Successful urbanization could free developing countries from the middle-income trap

Scores of countries have fallen and are falling into the middle-income trap as they strive to develop. And, because of income inequality, aging populations, and a lack of growth impetus, some may never escape.

Of the world's 199 countries and semi-sovereign economies, 88 are stuck in the middle-income trap: 20 are in Europe, 18 in North America, 16 in Asia, 15 in Africa, 11 in South America, and 8 in Oceania.

Four high-income countries have fallen back into the middle-income trap: Chile, the Seychelles, Trinidad and Tobago, and Uruguay.

The real hurdle to getting out of the trap is stagnant growth after reaching upper-middle-income status.

When an economy reaches the middle-income level, the unemployed and underemployed rural labor force pool drains out. Rural and urban wages begin to rise, eroding competitiveness in global trade.

It becomes more difficult to imitate foreign technologies, and capital accumulation starts to slow due to decreasing returns. Middle-income countries then face the challenges of high inequality and fast aging.

Growth slowdowns are less likely in countries where the population has a relatively high level of secondary and tertiary education and where high-technology products account for a relatively large share of exports.

Two drivers of the middle-income trap for middle-income countries are high income inequality, and longevity as more people live longer after leaving the workforce.

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Middle-income countries are likely to face rising income inequality, which is brought about by industrialization.

Lower incomes block access to credit, which suppresses growth by limiting investment in workers and machinery.

Large income disparity means weaker domestic demand, because poor people have less to spend beyond day-to-day necessities.

Growing inequality also means lower tax revenue for states to invest elsewhere.

High income inequality may become socially disruptive, deterring potential economic investment, as the poor perceive their incomes shrinking despite longer working hours, and wealth and political power concentrates in the hands of the few.

Aging represents another typical challenge faced by many middle-income countries, given that people usually have fewer children as an economy urbanizes and grows.

This is because economic development is typically accompanied by the transformation of an agricultural economy into a manufacturing one, where more and more of the population moves to cities.

Women who live in urban areas have more schooling and job opportunities than rural women, and urban women work more, marry later, and have fewer children.

Raising children becomes expensive as an economy develops and become urbanized.

In Viet Nam, the fertility rate has declined significantly from 5.4 children per child-bearing woman in the 1980s to 1.8 in 2010. In rich cities such as Shanghai in the People's Republic of China, the birth rate has fallen below the population replacement rate.

An aging population implies less labor input, less savings, and sluggish consumption.

Countries that escape the middle-income trap have greater equality and lower total dependency ratios; that is, the ratio of dependents up to 14 years old and over 65 to the total population aged 15 to 64.

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Escapees at all middle-income levels are less likely to see increases in inequality and decreases in the total dependency ratio.

International trade is a crucial determinant of growth: trade drives growth, and structural transformation drives development.

During the initial stages of development, poor countries can grow by reallocating labor from low-productivity agriculture to high-productivity manufacturing.

Rising de-globalization reinforces concerns. Even the People's Republic of China confronts the middle-income trap challenge.

The US withdrawal from the Trans-Pacific Partnership negotiations, set to become the biggest global trading bloc, has caused anxiety about growing protectionism and a return to bilateral partnerships.

For many countries—particularly lower-middle-income countries—rural–urban disparity is the largest component of national inequality and can be reduced through well-managed urbanization, which helps promote innovation and productivity.

Successful urbanization could be the single most important force freeing developing countries from the middle-income trap.

This episode is based on research done for ADBI by Chen Wang, an assistant professor at the School of Urban and Regional Science, Shanghai University of Finance and Economics; and Jiajun Lan, a PhD candidate at the Wang Yanan Institute for Studies in Economics, Xiamen University, People's Republic of China.

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