception, as it can be interpreted as implying democracy (though accountability is achievable without it). Removing this dimension from the calculation leads to small shifts for individual countries but does not change the overall pattern.

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