Institutions and growth in middle-income countries

Gael Raballand and Diane Zovighian*

Abstract

Is the 'middle-income trap' an institutional trap? If so, what institutional arrangements can help middle-income countries (MICs) escape this trap and move up the income ladder? We offer a political economy perspective on institutions and growth in MICs that helps explain why most MICs struggle to develop the institutions needed to shift from investment-led to innovation-led growth and reach high-income status. The trajectory of MIC 'escapees' shows that they tend to have more open political settlements that allow the emergence of:

(i) A strategic state shielded from vested interests and capture, and able to put in place rules and policies that open space for competition and create incentives for productivity and innovation among market incumbents;
(ii) Institutions that foster generalized trust and voluntary compliance with economic rules and policies among market players, rather than allow personalized and deals-based economic governance;
(iii) Long-term political stability conducive to sustained economic performance.

The paper concludes that donors should recognize that escaping the middle-income trap is fundamentally a political economy problem and provides preliminary policy recommendations in that direction.

Keywords: Political economy, middle-income trap, growth, middle-income countries, strategic state, trust, political stability

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Introduction

Despite decades of institutional and economic reforms, few countries have managed to transition from middle- to high-income status. A cursory look at growth trajectories worldwide shows that the middle-income trap[1] is a common occurrence (Kharas and Gill 2020): while some East Asian and European countries have managed to upgrade to high-income status, the overwhelming majority of middle-income countries in Latin America and the Caribbean, the Middle East and North Africa and Sub-Saharan African have not been able to graduate to high-income status.[2]

Inadequate growth policies partly explain this lack of convergence. Growth requires different economic strategies at different levels of development. While growth in low-income countries can be driven by capital accumulation and technological imitation, in middle-income countries the driver of growth shifts from investments to innovation. Middle-income countries that manage to graduate to high-income status display higher total factor productivity, spurred by innovation and a process of creative destruction as outlined by Joseph Schumpeter (1942) (Acemoglu, Aghion, and Zilibotti 2002; Aghion and Howitt 1992; Kharas and Gill 2020).

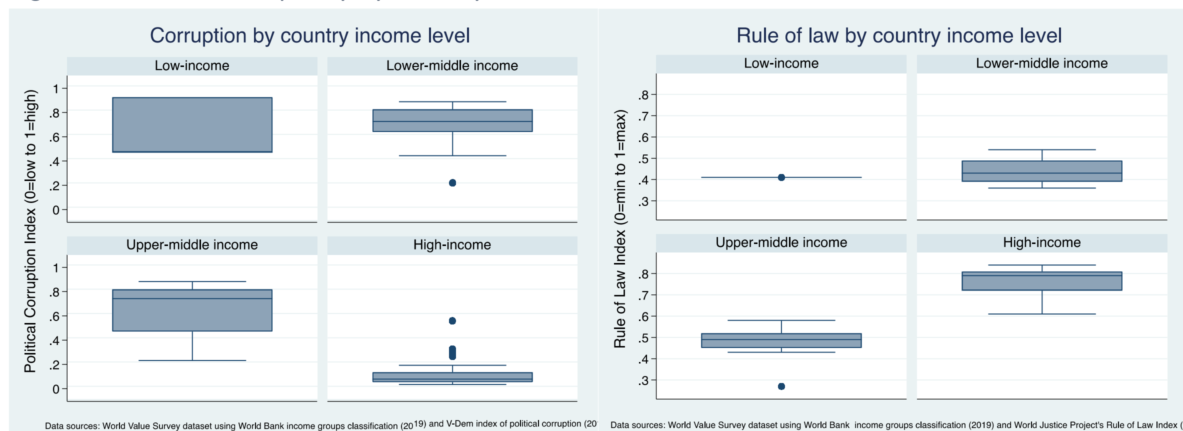
Capital-led versus innovation-led growth strategies are likely to require fundamentally different institutions:

- *Stirring technological convergence and escaping the middle-income trap requires a "smart state."* The transition from an imitation-based to an innovation-based economy calls for a "smart state" or strategic state, Aghion and Roulet (2014) argue. As they explain, "it is not so much the size of the state that is at stake but rather its governance." The state should act as a "catalyst," stimulating innovation by market actors through selective policy interventions, such as targeted public spending on a limited number of growth-enhancing sectors. Aghion and Roulet (2014) emphasize that private firms tend to underinvest in research and development (R&D) or training and the state should play an important role to act as a "co-investor in the knowledge economy." The state also plays a strategic role in devising policies that strike the right balance between preserving some rents to encourage incumbents to continue innovating while not deterring future entry and innovation from other firms.

- *Rule-based governance, ranging from property rights to contract enforcement and control of corruption, is also a central piece of the puzzle of growth in middle-income countries.* Following North (1990), new institutional economists, as well as promoters of the "good governance" agenda derived from it, have argued that growth in developing countries is largely contingent on the development of "market-creating" institutions (Rodrik and Subramanian 2003) such as property rights and credible enforcement mechanisms (including judicial mechanisms) to reduce economic

uncertainty and risk for market actors, and incentivize investment. Empirical evidence shows, however, that the relation between governance and growth is an uneasy and nonlinear one (World Bank 2017a). As suggested in figure 1, while high-income status is clearly associated with strong rule of law and lower levels of corruption, the picture is messier in low- and middle-income countries, which display surprisingly similar institutional characteristics despite different growth levels. This evidence suggests that while countries can muddle through subpar institutions at the low- and middle-income level, deep institutional transformations happen in countries that have reached high-income.

Figure 1. Institutional quality by country income level



Why do most middle-income countries struggle to develop institutions that allow them to shift from investment-led to innovation-led growth, and reach high-income status? What blocks the rise of a strategic state and the development of rule-based governance in middle-income countries? Building on the existing literature and our empirical insights and policy experience, this paper provides a political economy perspective on institutions and growth in middle-income countries to explain the divergent trajectories of countries that remain trapped and those that escape the middle-income trap. The main contention is that the development of these institutions is a protracted and deeply political process, and that many middle-income countries fall into political economy traps that prevent them from developing the "right" institutions. Vested interests get in the way of the policy interventions of "strategic states"; the resistance of incumbent market players prevent the adoption or implementation of regulatory reforms needed for investments and innovation; corruption and deals behind closed doors feed young firms' mistrust in rules and institutions; competition around undue rents feed elite infighting and political instability, which in turn harms growth; and so on.

Put simply, the experience of countries that have transitioned from middle- to high-income status suggests that overcoming the middle-income trap requires political settlements that allow the emergence of two features, in particular. The first is a state *shielded from vested interests and capture*, and able to strategically put in place rules and policies that open space for competition and create incentives for productivity and innovation among market

incumbents. The second is public institutions that foster *generalized trust and voluntary compliance* with economic rules and policies among market players, rather than preserve personalized and deals-based economic governance.

These institutional developments are nonlinear and long-term endeavors that require a renegotiation of political settlements, moving away from close and exclusive pacts and toward more inclusive and contestable pacts. In Northian terms (North et al. 2007), they require the (slow-moving and contentious) systemic transition from a "limited access order," characterized by exclusive elite pacts—whereby access to rents is personalized and deals-based and limited to few elite groups, and state policies are largely captured by dominant elite groups—to an "open access order" that allows rule-based, open competition among a broader range of societal groups.[3] This transition in power distribution is also a transition in trust regimes: in close and exclusive political settlements, levels of generalized trust are low and personalized trust and deals-based relationships between incumbent market players and the political elite substitute for impersonal rules-based contract enforcement (Diwan, Malik, and Atiyas 2019). In more inclusive orders, the radius of generalized social trust is larger—a precondition for voluntary compliance to rule-based governance. In the absence of this transition in power distribution and social trust, the deployment of strategic states is likely to be constrained by vested interests. Consequently, market-creating reforms, including the strengthening of the rule of law, are unlikely to be adopted or adequately implemented.

Long-term stability—a major correlate of growth in middle-income countries—plays out differently under different social orders. Policy capture and resistance to competition in limited access orders nurture the exclusion of large segments of the market and tend to generate long-term instability, which eventually harms growth. In contrast, in the long term, open access regimes, which allow for more open competition, tend to have higher survival rates and to be more stable—and to deliver better growth outcomes. There are, however, difficult trade-offs between regime transition and political stability. While in the long term, more open and accountable systems are good for productivity and innovation, political transition times can generate short- to medium-term instability and stifle growth.

The discussion that follows examines these institutional dimensions and traces the channels through which they can hinder or support innovation, productivity, and growth in middle-income countries. The paper concludes by offering some preliminary policy implications, including for the World Bank's engagement in middle-income countries.

Institutions for innovation and growth in middle-income countries

A political economy trap? Incumbents' vested interests and obstacles to the "strategic state" in middle-income countries

Productivity and innovation do not happen in a policy and institutional vacuum; rather, they are the result of strategic policy choices and reforms. The growth policy mix required for a successful transition to high-income status varies according to the structural conditions of country economies. States are central to establishing the right growth diagnosis and developing adequate policies and rules to support growth. They can promote innovation and growth through well-selected and properly governed public investments, tax policies, or subsidies; and manage the redistribution of national growth benefits through safety nets and public services (Aghion and Roulet 2014). They can also incentivize investments and regulate market competition through institutional reforms aimed at securing property rights and contract enforcement, and more broadly creating a regulatory environment conducive to risk-taking and private investments.

In practice, growth policy in middle-income countries is often subject to misdiagnosis, distortions, and implementation gaps (World Bank 2017a). In some cases, countries fail to adopt policies that can stir innovation—such as well-targeted public investments, funding for R&D, or tax support to emerging or innovating sectors—or adopt them too early or too late (Acemoglu, Aghion, and Zilibotti 2002). In others, policies are distorted to the benefit of dominant market players lacking the capacity or incentives to innovate and prevent the emergence of new firms or sectors. In a similar vein, the adoption of traditional "good governance" reforms aimed at improving the rule of law and fixing market failures have been shown to be unlikely, all things equal, to have a systematic effect on private investments or innovation.[4] These reforms are indeed often implemented only partially or to the benefits of a few market players.[5]

The concept of "political economy traps" helps explain why most middle-income countries struggle to put in place the right institutions and policies for growth. Political economy dynamics are at the core of innovation, which is by essence a conflictual process characterized by competition between incumbents and new entrants (Aghion 2016). "Political economy traps" emerge in middle-income countries when the vested interests of market incumbents impede the adoption or implementation of rules and policies supporting the switch from investment-based to innovation-based policies.

Political economy traps—and the associated rents—are arguably more problematic for innovation-based growth than for investment-based growth.[6] The nature of growth and the needs of the market differ in early and later stages of development. At early stages of development, investment-based strategies are compatible with "long-term relationships, high

average size and age of firms, large average investments, but little selection" (Acemoglu, Aghion, and Zilibotti 2002)—and hence, to some extent, with market rigidities and undue rents, which can incentivize private investments by incumbent market players when capital markets are deficient.[7] In contrast, middle-income countries switching to innovation-based strategy are characterized by "younger firms, less investment and better selection of managers" (Acemoglu, Aghion, and Zilibotti 2002). In that latter context, rent-seeking and policy capture by vested interests become more problematic: the policy and regulatory distortions they induce erect barriers to younger and new entrants and decrease incentives for innovation. Hence, while some rents can incentivize investments and be compatible with growth at early stages of development depending on the market, technologies, and companies involved (see Khan 2000), excessive rent extraction is more likely to play against innovation at later stages.

Rent management is therefore a fundamental aspect of market regulation in the transition from middle-income countries to high-income countries. Strategic states are expected to preserve rents, which serve as incentives for incumbent market players to invest in innovation and take risks, while not deterring entry and innovation by new market players (Aghion and Roulet 2014). Given that the economic behavior and rent opportunities of market incumbents differ across countries as well as within a country, depending on the economic sectors in which they operate, as well as their types of goods and clients (foreign or domestic), policy solutions to manage rents vary across countries, sectors, and firms. In some cases, innovation mainly requires well-targeted and well-governed support and incentive schemes to stimulate Schumpeterian innovation rents. In other cases, where incumbents overtly abuse their market power and prevent innovation, stronger antitrust regulations and sanctions are more likely to open space for innovation. The growth trajectory of East Asian tigers illustrates how well-managed rents can support innovation and growth in middle-income countries. As Schiffbauer et al. (2015) note, while the Republic of Korea displayed close linkages between political and business elites much like other middle-income countries in the 1960s or 1970s, it differed in its management of rents: although, for example, subsidies may have been directed disproportionately to businesses with political connections, these enterprises were still required to meet performance targets in line with the country's growth objectives.

In "trapped" middle-income countries, the vested interests and excessive rents of market incumbents have distortionary effects on productivity and innovation. New innovative entrants can be excluded from markets and sector regulation can be captured by an incumbent, slowing down innovation.[8] These dynamics have been studied empirically in the literature on the political economy of growth in developing countries. For example, Rajam and Zingales (2004) argue that if unrestrained, capitalism stultifies innovation because capitalists tend to erect barriers to entry for incumbents. In a similar vein, Akçiğit, Baslandze, and Lotti (2023), using data from Italy, show that incumbents innovate less (using a regression discontinuity design leveraging close connections to show that this relationship is causal). In

Tunisia, a lower-middle-income country, Rijkers, Freund and Nucifora (2017) demonstrate using firm-level data that, in highly regulated sectors, in the period before the Arab Spring, the market shares of firms connected with the family of President Zine El Abidine Ben Ali were positively correlated with exit and concentration rates. This suggested that the Ben Ali clan abused entry regulation for private gain, at the expense of competition. Firms connected to the Ben Ali clan were more prone to evade import taxes, which provided them with a considerable competitive edge (Rijkers, Nucifora and Raballand 2017). Those firms also benefited from privileged access to subsidies or financing. These dynamics were facilitated by a lack of transparency around policy making, as the general public and most competitors remained unaware of the undue privileges accruing to politically connected market incumbents. More broadly, in the Middle East and North Africa region, benchmarking eight countries in the region[9] (of which six were classified as middle-income) and assessing several key policies crucial for private sector creation and innovation, Mahmood and Ait Slimane (2018) find that weak job creation and insufficient private sector dynamism could be traced back to formal and informal barriers to entry and competition that privileged a few (often unproductive) incumbents who enjoyed a competition edge because of their connections or ability to influence policy. Such dynamics have also been at stake in Latin America: González and Prem (2020) show for example that, in Chile, firms connected to President Augusto José Ramón Pinochet were enjoying rents and started to innovate only upon learning his time in office would end.

The capture of the financial sector also creates barriers to the emergence of new sectors and firms in middle-income countries. Private investments require access to financing and thus functioning capital markets. Yet, in many middle-income countries, the financial sector fails to fulfil that role. Lebanon—a country that recently downgraded from upper-middle-income status to lower-middle-income status—is a case in point. In his study of the ownership, governance, and performance of commercial banks in Lebanon, Chaaban (2019) finds that 18 out of 20 banks had major shareholders linked to political elites, 6 banks had individuals currently holding public office among their management board, and virtually all banks had on their board former government officials or parliamentarians; Chaaban also finds a strong and positive correlation between political connections of banks and the presence of non-performing loans in their portfolio—suggesting that the political capture of the finance sector hindered capital allocation.

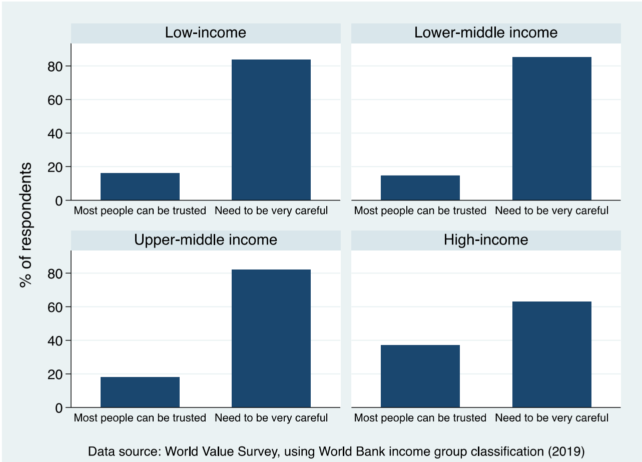
While path dependence can keep middle-income countries stuck in political economy traps, crisis and critical junctures can generate incentives to shift from investment- to innovation-led policies and growth. Where economic and political competition is low, dominant market incumbents are likely to use their monopoly profits and political connections to influence the design or implementation of anticompetitive policies and regulation, including through bribing and kickbacks. This can block the transition from investment-based to innovation-based growth strategies because market incumbents that benefited from policies supporting

investment-based strategies can turn into a powerful constituency against policy change. This path-dependent dynamic has been argued to be behind the nonconvergence of Latin American countries, including Mexico and Brazil. In these countries, anticompetitive and import-substitution policies supported rapid, investment-led growth until the early 1980s, but also created a strong constituency against policy change, competition, and growth after that (Acemoglu, Aghion, and Zilibotti 2002). While path-dependent dynamics tend to be strong, the trajectory of middle-income escapees show that under the right combination of political incentives, changes to competition and innovation policies are possible. The case of Eastern European countries, which make up an important share of successful transitions to high-income status in recent decades, illustrates the role of externally induced political incentives: the process of integration in the European Union created commitment to market reform and supported convergence within Europe.

Transitioning from deals-based to rule-based economic governance: Institutions conducive to generalized trust and voluntary compliance

Many middle-income countries are characterized by low levels of generalized trust; in those contexts, deals-based, rather than rules-based, economic governance tends to predominate. Figure 2 shows the gap in levels of generalized trust between high-income and middle-income countries, as well as the relatively smaller differences in trust levels between other income groups. In low-trust environments, personalized trust between incumbent market players and the political elite often serves as a substitute and provides selected (and often arbitrary) guarantees for private investments by cronies. As Diwan, Malik, and Atiyas (2019) put it, such crony relations are a "second-best solution to the commitment problem, where growth is facilitated through 'particular' rather than 'universal' rights for the private sector," guaranteeing to "a subset of asset holders that their property rights will be protected."

Figure 2. Generalized trust by country income level



Transitioning out of middle-income status requires a transition from personalized to generalized trust. As markets grow and policies become more complex, personalized, deals-based relationships can no longer be a substitute for impersonal rules-based contract enforcement, as Dixit (2004) suggests. The policies needed for economic growth in middle-income countries are likely to be contentious and difficult to implement, and can generate opportunities for rent-seeking by market players (such as credits, subsidies, tax-favored firm- or sector-level investments, and the like). A fundamental issue in middle-income countries is therefore to build trust between the state and market players to incentivize private investments and innovation, and foster market players' voluntary compliance to tax policies (that generate public revenues for much-needed investments)[10] or regulatory measures (such as contract enforcement) that sustain the rule of law.

There is empirical evidence of the correlation between trust[11] and growth[12] (see, for instance, Algan 2018; Fukuyama 1995; Keefer and Knack 1997; Zak and Knack 2001). It is estimated that a 10-percentage point increase in the share of trusting people in a country is associated with an increase in annual output growth rate of about 0.5 percentage points (Smith 2020).

The growth-enhancing role of trust plays out through different channels. Trust reduces transaction costs among market players (Fukuyama 1995), encourages the establishment of long-term contractual arrangements, and decreases risks in private investments and innovations. Trust also supports innovation by supporting the functioning of the financial markets, which are negatively affected by uncertainties that stem from moral hazard and difficulties in contract enforcement (Algan and Cahuc 2010). Trust is also a precondition for market players' compliance with regulations (including the enforcement of property rights and contracts) and tax and other policies (Dom et al. 2022).

Trust also facilitates adaptation to change without excessive disruption and can help break political and policy deadlocks—which often arise in times of shifts in growth policy. Developing countries experience violent transitions every eight years, on average (Cox, North, and Weingast 2019), underlining the difficulties involved in adapting institutions to manage emerging social and economic tensions. Social and institutional trust positively affects the relationship between voters and politicians, which can lead to improved public policy and stability (Keefer and Knack 1997). Trust also supports political agreements even when the positions of politicians and voters are strongly polarized and allows for greater policy innovations in times of change and new challenges (Knack 2001).

While there is no magic bullet to build trust, a growing body of literature suggests that notions of policy credibility and integrity are critical to increase market players' trust.[13] In practice, in the transition from investment-led to innovation-led growth policy, measures to enhance policy credibility can include clearer and more transparent communication on the design, the beneficiaries, and the expected benefits of innovation policies (such as public credits and

sectoral investments), as well as a more systematic reduction of the gap to implement critical regulatory reforms. Measures related to integrity are likely to be linked to reducing the scope of policy capture/distortions by politically connected firms. Given the politically contentious nature of such measures, they are more likely to happen in new/emerging sectors or sectors where incumbent market players are either divided (reducing the scope of collective resistance) or relatively less politically connected.

Long-term institutional stability, political trade-offs, and growth

Institutions matter for long-term political stability[14] and consequently long-term growth. Around the world, institutional change is the key ultimate factor behind the reduction in slowdowns in growth, Broadberry and Wallis (2017) demonstrate. Using annual data from the thirteenth century to the present, they show that improved long-term economic performance has occurred primarily through a decline in the rate and frequency that an economy shrinks rather than through an increase in the rate that it grows. As economic performance has improved over time, the short-term rate of growth has declined rather than increased. Institutional changes that support growth and innovation over time have been the main factor explaining the reduced frequency of episodes in which the economy shrinks.

Long-term stability sometimes comes at the cost of short-term instability, stemming from the renegotiation of exclusive political pacts. Historically, many transitions to open access regimes have generated political instability stemming from conflicts around the renegotiation of access to economic resources and opportunities between the ruling coalition and excluded segments of the population—as illustrated by the high levels of political instability in young democracies. Put differently, short-term political instability is, to a large extent, inherent to the building of stable and inclusive political pact able to generate growth in the long term.

Instability tends to create policy volatility and shorten policy horizons, leading to suboptimal macroeconomic policy decisions. It also decreases investors' confidence—depressing private investments. In contrast, long-term political stability appears to be a necessary (if not sufficient) condition for growth (Alesina et al. 1996; Aisen and Vega 2013; Ben Doudou and Rahali 2018)—among other reasons because it endows governments with longer time horizons, which creates incentives for long-term public investments (for example, to finance innovation-related policies).

The short-term economic successes of *some* stable limited access orders in middle-income countries have fed the myth of autocratic stability and growth. Selected middle-income countries country examples have shown that such regimes can deliver *short-term* stability and growth (and even growth acceleration episodes).[15] This is particularly the case in stable *(mature*) limited access orders, where rents are distributed among elite groups in a way that encourages their cooperation and decreases competition and violence within elites.[16] In the

short term, these regimes, which tend to be governed in a centralized and top-down manner, can also facilitate an innovation shock through their capacity to impose contentious reforms (such Robert Mugabe in Zimbabwe in the early years of his rule as prime minister). In contrast, many young democracies tend to be highly unstable in the short term, and to create perverse incentives for economic performance, whereby officials are better off concentrating on easy, visible tasks with clientelist payoffs (such as building roads capped by a ribbon-cutting ceremony to garner popular support) (Tanzi and Davoodi 1998), rather than engaging in more complex and challenging reforms to support productivity and innovation.

In the long term, however, limited access orders tend to be less able to sustain growth.[17] Several dynamics are at play. First, state capture and resistance to competition in limited access orders nurture the exclusion of large segments of the market, generating instability, which eventually harms growth.[18] Second, limited access orders tend to be associated with higher levels of inequality. Unemployment and economic inequality are important drivers of distrust of states because they undermine social contracts and then long-term growth (Brezzi et al. 2021). Trust in public institutions can indeed be eroded by real or perceived unfairness of state redistribution and taxation and repeated failures to address those issues. Policy failures usually have a long-standing effect on trust in institutions, especially when experienced by young people. In a low-trust country, citizens will seek in prioritize immediate benefits and will induce politicians to seek short-term and opportunistic gains through free-riding and populist attitudes (Gyorffy 2021). Third, captured state are also costly, and characterized by high debt levels, misappropriation, and inefficient public investment—which play against the fiscal health of governments and their ability to invest in and implement policies to enhance productivity or innovation. These considerations serve as a reminder that stability on its own is not enough for economic growth in middle-income countries, and that it needs to rest on healthy foundations.

Conversely, the growth-enhancing nature of more open and accountable systems plays out through multiple channels. First, open political systems provide a better research and learning environment for innovation. Aghion et al. (2008) provide empirical evidence that democracy is particularly growth-enhancing in frontier industries. This relationship is attributable to the very nature of innovation processes, which require strong research universities that allow researchers to develop their research agenda in a non-incremental and nondirected way—which is more likely in a political environment in which freedoms of thought, expression and communication, among others, are safeguarded (Aghion and Roulet 2014).

Second, open and accountable political systems are characterized by more transparency and stronger checks and balances. These institutional features support competition and innovation by ensuring that performance and merit rather than political connections and corruption drive policy design and implementation, and that individuals and firms can take action to redress unfair or inequitable decisions when this is not the case—in doing so, they

also decrease potential conflicts between market incumbents and new players and foster long-term stability. It is noteworthy in that regard that even autocratic East Asian middle-income escapees institutionalized checks and balances (such as by developing autonomous and accountable bureaucracies), and put in place spaces for consultation and deliberation with the private sector to enhance cooperation and create an environment conducive to growth. As argued by Campos and Root (1996), it was those capacities, rather than the authoritarian nature of regimes, that facilitated the transition of those countries out of the middle-income trap.

Finally, more democratic governments are more likely to manage the redistribution of national growth benefits in an equitable way because they tend more representative of and responsive to the interests of different social groups.[19] They are also more likely to invest in public services such as education (Acemoglu et al. 2015; Stavasage 2005), which are needed in innovation-led economies and are associated with higher levels of stability.

These considerations point to the importance of accounting for time horizons in economic policy making and evaluations in middle-income countries. While the top-down and centralized decision-making style associated with some limited access orders can help support innovation shocks in the short term or facilitate the adoption of regulatory reforms, this mode of governance is unlikely to generate sustained growth in the long term, in part because of the dynamics of capture and extractive rent-seeking on which it rests, which stifle innovation, erode or pervert implementation of regulations, and more generally make instability (and its economic consequences) much more likely.

Some (tentative) policy implications

Unverified assumptions about the institutional determinants of growth in middle-income countries can hinder the effectiveness of support by the World Bank and other donors. "Do no harm" is the usual motto of development practitioners providing financial and technical support to developing countries (whether middle-income countries or low-income countries). However, harm can be created due to false assumptions, ignorance, or sometimes lack of willingness to confront reality. As argued by Easterly (2015), there is sometimes a leniency regarding "benevolent autocrats" (leaders in nondemocratic regimes who receive credit for high growth), especially based on some earlier achievements. Easterly (2015) and Dercon (2022) demonstrate that this concept of benevolent autocrat or "big men" is not a recipe for success worldwide for long-term growth.

By overlooking these considerations, donors risk reinforcing an exclusive elite pact and giving too much prominence to some incumbents in a weak regulated environment—which can be detrimental to sustainable growth in middle-income countries. Even though growth is more about managing imperfect competition, it is important to keep in mind that, in some cases,

some incumbents benefit disproportionately from public support and advantages (formally and informally). Moreover, privatizations may actually reinforce incumbents or crony companies. Therefore, it not so surprising that Estrin and Pelletier (2018), taking stock of the impact of privatization after several decades, find that the impact on efficiency of privatization in infrastructure mostly depends on the quality of regulations and the regulatory regime, which in turn depends on the quality of institutions and on political economy aspects. Cordelli (2020) even identifies a "privatized state" where numerous state functions have been privatized and therefore have growing legitimacy problems. Donors can, in some cases, inadvertently, help undermine state sustainability and limit long-term growth.

In this context, how can donor support be tailored to the needs of middle-income countries? What can be done differently to help middle-income countries escape the institutional trap? While it is true that in middle-income countries donors may have a more limited leverage with respect to the elite pact because, by definition, local resources and capabilities are higher than in low-income economies, the three institutional dimensions analyzed in this paper can help rethink priorities for World Bank support to growth in middle-income countries.

First, donors should recognize that escaping the middle-income trap is fundamentally a political economy problem. Considering the high and unequally distributed short-term impacts of transitions from middle-income to high-income status, policies to support innovation and productivity are likely to be resisted by many market players and social segments.

Donors can play a stronger role in supporting inclusive "upgrading coalitions" by being more explicit and cognizant of their influence on local political economies and working around or against vested interests. The objective is two-fold: (1) addressing elite capture, which creates resistance to reform coalitions to support innovation and productivity across interests and over time; and (2) opening space for new entrants. This has practical implications for World Bank engagement:

- Tackling elite capture should be a central objective, to diminish resistance to reform and enlarge reform coalitions. Depending on the nature and mechanisms of elite capture, which can take many forms depending on the market structure and the political system in place, this can be addressed fighting corruption and working toward more accountable and depersonalized institutions to level the playing field and decrease barriers to entry for new market players; by fostering transparency around competition policies, subsidies, public procurement, tax exemptions, and all the rules and policies that can create a distortion in favor of incumbents; supporting media and investigative journalism to strengthen accountability; or tracking and fighting illegal financial flows and money laundering through which the proceeds of policy capture are safeguarded.

- Injecting *gradual* competition into *selected* sectors of economies through small disruptive competitive shocks, rather than full-fledged open competition, which is more likely to be vehemently opposed by incumbents.

- Supporting new entrants, economically (through targeted support) and politically, by using the World Bank's convening power to give them voice in economic policy discussions and opening space for transparency and contestability in economic policy making—in particular, around innovation and productivity-related policies that are vulnerable to capture and distortions (such as subsidies and tax exemptions).

- Leveraging differences between various incumbents. For diverse reasons, some incumbents may not have the same views of the different tools to reduce competition and may be more willing to open markets. Some bargaining may actually be sought, in the spirit of a "development bargain" as identified by Dercon (2022).

Second, strengthening generalized trust is key for growth in middle-income countries. Without such trust, good governance reforms are unlikely to have their expected effect on investors' confidence and risk-taking. Moreover, market players' compliance with much-needed tax and other innovation-related public policies is likely to be lower.

In that context, efforts to expand trust can be driven by reforms supporting policy credibility (such as through more transparency or better communication around the adoption or implementation of policy reforms, and lower levels of arbitrariness in policy implementation), as well as by fairness and equity (such as equitable access to or treatment by courts, fair and progressive tax policies, and transparent and fair implementation by tax authorities). Donors tend to seek these elements—although not systematically, and sometimes forget them when short-term objectives prevail.

Finally, donors must contend with difficult dilemmas relating to the trade-offs between short-term and long-term engagement and impact. As discussed, in limited access orders, high growth in the short term is rarely inclusive and sustained. Yet, development practitioners sometimes face an unconscious dilemma and privilege short-term growth. This dilemma is particularly present with some Development Policy Operations (DPOs): while budget support can promote short-term growth, DPOs are also likely to contribute to the stability of exclusive elite pacts, which are not conducive to sustainable reform and growth, and hence keep middle-income countries stuck in a suboptimal institutional and economic equilibrium.

Time horizons, and in particular the short-term versus long-term growth payoffs of political stability, must be taken into account when promoting and assessing the impact of donor-supported economic and governance reforms in middle-income countries. Short-term reform

successes can, in effect, be detrimental to long-term growth if and when they contribute to the stability of limited access orders, which tend to have worse growth outcomes in the medium to long term (such as growth deceleration, unequitable growth, and so on). Accounting for time horizons can help policy makers and donors think more explicitly about the donor dilemma previously mentioned: to what extent are budget support, grants, or investments sustaining short-term stability and growth at the expense of long-term growth? In practice, this calls, for example, for a more politically savvy use of DPOs. A programmatic approach can help sustain reforms over time, while political economy assessments can provide insights about the effective impact of donor financing on reforms and growth—allowing teams not to be misled by the adoption of formal rules and commitments. As an example, in most countries, competition commissions[20] or regulation institutions have been created, but their implementation on the ground is hampered or almost nonexistent, in large part due to resistance by elites in the face of curtailed rent-seeking opportunities.

Those three different institutional dimensions should be approached concomitantly and using all various instruments available within the World Bank Group, ranging from investments and advisory services by the International Finance Corporation (IFC), to the World Bank's DPOs, Program-for-Results (PforRs) financing and analytical work. This approach would probably create more tensions in some countries, but this is the cost that must be borne if middle-income countries can be expected to exit the institutional trap and achieve long-term growth.

Notes

[1] The term was coined by Gill and Kharas (2007).

[2] The world currently comprises 26 low-income, 108 middle-income, and 83 high-income economies. Between 1990 and 2019, 31 middle-income countries transitioned to high-income (estimates of the *World Development Report 2024* team). Some of them are island economies or oil-producing enclaves. This paper, and the *World Development Report 2024*, consider these countries to be special cases and restrict analysis to countries with more standard economies. Countries that have successfully transitioned include, for example, Japan, Poland, Portugal, Spain and the Republic of Korea.

[3] The need for broader political settlements, or coalitions, is highlighted by Doner and Schneider (2016) who argue that "upgrading policies" in middle-income countries requires some level of consensus-building between incumbent market players and new entrants and the political support of key socioeconomic groups. The composition and duration of those coalitions is highly context specific. As highlighted by Doner and Schneider (2016), they range from the "marriage of iron and rye" (large landowners and heavy industry) in nineteenth-century Germany; to Japan's postwar "corporatism without labor"; to Northeast Asia's postwar "cohesive capitalist states," also labeled "conservative coalitions" or "state corporatism," in which authoritarian leaders prioritized rapid industrialization by working "closely with industrialists"; to the more horizontal, "societal" corporatist arrangements, usually involving labor as well as business and the state, in the small states of Northern Europe and Ireland.

[4] See Khan (2007) and Grindle (2004).

[5] See World Bank (2017b) and Diwan, Malik, and Atiyas (2019).

[6] Political economy traps are not specific to middle-income countries; economic history in low-income countries is ripe with examples of rent-seeking and policy capture, whereby access to economic resources and opportunities is determined by political power and connections—rather than merit and ideas—and well-connected economic actors make profit out of deals-based relationship, including through corrupt deals between governments and businesses (see, for example, Canen and Wantchekon 2022). Here, however, the discussion is concerned not only about the net effect of rents on growth, but also about the specific barriers they create for innovation.

[7] As Acemoglu, Aghion, and Zilibotti (2002) explain, at early development stages, "economies can often maximize investment by channeling money to existing firms, and making use of the experiences of established firms and managers. This is

particularly the case in the presence of incentive problems, which are partly relaxed for existing firms and managers because of their retained earnings, thus increasing their investment capacity relative to newcomers." Khan (2000) makes a similar point.

[8] The patterns of state capture are extremely diverse, as illustrated by Fiebelkorn (2019).

[9] Algeria, the Arab Republic of Egypt, Jordan, Lebanon, Kuwait, Morocco, Oman, and Tunisia.

[10] As governments look for ways to strengthen tax collection systems, a holistic approach to tax reform that includes building citizens' trust is required; without strong voluntary compliance, tax collection, needed for public goods, is bound to be suboptimal. See Dom et al. (2022).

[11] Coleman's (1990) definition of trust states that "An individual trusts if he or she voluntary places resources at the disposal of another party without any legal commitment from the latter, but with the expectation that the act of trust will pay off."

[12] Arrow (1972), cited by Algan (2018), puts it: "Virtually every commercial transaction has within itself an element of trust, certainly any transaction conducted over a period of time. It can be plausibly argued that much of the economic backwardness in the world can be explained by the lack of mutual confidence."

[13] See, for example, Zovighian, Cloutier, and Bove (forthcoming).

[14] Stability derives from the state's ability to establish centralized and consolidated control of violence (as described by Weber 1978). As such, it requires cooperation among different elites and the recognition of state legitimacy by citizens (World Bank 2017a). Elite infighting (for example, around the distribution of rents) or citizen protest (for example, around dissatisfaction with redistribution) can challenge stability. Consequently, stability is strongly associated with the *quality* of growth, because inequitable growth tends to trigger higher levels of instability.

[15] Countries with top-down, authoritarian models of governance have at various times managed to successfully introduce select governance reforms. This has happened at the cost of limited political opening and accountability, which create medium- to long-term risks to political stability and development. Ethiopia is a case in point: autocratic governance backfired into civil conflict, ultimately undermining the progress of reforms and the country's development.

[16] North et al. (2007). See also Olson (1993).

[17] In this regard, it is important to remember Easterly's (2015) point that while limited access orders have been behind *some* of the big successes in developing countries, they have also been behind *most* of the biggest failures.

[18] This echoes a point made by Smith and de Mesquita (2012), who argue that the elite pact needs to grow to ensure stability, yet for dictators, it has a tendency to shrink and become increasingly exclusive.

[19] This echoes the point made in Acemoglu and Robinson (2012) about the virtuous cycle between inclusive political institutions and inclusive economic institutions.

[20] See, for example, Cardozo et al. (2014).

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