Beyond the Middle-Income Trap: The Role of Institutions in China’s Growth

What would it take for China to get back on its growth trajectory?

After decades of economic expansion, is China losing steam? Discussions around the causes and nature of the economic slowdown in China centre around issues such as the real estate crisis, debt overhang or deflationary spirals. Many of these narratives – such as Adam Posen’s recent article in Foreign Affairs on “The End of China’s Economic Miracle” – highlight the confluence of many factors that contribute to the slowdown. Our research has focused on one of these factors that is structural to the Chinese economy, which we believe is one of the main impediments to growth: the quality of institutions.

We first raised the question of how long China’s economy would continue to grow in a Harvard Business Review article back in 2009. To this question, our answer was, “Not much longer, we suspect, unless the country engages in deep structural reforms that improve its institutions.”
Unveiling patterns of growth

Without strong institutions, a country cannot grow past the middle-income level of development to become rich. In 2009, we illustrated the relationship between the quality of institutions and income per capita with a simple scatterplot (as shown in figure 1 below). As a measure of institutional quality (on the vertical axis), we used the average of six governance indicators produced by the World Bank. These include: rule of law, voice and accountability, quality of regulation, political stability, control of corruption and government effectiveness. On the horizontal axis, we plotted income per capita adjusted for purchasing power parity.

\[ \text{Figure 1: The Great Wall} \]

When we analysed this scatterplot by quadrants, interesting patterns surfaced. First, there was almost no country in the upper left quadrant and the lower right quadrant. This means there were no poor countries with high-quality institutions or any rich countries with low-quality institutions (except
resource-rich countries like Saudi Arabia).

Second, for poor countries with low quality institutions (lower left quadrant), the correlation between the quality of institutions and income per capita was very weak. This implies that a poor country with below-average institutional quality could grow (move to the right of the scatterplot) over time without improving its institutions. To put it differently, countries with similar institutional quality could have wide-ranging income per capita of US$800 to USS$12,800 (US dollars based on 2007 values).

Finally, the relationship between the quality of institutions and income per capita was very strong in the upper right quadrant. This suggested the richer a country was, the higher the quality of its institutions, although no causation was implied.

“The Great Wall” phenomenon

Back in 2009, we believed that China would continue growing. However, we were concerned that without significant continuous improvements in its institutions, it might stagnate once it reached middle-income level. We called this region of stagnation (the grey area on the chart) “The Great Wall”, a phenomenon experienced by several countries in the past.

We have been updating this scatterplot every year since 2009, and the dynamics described above have always been present in the data. What about the position of China? It has continued developing albeit with limited institutional reforms. In fact, one can argue that the Xi Jinping administration has taken a step back in reforming the country.

When we replicate our analysis using data from 2022 and create a similar “Great Wall” region around the inflection point (see figure 2 below), we once again observe the four quadrants with similar patterns. And, as in 2009, we see that only countries with significant oil resources can escape the logic that institutional reform is needed for countries to move from middle income to advanced status. We represent countries where the rents of oil are higher than three percent of GDP as black squares.
Figure 2: The role of institutions

In our updated chart, China (represented as the red dot) sits towards the end of the “Great Wall” region. In other words, China has reached a level of GDP per capita where it is very unlikely to continue its ascent towards the ranks of rich countries without improving the quality of its institutions.

Charting a new path

One may wonder whether China could take a different path from the one depicted on the chart. Is there an alternative beyond the set of institutions represented in our index that would allow China to continue growing without reforms? We believe the answer is no because our chart captures fundamental dynamics. Countries such as China developed rapidly in the past, driven by manufacturing sector growth, boosted by centralised decisions such as investment in infrastructure or urbanisation. This growth was made possible in centrally planned economies by mobilising resources and directing policies towards sectors where investments were needed.
As China moves forward, its growth needs to come from the service sector and through more efficient resource allocation. This means that resources must be predominantly allocated by the market in a predictable environment, under the rule of law and high-quality regulation. That is where reforms are needed.

Low wages and strong investments were the right policies to build a strong manufacturing sector, but to build new engines of growth such as the financial or high-tech sectors, massive investments in manufacturing alone will not suffice. It needs reforms. The recent conflicts between the Chinese government and successful entrepreneurs and companies in these sectors point to the importance of decentralisation, clear rules and, in many areas, limiting market intervention.

China’s growth after 1978 has been spectacular, following the path of economies catching up with advanced countries. Economies that improved their institutions as they reached middle-income levels subsequently moved up to the top right of the chart to join the rich countries. Those that did not, stagnated.

Reform is the only way forward for China. The basis of this is simple: From a historical point of view, no country has become rich without the appropriate institutions. We stand by our view from 2009 - without serious institutional reform, it is unlikely that the world’s second largest economy will reach the incomes observed in Western Europe, the US and other advanced economies.

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