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The Nature and Avoidance of the “Middle Income Trap”

Abstract The “middle income trap” is a significant theoretical and practical issue closely related to the economic and social transition and sustainable development of a country. This paper explores the essence of the “middle income trap” and ways to avoid it. It reveals that the inner nature of the “middle income trap” lies in the institutional transition dilemma, which results essentially from a lack of reasonable and clear definitions of governance boundaries between government and market as well as government and society. This lack of boundaries causes coexistent and interrelated government inefficiency, market distortion/failure and social anomie, leading to a stagnant transition from a factor-driven to an efficiency-driven and further innovation-driven economy. Moreover, this paper proposes that the proper way to avoid the “trap” can be found in the reconstruction of the state governance mode, that is, to transition from a development-oriented and omnipotent government to a public service-oriented and limited government, from factor-driven to efficiency-driven and further innovation-driven development, and from a traditional society to a modern civil society through defining reasonable and clear boundaries between government and market as well as government and society. Thus, reconstruction can establish a state public governance mode featuring the interactive role of government, market and society, and achieve the modernization of state

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1 Introduction

In the year 2007, China's aggregate GDP rank rose up from 6th to 4th in the world, and its per capita GDP reached the average level of middle-income countries defined by the World Bank. At the same time, a global economic and financial crisis triggered by the U.S. subprime crisis quickly spread around the world and affected China. This led to a substantial slowdown of China's economic growth, a major adjustment in the government's macroeconomic policies,¹ and certain damage to the Chinese economy. In recent years, with the continuous economic shocks and adjustments in the global economy, especially in developed economies, escalating global trade protectionism, and increasingly intense competition in international trade and currency devaluation, the dividends of globalization that China has enjoyed for a long time are drastically shrinking. Moreover, China faces a series of deep-seated challenges of its own in social and economic development, such as diminishing growth momentum, distortions in economic structure, lack of public services, widening income gaps, stagnant social mobility, serious environmental pollution, and severe resource constraints. These challenges pose the potential risk to China of falling into the "middle income trap" in the future.

As a concept and phenomenon, the "middle income trap" has been defined by World Bank experts, Gill and Kharas (2007), based on a long-term observation of historical practice of economic and social transitions in many countries. It mainly refers to the phenomenon that the further economic growth of economies in the middle-income group slows down or stagnates, being constrained by the existing growth mechanism. It is difficult for per capita national income in these economies to surpass the upper middle income level due to problems like political instability, wealth polarization, rampant corruption, urban gigantism, lack of social public services, high unemployment, social unrest, religious conflict,

¹ For a detailed discussion on macroeconomic governance in 2008, see Tian and Huang (2008).

fragile financial systems and so on. The most typical examples are Argentina, Chile, Mexico and other Latin American countries. The issue of the “middle income trap” has been discussed from different perspectives by scholars at home and abroad (Cai, 2011; Ma, 2009; Kohli and Mukherjee, 2011; Ohno, 2009). These discussions gave rise to both consensus and different opinions. Some scholars regard the “middle income trap” as a phenomenon of economic growth, while others consider it to be a more general issue of economic development. Moreover, there are also scholars who hold that the laws of socio-economic development do not justify the existence of the so-called “middle income trap,” which is merely an illusion of the “modernization trap” (Liu, 2011).

Although the “middle income trap” may not be an “economic law,” we should not ignore it as long as this phenomenon is general enough to have certain statistical significance. For China, it is neither inevitable nor impossible to fall into the “middle income trap.” In order to avoid the “trap,” we must first clearly understand the nature of the “middle income trap.” With a careful review of those countries that have fallen into or are still stuck in the “middle income trap,” we can find that the “middle income trap” is often caused by various factors, rather than by a single determining factor. Many scholars have discussed this from the perspectives of underdeveloped social structure, failure of economic institutions, lack of social mobility, defects of development patterns, excessive social welfare and inadequate consumption, etc., but have yet to explore the essence of the “middle income trap.” Our analysis aims to answer the following questions: What are the most important and fundamental factors that have led to the “middle income trap”? How to develop a general and holistic understanding of it? What are the inherent causalities between various factors? Only when the root of the problem is traced can we find effective ways to avoid or surmount the “middle income trap.”

This paper argues that the “middle income trap” is essentially the result of two factors. First, the existing pattern of economic development with its bottlenecks has failed to support the new economic transition from a factor-driven to an efficiency-driven and further innovation-driven economy (Liu, 2011; Ma, 2010). Thus, the transition of economic development mode is essentially a transformation and upgrade of the economic structure (Cai, 2008; Ma, 2010; Zhou, 2012). Second, the deep-seated institutional transformation from extractive institutions to inclusive institutions comes across obstacles (Acemoglu and

Robinson, 2012), leading to poorly defined boundaries between government and market as well as government and society, which then fails to promote the transition of economic development mode and economic structure (Tian, 2012a). Of the two factors, the former is the direct cause while the latter is the fundamental cause. Both have resulted in the problems China has met and is currently facing, and add to the possibility of China falling into the “trap”. *The Decision on Some Major Issues Concerning Comprehensively Deepening the Reform* adopted at the Third Plenary Session of the 18th Central Committee of the Communist Party of China has vowed to properly handle the relationship between government and market, but it lacks systematic thinking and strategic judgment on the relationship between government and society, and does not reach a due theoretical level. This is actually an indispensable theoretical and practical step to truly achieve modernization of the state governance system and its capacity.

Compared with traditional studies from the viewpoint of economic growth and development, this paper mainly studies the “middle income trap” from institutional transition and state governance. Moreover, a large number of traditional studies only focus on the relationship between government and market, but this paper puts government, market and society into an interrelated, interactive framework for a more comprehensive and profound understanding of the essence of the “middle income trap,” based on which we show the direction of reform for China to avoid the “middle income trap” through modernization of the state governance system and capacity integrating governance of government regulations, guidance of market incentives, and autonomy of social norms.

2 Essential Features of the “Middle Income Trap”

In the two stages of economic development from low income² to middle income and from middle income to high income, the challenges for a country are different. Many institutional arrangements that could effectively address and

² The challenge of the low-income stage is generally to break out of the “poverty trap,” mainly referring to the long-term state of being stuck in the vicious cycle of poverty or low-level equilibrium. For some economies, even the factor-driven economic mode is not well established, which needs to be addressed by virtue of liberalization and marketization. Azariadis and Stachurski (2005) reviewed various self-reinforcing mechanisms leading to the “poverty trap.”

handle the challenges in the earlier stages are often transitional and not sustainable, which serve at best as short-term and partial suboptimal arrangements, rather than long-term and holistic optimal arrangements. There are two basic criteria for assessing the effectiveness of a policy or an institutional arrangement. First, information efficiency, i.e., whether or not the individual information symmetry is easy to obtain, and thus, incurs low running costs for achieving certain social goals (that is, realizable). Second, incentive compatibility, i.e., whether or not individual rationality and collective rationality are compatible, thus, generating the incentive constraint mechanism with intrinsic motivation for enforcing policies or institutional arrangements (that is, implementable).³ With the changing internal and external economic environment and real conditions, some institutional arrangements that once played an important role may decline in efficiency, and information inefficiency, invalidity and incentive incompatibility may frequently occur, so that they may become invalid institutional arrangements and even damaging institutional arrangements. Thus, if we do not carry out timely and proper institutional transformation, but rather fix and finalize some temporary, transitional institutional arrangements, the effective institutional supply and demand will be reduced to an unbalanced state again, and will be unable to address and handle the new challenges, problems and contradictions in social and economic transition and development. Thus, further economic growth and development will be severely constrained. In recent years this has also been a focus for the controversial “China model.”

Kornai (1992) held that there are several coordination mechanisms that coordinate economic activities in society. Among them, the basic three types are respectively government as mandatory bureaucratic coordination, market coordination as the sum of self-interest trading relationships, and self-governing coordination or civil society that is voluntary and mutually beneficial. Government, market and society correspond exactly to the three basic elements of governance, incentive, and social norms in an economy. Regulatory governance, as the most fundamental institutional arrangement and management rule, is mandatory. The basic criterion for whether to formulate such rules and regulations is whether or not they are easy and clear to define (information

³ In economic literature, “realization” and “implementation” are generally used to represent the information and incentive factors respectively when an economic mechanism achieves a social goal.

transparency and symmetry), and whether or not the costs of information acquisition, regulation enforcement and supervision are excessively high. If a regulation is too costly to supervise, it is not feasible to implement. Protection of property rights, contract implementation and proper supervision all call for formulating rules and regulations that require a third party to oversee their enforcement. This third party is the government. In order to maintain market order, the role of government is indispensable. As government is also an economic agent, being both the referee and a player, it has large externalities. This requires clear procedures and regulations on government behavior that should be clearly and accurately formulated. Regulations on other economic agents and the market should be quite the opposite, mainly because of individual self-interest and the fact that economic information is highly scattered and symmetry is difficult to achieve in normal circumstances. Thus, the adoption of a decentralized decision-making market mechanism is inevitable, which is the institutional arrangement with the most extensive application scope. Government regulations in this regard should not be detailed, so as to impose no or minimal intervention, give individuals more economic freedom and policy space, and let the market play a fundamental and decisive role in the allocation of resources. The overlap and long-term interaction of these two kinds of formal institutional arrangements will help guide and shape the normative informal institutional arrangements, enhance the predictability and certainty of socio-economic activities, and significantly save transaction costs.

Therefore, in the three-dimensional framework of government, market, and society, government as an institutional arrangement is a devisable and controllable variable, with strong positive and negative externalities that plays a vital role. It can help make the market efficient, become the impetus for economic development, avoid the “middle income trap,” construct a harmonious society, and achieve balanced and sustainable development. On the other hand, government may also make the market inefficient, cause the economy to fall into the “middle income trap” and lead to various social contradictions. In this sense, the negative features of the “middle income trap” are only superficial phenomena or results, while the inner nature and root lies in that the country is trapped in the institutional transition dilemma, where it does not properly handle the relationships between government and market as well as government and society, the government over-plays, under-plays, or misplays its role in governance, and

it is difficult to transform from extractive institutions to inclusive institutions. This institutional transition dilemma is what many middle-income countries faced and what China is potentially facing now. Once trapped in this dilemma, the three-dimensional state public governance framework of government, market and society can hardly be effectively integrated. Thus, it gives rise to the following general negative phenomena:

First, government inefficiency. Government under-playing its role leads to a lack of necessary and adequate ruling and governance capacity in economic and social transformation as well as the reasonable positioning of itself. Government then fails to provide necessary and sufficient public goods and services as expected when the economy and society develop into a new stage to make up for market failure. On the other hand, due to the over-playing of its role, government excessively participates or interferes in economic activities. The misplaying of its role sees private interest override public interest, and the manifestation of rent-setting, rent-seeking and corruption. According to the Corruption Perceptions Index 2013, which ranks 175 countries, some countries that have been caught in the “middle income trap” for a long time such as Argentina (106) and Mexico (106), ranked relatively low.⁴ Social fairness and justice is thus impaired to a great extent. Particularly, it is worth guarding against the so-called “State Capture,” which is “a form of corruption in which firms make private payments to public officials to influence the choice and design of laws, rules and regulations. ... By capturing state institutions, firms are able to encode preferences for themselves in the basic rules of the game for the market economy, creating a wide range of policy and institutional distortions that generate highly concentrated gains to narrow sectors and groups, often at a high social cost” (Hellman, 2002). Thus, the expected neutrality and impartiality in the rule of law is lost, which entails enormous social costs, the decrease of government credibility, and severe distortions of incentives in economic activities. As a result, the interest groups tied up with government grow increasingly powerful and the equilibrium of local high efficiency but overall low efficiency in public choice can continue for long, thereby causing great damage to social welfare.

Second, market distortion/failure. Market distortion and market failure both reflect the imbalance of resource allocation by the market, but the causes are

⁴ See “Corruption Perceptions Index 2013,” at <http://cpi.transparency.org/cpi2013/results/>.

different. The over-playing of government role causes market distortion, whereas the under-playing of government role causes market failure. Market failure in the general sense refers to the phenomenon that monopoly, externalities, public goods, information asymmetry, and other factors in the economy lead to low efficiency in resource allocation, which requires a rectification of the market by government. However, government intervention should be limited. Once the government overplays its role and enters the competitive field, it will lead to market distortions and low efficiency in resource allocation due to information and incentive problems. The mechanism design theory has revealed that under the non-public goods economic category exclusive of externalities, an institution based on solving problems by bureaucratic and centralized decision-making entails extremely high costs of information processing and regulation implementation compared with those of decentralized decision-making (Hurwicz and Reiter, 2006). An efficient market should be established based on the rule of law that has two roles. First, it binds arbitrary government intervention in market economic activities, which is the fundamental role. Second, it further supports and promotes the market, including the definition and protection of property rights, the enforcement of contracts and laws, and the maintenance of fair market competition, etc. If market is interpreted as a spontaneous social order, it will truly play its role only when governance by law, referred to as the “general rule” by Hayek, is introduced. Due to the deep influence of traditional systems, a distinct feature of transition economies is the excessive intervention of government in economic activities. This external excessive intervention unbound by law makes it quite difficult for the endogenous market economic laws to fully play their role in improving efficiency and inspiring innovation.

Third, social anomie. Anomie is a prominent and general social phenomenon in transition countries, which mainly refers to the situation of individual or group behavior deviating or violating the established social norms, where it is hard to form an independent and autonomous civil society with the ability to coordinate interests and mechanisms for self-restraint. Zhao and Cao (2010) applied Durkheim’s social transition theory to explain the variation of anomie in 30 nations in the world, and they found that some countries that have remained in the middle-income stage for a prolonged period, such as the Philippines, Brazil and Mexico, have a relatively high degree of social anomie. This is because in an open environment, rapid economic and social

transformation often weakens the traditional informal institutional system of a society, including values and beliefs, customs, cultural traditions, ideology, morality and ethics, or even causes them to fade away under strong external shocks. In addition, because of the above-mentioned government inefficiency and market distortion/failure, the formal institutional evolution and change cannot be advanced in a timely and effective manner under the intervention of vested interest groups. Therefore, both formal and informal institutional arrangements are in the state of severely unbalanced supply and demand. This chaos of institutional imbalance is prone to breed anomie and even criminal behavior. As a result, the uncertainties in the institutional environment and the transaction costs of socio-economic activities will increase while the efficiency and benefits of socio-economic development decrease. As Davis and North (1971) pointed out, institutional innovation itself is an alternating process of change between institutional balance and imbalance. In the state of imbalance, changes to the existing institutions may bring out new potential economic benefits and opportunities of institutional innovation.

It is worth mentioning that the current social and economic development of China is not very far from the above-mentioned three basic features, which stem from the fact that the governance boundaries between government and market, and government and society have not been reasonably defined, and the factor-driven to efficiency-driven and further innovation-driven transition mechanism has not been truly established. First, although the central government has put forward the goal of accelerating the transformation of government functions, under the influence of traditional interest pattern and path dependence, it still cannot get rid of the shadow of an omnipotent and development-oriented government under the traditional planned economic system. This leads to the common phenomena of over-playing, under-playing and misplaying the government role. It also gives rise to new features and trends of corruption, one of which is that corruption has penetrated into the process of political decision-making and policy formulation (Guo, 2013). Thus the normal market order is disturbed. Second, the market is far from fully playing its fundamental role in resource allocation, leading to the distortion of the three basic functions of price in conveying information, providing incentive, and determining income distribution. As government has been long holding a dominant position in resource allocation and highly involved in economic activities, the national wealth distribution pattern becomes increasingly unreasonable, and the income gaps

between the nation and the people, the rich and the poor, and the urban and rural residents have been widening (Tian, 2013a). Besides, in the process of the stratification and solidification of interest groups, social mobility also shows a trend of decline. The frequent social issues in China such as the “melamine tainted milk,”⁵ “illegally recycled waste cooking oil”⁶ and “tainted steamed buns with artificial coloring”⁷ have indicated a lack of integrity, moral decline and interpersonal indifference. This has revealed a severe distortion of incentives in social development under the impact of economic interests. Once the basic trust chain breaks, it will result in very high explicit and implicit market activity transaction costs, which considerably increases the risk of falling into the “middle income trap”.

3 Ways for China to Avoid the “Middle Income Trap”

Japan and the Four Asian Tigers (Chinese Hong Kong, South Korea, Singapore and Chinese Taiwan) that share the same Confucian culture with China are successful examples of economies that transitioned from the middle income to the high income stage after World War II. Although the five economies are different in initial conditions of factor endowments, institutional environment and technological development, just as Lim and Spencer (2011) pointed out, there are at least five similarities: (1) they have made full use of the global economy, introduced a wealth of new concepts, technologies and knowledge from the outside world, and successfully explored the global market for products; (2) they have maintained macroeconomic stability, moderate inflation and fiscal sustainability; (3) they have kept high savings and investment rates and provided funding for economic growth; (4) they have attached due importance to the fundamental role of the market in resource allocation; (5) they have responsible, reliable and capable governments, which have a firm commitment to economic growth and the capability of effective governance. Among these five similarities, government and market play their own respective roles.

⁵ In 2008, milk formula laced with melamine led to the deaths of six babies and sickened a total of 300,000 babies. The scandal sparked public anger over inferior food safety regulation systems and questions of business ethics.

⁶ The so-called illegal recycled waste cooking oil is made from discarded kitchen waste and reused in the preparation of meals at restaurants.

⁷ In early April, 2011, several supermarkets in Shanghai were found selling tainted steamed buns. The so-called tainted steamed buns were made of steamed buns which had added colorants.

If taking the experience of the above economies as reference, we can see that the statement delivered at the Third Plenary Session of the 18th Central Committee of the Communist Party of China captures the key to the problem, “well handling the relationship between government and market” and emphasizes “making market play a decisive role in resource allocation and giving better play to the government role” in the reform. Actually, we should also pay due attention to this in the reform of other fields. As Tian (2008) discussed, “the current focus of reform and urgent major problem to be solved lies in the reasonable definition of the boundary between government and market, which is also the key to properly handling efficiency, equity and harmonious development.” However, when further analyzing the inherent logic of reform and development, we may find that it is not sufficient to only consider the relationship between government and market, but society should also play a part in the power game of reform and state public governance. We need to properly tackle the relationship and reasonably define the governance boundary between government and society, as only a sound society can possibly support a sound government and a sound market. Social organization can serve as a buffer zone and stabilizer between government and market, which can step into the fields where government and market are incapable, gather and express individuals’ scattered demands and interests, and achieve the integration and adjustment of social interests. Thus, it is an integral part of state public governance.

To avoid falling into the “middle income trap” and achieve the balance of efficiency, equity and the rule of law, a country in transition should rely on deep institutional innovation and transformation, which is a complex and difficult process. The key is to clearly define reasonable governance boundaries between government and market, and government and society, and thus reconstruct the state public governance mode, so as to effectively respond to the institutional change requirements raised by government inefficiency, market distortion/failure and social anomie. The period from the present to 2020 is crucial for China to avoid the “middle income trap” and lay a foundation to be a high-income country. In the future, China needs the overall design⁸ and comprehensive governance

⁸ Speaking of the overall or top-level design, many people regard it as a detailed and comprehensive design, which is a total misunderstanding. The essence of overall or top-level design is to give principled comprehensive consideration to the most essential aspects of institutional transition such as the goal, orientation, content, strategy and vision of reform, and also make an overall consideration and design on the procedures, methods and priorities of reform.

embracing government, market and society, as well as the longer lasting factor of culture that is formed with time-honored accumulation, in order to constantly promote the comprehensive, coordinated and sustainable economic and social development of China. If we review China's transformation since the initiation of reform and opening up, we would find that it is actually a process in which an omnipotent and development-oriented government under the traditional system has its power and the purview of authority gradually reduced and adjusted, meanwhile market and society keep expanding their self-organization, self-management scope, and improving their self-governance capability.

Transition is a long, dynamic and evolutionary process. Due to various constraints, it is impossible to clearly define reasonable governance boundaries between government and market, as well as government and society in one step. Some transitional institutional arrangements including the government-led institutional arrangements are needed to foster the market and support society. However, we must be fully aware of the explicit and implicit negative effects of the government-led institutions, and meanwhile have enough confidence in the self-organization and self-management capabilities of the market and society. Therefore, the direction of future reform should be for government to further orderly exit from the fields where the market and society can well manage themselves and delegate power to the market and society so as to arouse their vitality to the greatest extent. As such, structural economic reform and deep economic transformation are guaranteed. In this sense, whether or not China can successfully avoid the "middle income trap" depends critically on the proper internal institutional adjustments, the realization of a new equilibrium of supply and demand, and the transformation from extractive institutions to inclusive institutions. Specifically, it depends on the transition from a development-oriented omnipotent government to a public service-oriented limited government, from a factor-driven to an efficiency-driven and further innovation-driven economy, as well as from a traditional society to a modern civil society.

First, we should redefine the role of government and accelerate the establishment of a limited and service-oriented government. It is possible to define reasonable governance boundaries between government and market, as well as government and society only when the government loosens its omnipresent "visible hand," the functions and governance boundary of the government are scientifically and reasonably defined, and the over-playing,

under-playing and misplaying of the role of government are effectively addressed. Thus, we ask the question how does one reasonably define the basic functions and roles of government under a modern market economy to better play the government role? The basic functions and roles of government can be generalized as “maintenance” and “service,” that is, making the fundamental rules, ensuring social order and stability, and providing public goods and services. Although in the field of public goods and services, the information cost of government-led mechanisms becomes higher, yet considering the huge positive externalities, higher information and operating costs are necessary and worthwhile. According to Hayek (1979), government has two basic functions: on one hand, government has to undertake the functions of enforcing the laws and resisting foreign aggression. On the other hand, government has to provide the services that the market is unable to provide or unable to sufficiently provide. Meanwhile, he also stated that “it is indeed most important that we keep clearly apart these altogether different tasks of government and do not confer upon it in its service functions the authority which we concede to it in the enforcement of the law and defence against enemies.”

Specific to China, it requires our government to change its concept of governance first, to accelerate its exit from the direct intervention in production, distribution and resource allocation, to delegate power to the market and society based on the guidelines of informational efficiency and incentive compatibility, and to strive for the transition from an omnipotent government with excessive administrative intervention to a limited government, and from a development-oriented government competing with people for profits to a service-oriented government seeking public interests (Tian, 2012b).⁹ Thus, from one perspective, whether a government is truly capable and efficient lies not in the scope of its governance but in whether or not its governance scope and extent are reasonable, whether or not its governance manners and results are effective,

⁹ Actually, there was also economic thought on governance in ancient China. For instance, during the reign of Emperor Wu of the Han Dynasty, the grand historian Sima Qian proposed the “Follow-nature Theory” in his work *Shiji: Huozhi Liezhuan (Records of the Grand Historian: Biographies of Merchants)* that “The master way is to follow the natural law and not to intervene, to guide with interests comes second, to teach with moral comes third, to rule by regulations comes next and to compete for profits comes last.” This implies that following human nature and spontaneous social order is the best way to achieve efficient governance with minimal costs. On the contrary, both “ruling by regulations” and “competing for profits” are unwise strategies.

and whether or not it makes the market and itself efficient. According to Lao Tzu (a famous ancient Chinese philosopher, and the founder of Taoism), we should “govern the state with fairness, use tactics of surprise in war, and win the world by non-intervention.” (Chapter 57, *Tao Te Ching*). This can be interpreted as “to be righteous in deed, flexible in practice and minimal in intervention.” “To be righteous in deed” means following the right principles and natural laws, “to be flexible in practice” means analyzing specific and concrete situations, and “to be minimal in intervention” means that the boundary of government authority should be strictly restricted, rather than one of complete non-governance. The reason is that the rational economic agent needs to be subject to certain regulatory constraints; otherwise, it will probably undermine social and market order and impede the establishment of an efficient market.

From another perspective, in order to promote the fundamental transformation of government functions and thereby achieve good governance, we should realize that it is far from sufficient to rely on GDP indicators only when evaluating the performance of government and its officials. Thus, the political performance evaluation incentive mechanism should be shifted from “competition for economic growth” to “competition for services of public interest.” As such, social public service indicators should be taken as a hard constraint, so that the government will be guided to extend the “helping hand”, instead of the “grabbing hand”,¹⁰ for the flow of wealth to the people to maximize social welfare. Meanwhile, the appointment and dismissal of officials should reflect local public opinion so as to make local and lower-rank officials hold themselves truly responsible to the local people, rather than for the upper authorities only. If the government performance evaluation system can completely change the local officials’ economy-dominant concept and lead them to focus more on balanced development and human development, it will definitely be helpful for realizing the central government’s policy goals and achieving incentive compatibility for stable and rapid sustainable development.

Secondly, we should respect the laws of the market economy and establish efficiency-driven and innovation-driven endogenous mechanisms. Efficiency-driven and innovation-driven mechanisms are both outcomes of market dominance, which are closely related to the basic inherent laws of the market

¹⁰ For a detailed discussion on the “grabbing hand,” see Shleifer and Vishny (1998).

economy such as the law of value, the law of supply and demand, and the law of competition, yet essentially stem from the effect of information and incentive factors. Economic mechanism design theory has proved that under normal circumstances, competitive market mechanism is the unique informationally efficient mechanism that achieves efficient resource allocation (Hurwicz, 1986; Jordan, 1982; Tian, 2006). Innovation, on the other hand, is the only way to legitimately acquire monopoly profits in market competition aside from administrative monopoly and natural monopoly. In China’s economic practice, due to the neglect and non-compliance of these basic laws and inherent logic, the market economic factors conducive to promoting efficiency and innovation such as fair competition, contractual awareness, fiduciary duties, and entrepreneurship have also been suppressed. Hayek once quoted Joseph Needham in his work *The Fatal Conceit*, describing that during a period of the Empire of China when government control was temporarily weakened, individual initiative was often released to some extent, leading to great advances of civilization and sophisticated industrial technology. On the contrary, once government control was restored, “these rebellions or aberrances were regularly smothered by the might of a state preoccupied with the literal preservation of traditional order” (Hayek, 1988; Needham, 1954).

It is worth mentioning that for some years, the macro-control of government has, to a considerable extent, shifted to micro-control in some competitive markets. Many well-intentioned price intervention measures have brought or may potentially bring opposite effects due to the neglect of the inherent laws of the market economy. Besides, the factor market and basic resources market are mostly monopolized by state-owned enterprises. Government over-controls market access¹¹ and changes from a market order maintainer to a major market participant impeding the efficiency enhancing role of the market. Furthermore, as the distortion of factor prices bears strong conductivity and diffusivity, it results in a series of microeconomic behavior distortions behind macroeconomic imbalances. The ongoing transformation of the mode of economic development should actually be the result of the role of the market and the independent choice of economic agents under the constraint of factor

¹¹ Of course, with the gradually deepening understanding of the reasonable boundary of the market, the intensifying reform of administrative approval, and the exploration of the negative list management mode, the situation in this regard is improving.

scarcity. If government could orderly release the actual control on the price of scarce resources such as water, electricity and refined oil, establish a resource factor price formation mechanism reflecting market supply and demand as well as the scarcity of resources, and let the market play a fundamental and decisive role in resource allocation, it would facilitate the formation of internal impetus for enterprises to improve resource utilization efficiency under the pressure of market competition.

On the basis of a high degree of market efficiency, innovation has become the main drive for economic development in major developed market economies today, which relies not on the state sector but on the private sector. Generally speaking, due to the strong motivation to pursue its own interests, the private economy has the greatest awareness and capacity to innovate. Innovation here refers not only to the so-called destructive, revolutionary and disruptive innovation by Joseph A. Schumpeter, but also to the micro-innovation of details. Innovation needs to be transformed into actions and results; thus, it requires entrepreneurs to systematically manage innovation and create new value for society, which is the essence of entrepreneurship. China's booming economic development over the past three decades results essentially from the release of highly restrained creativity and entrepreneurship. The future sustainable development of the Chinese economy still depends largely on the full release of innovation and entrepreneurship. In a highly competitive market environment, the only way for an enterprise to cope with rapid changes and intense competition is to constantly strive for the innovative edge, to improve on its current strengths, and to develop new competitive and price advantages. Otherwise, without continuous innovation, sooner or later it will be surpassed even if it enjoys advantages for a time.

Thirdly, we should let social forces play their role to lay a solid social foundation for deepening transition and development. Social forces themselves are the internal impetus for promoting social and economic development. From the practice of different countries, transition has inevitably brought about the differentiation of social structure and the reorganization of interest groups. This may probably be the "booster" for social and economic development at the early stage; however, if the pattern of "big government – small society" cannot be reversed, differentiation and reorganization may lead to the fracture and collapse of society, which will in turn hinder the healthy development of society and bring

about negative economic consequences. Thus, it requires the synchronized readjustment of state public governance philosophy and system, the reasonable definition of governance boundaries between government and society, the gradual decentralization to society to meet the demands of transition and development, as well as the cultivation of social self-organization, self-management and self-service capabilities. Actually, in 1978 eighteen local farmers in China’s Xiaogang Village¹² took big risks making a secret agreement to subdivide common farmland into family plots, which is essentially a kind of self-organization and self-management for pursuing their own interests.

It can be said that state public governance without good social self-management is hardly mature. Apparently, it is far from enough to rely only on government to tackle social contradictions with extremely complex information and increasingly onerous social administrative tasks in the transition process. This may even bring about counter effects and lead the focus of contradictions towards government itself. International experience has shown that society can function as the key to balancing and controlling the tension between government and the market, and social organizations can play a complementary and substitutive role for government in coordinating the interests of different parties, sharing public resources, and promoting fairness and justice. Thus, it requires government to exit from the specific and micro social management aspects, and leave the fields it fails to manage or only poorly manages to social organizations for self-management. Besides, it also requires government to make clear rules and take certain measures to encourage people to participate in the discussion of social public policies and fully express their own desires and appeals so as to ensure that government decisions are scientific, democratic, fair and incentive compatible, to consolidate the basis for fair public interests, and to make government itself a lubricant and catalyst for social development to reduce social friction and development costs.

Apart from promoting society’s self-organization and self-coordination, it is also necessary to address the problem of increasingly serious social anomie. Behind social anomie is a widespread lack of common values, a sense of awe

¹² A small village in Fengyang county, Anhui province in China. In 1978, 18 farmers in the village made a secret agreement among themselves that each plot was to be worked by an individual family and each family would turn over some of what they grew to the government and the collective whilst at the same time agreeing that they could keep the surplus for themselves. This brave move pioneered the rural economic reform that eventually ended collective farming in the early 1980s.

towards law, compliance of ethics and establishment of humanistic care in society. This value system under construction should play a stabilizing, cohesive and guiding role. We should not impose uniformity in all cases, but should consider different levels and categories in establishing the value system with concentric circles or intersecting circles. The center or intersection of the circles should be the most fundamental code of conduct and common humanistic values, such as integrity, generosity, gratitude and devotion. The values should be built up through education as well as institutional arrangements such as legal constraints and market incentives. For instance, there are many doctrines about integrity in traditional culture, but integrity fails to be widely established in society. The reason is an incomplete norm of market system and excessive government intervention in the market, so that the signaling mechanism, information mechanism, public opinion mechanism, resource allocation mechanism, etc., all fail to come into full play. Under current rules and regulations, the expected behaviors of integrity do not yet form the optimal equilibrium so that many people who do not behave according to the rules and morals are not punished, and can even make profits, which results in the phenomena of rent-seeking and false, big, and empty words. A harmonious society built through a modern market system is conducive to restoring and carrying forward honesty, integrity and other traditional virtues, eliminating fraudulent conduct, and purifying the economic, political and cultural life.

As the saying goes, “Only at times of plenty will people observe etiquette.” Orderly social self-organization, self-coordination and positive social norms are built on the basis of the wealth of people and a relatively large, well-educated middle class. Therefore, national development still needs government support and guidance for social forces to truly develop into a rational and constructive internal impetus, especially in the respect of vigorously fostering and expanding the middle-income group, which is an important factor in achieving social stability and development. From the development experience of Japan and South Korea, their middle-income groups accounted for over 70% of the total population before they became high-income countries (Zhang, 2012; Ma, 2011). This proportion¹³ in China is currently below 30% (Kharas, 2010; Su, 2012).

¹³ The definition and measurement of the middle class varies across countries and regions. However, regardless of the criteria, such as income standards, professional standards and education standards, the fact that China’s middle class is weak is widely recognized.

This is the reason why a civil society has not been established yet. As the saying goes, “possessions make a stable mind,” and the middle-income group generally owns certain properties and has a strong demand for the protection of private property rights. Meanwhile, this group is usually well-educated with the ability to think independently and make judgment, as well as a relatively good awareness of individual rights and obligations, which forms the essential foundation for the construction of a democratic, law-governed society in China. Moreover, as the middle-income group has growing expectations for differentiated products and services, it will provide a powerful drive for total factor productivity growth (Kharas, 2011).

The growth of the middle-income group will definitely lay a solid social foundation for China’s intensified transition, economic development and advance towards becoming a high-income country. This requires deep reform of the social welfare system impeding the expansion of the middle-income group and further clarification of the distribution relationship between government, enterprises and individuals. The Outcome Fairness Theorem in modern microeconomic theory shows that as long as everyone has equal initial endowments, resource allocation of both efficiency and fairness can be achieved through the operation of the competitive market, even if individuals pursue self-interest (Tian, 2013b). Therefore, we should divide the cake of wealth in a better way while making it bigger, and provide a fair starting point for individuals to participate in market competition and public life to achieve higher-level balanced development. By implementing total and structural tax cuts and making an overall and comprehensive social welfare reform package plan covering employment, pensions, medical care, housing, and education for the future 5–10 years, we can truly return wealth to people and keep wealth in the hands of the people. However, system reform in this regard should also attach importance to the self-restraint mechanism’s institutional design so as to prevent moral hazard, and avoid the problem of severe negative incentives and huge financial deficits due to excessive welfare that once occurred in western and northern European countries.

4 Conclusion

This paper reveals that the outward manifestations of the “middle income trap” are the slowdown of economic growth and resistance in per capita income

growth, but its internal essence lies in the dilemma of institutional transition. Its fundamental cause is a lack of reasonable and clear definition of governance boundaries between government and market as well as government and society, which leads to the coexistent and interrelated government inefficiency, market distortion/failure and social anomie, as well as the stagnant transition from a factor-driven to an efficiency-driven and further innovation-driven economy.

This paper proposes to reconstruct the mode of state public governance for China to avoid and surmount the “middle income trap,” that is, to achieve the transition from a development-oriented and omnipotent government to a public service-oriented and limited government, from factor-driven to efficiency-driven and further innovation-driven development, and from a traditional society to a modern civil society through defining reasonable and clear governance boundaries between government and market as well as government and society. Thus a state public governance mode featuring the interactive role of government, market, and society will be established, and the modernization of state governance systems and capacity will be achieved.

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