

The Other Middle Income Trap: A Global Perspective

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Introduction

- The term Middle Income Trap (MIT) was coined by Kharas and Gill in 2006 to suggest the possibility that countries newly graduated from Low Income Country (LIC) to Middle Income Country (MIC) status faced a series of challenges to continued progress towards the High Income Country (HIC) category.
- Since then a large technical and policy literature has developed, exploring the nature of the MIT for MICs. The policy discourse has focused primarily on what MICs should do to escape the MIT. There has been particular attention on infrastructure investment and on institutional and governance reforms.

- But there has also been a (smaller) literature on what the international community can do to help MICs escape the MIT. As Kharas (2020) notes, “Given all the complexities of middle-income country development, there is surely a role for aid to help the transformations needed to avoid a middle-income trap.”
- But here we face what might be termed the Other Middle Income Trap (OMIT) or the Development Assistance Middle Income Trap (DAMIT).
- Almost every development assistance agency has “graduation” criteria driven primarily by per capita income, with a cutoff beyond which concessional aid flows start to taper off sharply and then stop.

- To take a leading example, the World Bank's soft loan agency IDA has an "operational cutoff": "Eligibility for IDA support depends first and foremost on a country's...GNI per capita [being] below an established threshold....updated annually (\$1,185 in the fiscal year 2021)." ([IDA Borrowing Countries | What is IDA? | International Development Association - World Bank](#))
- This is not exactly the LIC/MIC dividing line of \$1,035 GNI per capita, but it is not an unfair characterization to say that with entry to MIC status a country is well on the way to losing access to IDA funds.

- Per capita income is not the only criterion used, and I will discuss welcome but quite inadequate modifications that are underway.
- But it is the dominant criterion in the current development assistance mindset. And it is this mindset that needs to be changed.
- In this discussion I will take a global perspective, highlighting the broad issues that arise the world over, leaving the specific discussion of the Caribbean for the distinguished panel that follows.

Performance and Need

- How should scarce development assistance resources be allocated across competing needs in a range of countries?
- A classic distinction, for allocation of scarce resources in any setting (for example to competing school districts from a limited education budget), is between Need and Performance.
- All else held constant, the greater the need the higher should be the allocation. Similarly, all else held constant, the better the use of funds to address the need, the higher should be the allocation.

- Performance Based Allocation (PBA) has long been the mantra of development agencies, and the allocation formulae used by development agencies use indicators which are supposed to capture performance. This is not a controversy free area and there has been much written on the topic.
- For example, in my earlier writings (Kanbur, 2005) I have argued that the performance component of the IDA allocation formula and its indicators espouses a theory of development for which empirical support is not wholly convincing.
- However, my focus in this presentation is on the need component, and the overarching indicator used here is per capita income.

- But how good an indicator of need is per capita income of a country?

Income and Poverty

- Start with official World Bank country income based classifications, and the World Bank's official absolute income poverty line. The following two facts are true (Sumner, 2012, Kanbur and Sumner, 2012):
 - 30 years ago, 90% of the world's poor lived in LICs.
 - Today, 75% of the world's poor live in MICs.
- The poor haven't moved of course! But they have been reclassified. The fact of the matter is that over the last three decades a number of large countries have grown fast enough to lift themselves into MIC status, but not equitably enough to take large numbers of their poor into non-poverty status.

- The geography of world poverty has thus changed dramatically. Thirty years ago, the connection between a person being poor (as measured by being below the poverty line) and their country being poor (as measured by per capita income) was tight. This is no longer the case.
- And all of the above is for an *absolute* poverty line. But a consensus is developing that poverty in the income dimension should be a *relative* concept, linked to average income in that society.
- The conceptual foundations of this lie in Amartya Sen's capability theory, where wellbeing is seen in terms more fundamental than income, with income being only instrumental in achieving human dignity and flourishing.

- While fundamental deprivation could be specified in absolute terms in the capability dimension, its translation into the income dimension is an additional step which depends on a whole range of contingent factors. As societies develop and get richer on average, and in particular if this is accompanied by rising inequality, the income needed at the lower end to achieve minimal dignity will also change.
- This conceptualization is implemented in practice in the European Union, for example, by making the poverty line in a country equal to 60% of the median (equivalized disposable household) income in that country

Vulnerability

- In the previous section I have developed the idea that it is inappropriate to think of a country as being a single individual with the per capita income of the country. I have highlighted variations around the average, and in particular (absolute and relative) poverty.
- However, let us now indeed think of the country as a single person, to highlight conceptually another key sense in which per capita income fails as a measure of wellbeing and need.
- National income is volatile for reasons that are well known. To the traditional reasons of export fluctuations and tourism uncertainty are now added climate related risks and swings associated with global financial markets, over which any particular country has no control.

- Surely the average income of a country should be adjusted to account for this volatility, just as the average return from a portfolio is adjusted to account for risk?
- The standard formula for the “risk premium” or “cost of risk” as a fraction of the mean return is

$$(1/2) \times (\text{sd})^2 \times R$$

where sd is the standard deviation of the variable in question and R is the degree of “risk aversion”.

- The standard deviation of per capita income can be calculated from past time series data.
- The crucial element is R , “risk aversion” which in this national context measures the true wellbeing cost of shortfalls of national income when they cannot be insured against.
- In the national context the cost of risk in effect gives us the adjustment downwards of per capita income that is necessary to account for this cost. With risk, it is “as if” the country’s per capita income were lower than shown in the official figures.

Future Imperfect

- In assessing individual wellbeing, a snapshot of the present can be an inadequate representation because it may not capture future expected trends.
- An investor may buy an asset with a present low return in expectation of a higher return in the future. Present discounted value (or internal rate of return) calculations convert the anticipated future flows into commensurate amounts to compare with current costs and benefits.
- And if projected returns are lower than present return this adjustment needs to be made to correct for the valuation of an asset.

- What about a country which has a relatively high officially measured per capita income but whose future prospects are anticipated to be less than rosy because of factors outside its control?
- The most obvious case is that of climate change. Quite apart from greater volatility immediately, which we have addressed in the last section, there is the prospect of lower (relative to trend) per capita income in the future. Inexorable sea level rise for small island economies is the most vivid case of such a scenario.

- Of course the consequences of climate change can be adapted towards, with current investment in appropriate infrastructure.
- And that is the point. An economy with a relatively high present per capita income needs investment to prevent future downturns in per capita income as the result of a Global Public Bad over which the economy has no control. But it cannot get access to development finance to undertake this investment precisely because of its present high per capita income!
- That is the Catch 22 of OMIT or DAMIT.

- Finally, from the global perspective, consider the case of a larger MIC which will not only suffer from the consequences of climate change but whose emissions are a significant contributor to climate change.
- Mitigation measures in this large country are a Global Public Good, but will impose an immediate cost on the country. The world should want to incentivize this country to undertake these measures, but current rules on development assistance for MICs make this difficult.
- Once again, the current (over) reliance on per capita income as a guide is shown to be problematic.

Cliffs

- Even if there was an argument for tight conditioning of development assistance on per capita income, and we have seen that there are equally strong counterarguments, the current design of “graduation” has another feature which is problematic.
- This is the “cliff” a country faces when it crosses the graduation threshold with, in principle, sharp fall off in access to development finance at the graduation threshold.
- There are some operational advantages to creating well defined categories such LICs and MICs, but the sharp tapering of aid at the cross over point does not allow countries to plan appropriately.

- Of course in practice the actual graduation process is smoother than this. For example for IDA, a country enters the graduation process when its per capita income has been above the operational cutoff for three years in a row. This gives time, but the cliff at the given income level still remains.
- If there is to be a fall off in development assistance at per capita income rises, it should be a smooth tapering as a function of income rather than in the form of a cliff.

Modified Criteria

- The counterarguments to sole reliance on per capita income, and that too with sharp categorization with thresholds, have of course been noted in the operational settings—to some extent.
- Thus, to quote from IDA:
- “IDA also supports some countries, including several small island economies, that are above the operational cutoff but lack the creditworthiness needed to borrow from the International Bank for Reconstruction and Development (IBRD).”
- But this barely addresses the critiques laid out in the previous sections.

- Other agencies have moved further in the direction of modifying the pure income criterion.
- The UN's classification of Least Developed Country (LDC) now depends on three criteria—per capita income, human assets index, and economic vulnerability index, [LDC Identification Criteria & Indicators | Department of Economic and Social Affairs \(un.org\)](#).
- Of course one can discuss further the details of the two supplementary indices, but this is a welcome advance in broadening the concept of need for development assistance.

- However, a closer look at the details should make clear that income per capita still retains pole position in determining graduation.
- This is apparent in the so-called “Income-only exception” in the graduation criteria: “per capita GNI is at least twice the graduation threshold in two consecutive triennial reviews.” The income graduation threshold for the UN is the World Bank’s LIC threshold of \$1,035, so if a country’s GNI per capita exceeds \$2,070 over six years it ceases to be a least developed country and loses access to development assistance associated with that status.
- In fact, the UN also has the “2 out of 3 rule” for graduation, so a country which crosses the \$1,035 threshold and one of the other thresholds for human assets or vulnerability “graduates.”

Next Steps

- Overall, then, while movements in the right direction are obviously welcome, we are still in a mindset dominated by per capita income as the main indicator of need. And the cliff still remains.
- An appropriate response, in light of the critique advanced in the previous sections, would be to move much more strongly in the direction of:
 - Adjusting the relationship between per capita income and poverty by using a relative poverty line which moves with per capita income.
 - Adjusting the per capita income criterion to take account of risk and vulnerability.
 - Adjusting the per capita income criterion for known negative future “business as usual” trends.
 - Adjusting the flow of development assistance more smoothly to the modified per capita income criterion, so that countries don’t face a cliff in resource flows shut off.

- These adjustments would serve to remove OMIT or DAMIT as a further addition to MIT in holding back the development of MICs to HIC levels of development.

Thank You!

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