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Examining the economic growth and the middle-income trap from the perspective of the middle class

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ABSTRACT

In recent decades, while some countries have been growing consistently, others were not able to keep high growth rates and got stuck in the "middle-income trap." This study aims to explore the relationship between the middle class and the persistence of economic growth, and understand the role of the middle class in avoiding the middle-income trap which is a serious threat for many emerging markets, yet an understudied topic in the academic literature. Our findings suggest that the key growth factors including the middle class, innovation, productivity, and foreign direct investment have diminishing marginal effect on economic growth. Moreover, the middle class plays an important role in avoiding the middle-income trap. We also find regional differences in the middle-class growth and economic evolution of emerging markets over time. To our knowledge, this is the first study examining the relationships between the middle class, economic growth, and the middle-income trap.

1. Introduction

At the consumer level, the rise of the global middle class is a stimulating, and yet to be explored phenomenon of the recent decades. Along with the rise of the middle class, countries also rise in prosperity because middle class provides the key factors for growth such as consumption demand and labor supply. A substantial growth of middle-class consumers is happening in fast growing emerging markets that are going through the stages of economic development from low-income to high-income path. However, there is a threat to these fast-growing markets during their growth process in the middle-income stage. This threat is called the "middle-income trap."

In recent years, many emerging markets such as China, Hong Kong, India, Singapore, Malaysia, Brazil, and Argentina have experienced considerable income growth. While some countries including Singapore, South Korea, and Hong Kong have shown consistently and extraordinarily increasing patterns of growth, others such as Malaysia and Thailand have stagnated or slowed down over time after transitioning from low-income to middle-income economy. As an illustration, Fig. 1 shows GDP per capita comparisons for Southeast Asian countries in 1970 versus 2011. While South Korea managed to grow about 80 times more from 1970 to 2011, Malaysia, which had much bigger GDP than South Korea in 1970, could only grow about 25 times more by 2011. At certain middle-income stages, economies with high growth rates struggle to keep that rate of growth and face with economic slowdown or stagnation (Cai, 2012b). These countries fail to transition to a high-income economy due to rising costs and declining competitiveness (Griffith, 2011). This phenomenon is explained by the middle-income trap.

Economic growth is not a linear function. As a country keeps growing from low to high-income stages, it gets harder to grow further. Fast growing countries can get stuck in the middle-income stage. Middle-income trap is a critical issue for middle-income countries which consist of many emerging markets with rising middle-class consumers. It is important to emphasize the escalating middle class in emerging markets, and the rising prosperity related to the middle-class growth. However, without the discussion of the middle-income trap, the discussion on the middle-class phenomenon would be narrow, insufficient, and somewhat optimistic. Middle-income trap is a real and serious concern for fast-growing emerging markets. Discussing the threats to the rising middle class in emerging markets in terms of the middle-income trap provides a broader perspective for understanding its implications. Our study completes the big picture by examining the expanding middle class in emerging markets from a cautious perspective at the country level.

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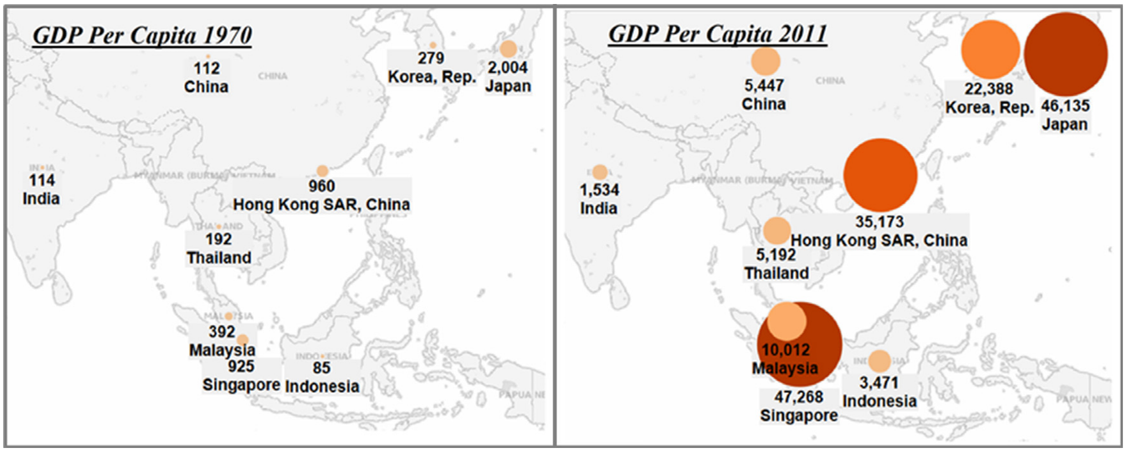

Fig. 1. Comparison of GDP per Capita (in US$) for Southeast Asian Countries in 1970 versus 2011.

In this study, our purpose is twofold: (i) to examine the relationship between the middle class and economic growth; (ii) to identify the role the middle class plays in avoiding the middle income trap. First, we conceptually discuss the middle-class consumers, middle-income economies, and the middle-income trap. Then, we analyze the evolution of emerging markets along their economic growth path over time, and identify countries facing the risk of the middle-income trap. We also analyze the evolution of the middle class in emerging markets over time and across regions. Then, for an augmented set of countries (76 countries including those beyond emerging markets), we empirically show how the middle-class, along with other key growth factors such as innovation, productivity, and foreign direct investment (FDI) affects economic growth. Finally, we empirically demonstrate the role of the middle class in escaping the middle-income trap.

Our analysis on the economic development of emerging markets shows that there are 11 emerging markets that have stayed in the middle-income stage over 33 years. These 11 markets are identified as those facing the threat of middle-income trap. The subsequent analysis on the evolution of the middle class in emerging markets shows that the share of income belonging to the middle-class within the total income in a country (hereafter referred as *the middle-class income share*) is converging across emerging markets over time. We also detect regional differences: Middle-class income share is increasing in Latin America, whereas it is mostly stable or decreasing in all other regions. In our empirical growth model, we find diminishing marginal effects of major growth factors (i.e. the middle-class income share, innovation, productivity, and FDI intensity) on economic growth. Our results confirm that as a country grows from low to higher income categories, it gets harder to grow further because of the diminishing marginal effects of the growth factors. Finally, we find that the middle-class income share is very effective in escaping the middle-income trap. A one percent increase in the middle-class income share increases the odds of moving up from middle to high-income economy by a factor of 4.95.

In investigating the middle-class phenomenon, this study contributes in two main areas: (i) in examining its relationship with economic growth, we demonstrate the diminishing marginal effects of the middle class on GDP growth; and (ii) in examining its role in the middle-income trap, we find that the middle class plays a key role by increasing the odds of escaping the middle-income trap. Our study also adds to the literature by conceptually examining the middle-income trap and empirically identifying those facing the trap, as well as analyzing the evolution of the middle class over time and detecting the convergence of middle-class income share across emerging markets over time.

This paper is organized as follows: In the next section, we provide a conceptual discussion on the middle-class consumers, middle-income economies, economic growth, and the middle income trap. In the empirical section, we first identify countries facing the risk of the middle-income trap. Then, we analyze the evolution of the middle class in emerging markets over time. In the subsequent analysis, we conduct a fixed effects regression to examine the effect of the key growth factors including the middle-class income share, innovation, FDI intensity and productivity on economic growth. In the final empirical analysis, we conduct a binary logit model to evaluate the effect of the middle class on escaping the middle-income trap. Finally, on the fourth section, we conclude with the contributions and implications of our study, followed by limitations and possible future research areas.

2. Conceptual discussion

2.1. The middle-class consumers, middle-income economies, and economic growth

The global middle-class phenomenon has recently started attracting the attention of scholars. It is generally studied through within-country analyses or compare-and-contrast approaches across countries. Yet, in order to understand the phenomenon thoroughly at the global level, a reflection of the middle-class consumers from consumer to country level would be helpful. For this purpose, we first define the "middle class" at the consumer level, and then define the "middle-income" at the country level.

There is not a consensus for the definition of the middle class. There are two main approaches in defining the middle class (The Economist, 2009): relative terms, and absolute terms. Relative approaches define the middle class in various ways such as people with income between 75 percent and 125 percent of the median income level in a country (Birdsall, 2010, p. 162; Birdsall, Graham, & Pettinato, 2000; Thurow, 1986); those in the middle three quintiles of income (Easterly, 2001, p. 10); or households having one third of their gross income left as discretionary income (Parker, 2009). Similar to the relative approach, there are also various proposed classifications in the absolute approach. Some absolute definitions are based on the daily per capita income: e.g. between $12 and $50 in 2000 PPP (Milanovic & Yitzhaki, 2002); between $2 and $13 in 2005 PPP (Ravallion, 2010); between $10 and $100 in PPP (Kharas & Gertz, 2010). Since there is not a unique established definition of the middle class, the choice depends on the goal of the