Focusing on high income as a policy target is misleading

By **Letter to the Editor** - May 1, 2021 4:26 PM

From Paolo Casadio and Geoffrey Williams

The problem of the so-called "middle-income trap", which has kept Malaysia among the upper-middle-income countries for many years despite growing faster than most of the high-income counterparts, has been debated for a long time.

The good news is that both the World Bank and the government have recently projected that Malaysia is finally "very likely" to achieve high-income status between 2024 and 2028.

This is celebrated as a huge achievement, just as it was in the 10th Malaysia Plan in 2010 when the government first aimed to hit this threshold by 2020. In 2015, then minister in the Prime Minister's Department in charge of economic planning, Abdul Wahid Omar, said they were on target to surpass the threshold by 2020.

However, among mature economists, the classification of countries into high, middle or low-income economies has no particular economic meaning and, formally, it is simply a way of deciding whether or not a country will be eligible for financial assistance from international agencies.

For 2021, the high-income economies are those with a gross national income (GNI) per person of US$12,536 (RM51,340) or more, using a statistical calculator called the World Bank Atlas method, which adjusts for exchange rates and purchasing power.

This is not an exclusive club as 83, or 38%, of 218 economies are classified by the World Bank as high-income, including Lichtenstein with US$116,430 (RM477,000) per person in 2019, nearly 10 times greater than a threshold country like Romania.

Large economies such as the US, with a population of 330 million, sit next to tiny islands such as Nauru, with a population of less than 11,000.

High-income status also doesn't tell us much about the level of development. For example, the United Nations classifies some high-income economies, including the oil-exporting countries of the Middle East, as developing countries.

It tells us nothing about how the high income was achieved. Among the 83 high-income countries, we find many oil-based economies with little or no manufacturing and financial services-based economies and with none of the high-tech industries touted as the future of growth.

Others, such as those in Europe, are wealthy due to historical accumulation but now have stagnant growth and high unemployment.

Of course, the average income per person also tells us nothing about the distribution of income, with massively wealthy elites and desperately poor masses in even the highest-income countries.

So the US$12,536 (RM51,340) limit is best viewed as a bureaucratic cut-off point — an achievement rather than a policy target.

For a vital and dynamic economy like Malaysia, with historical growth close to 5%, reaching this threshold is more a matter of time than a measure of extraordinary performance.

So, focusing on high income as a policy target is not only misleading, it can be a dangerous distraction from more urgent underlying challenges in economic growth and development.

We now know, for example, that the underlying potential growth rate in Malaysia is on a downward trend, hugely accelerated by the recent shocks from Covid-19, which is repeating the negative impact on potential growth that we saw in the Thai baht crisis.

Almost one year ago, we already forecast a decrease in underlying growth of about 0.5-0.75% due to weak investment. This concern has been recognised and supported by Bank Negara in their recent annual report estimates that potential growth has fallen by 1.3% to 3.5% from 4.8% before the crisis.

This is a big problem that must be at the top of the policy agenda, above the high-income target.

The economic and social cost of substantially lower potential growth are twofold.

First, structural unemployment rises when the slower rate of growth of the economy is insufficient to accommodate the flow of people entering into the labour market.

This will increase the rate of unemployment which will be made worse by automation and the substitution of workers due to the Fourth Industrial Revolution (IR4.0). On the other side, an excess supply of labour will put a downward pressure on salaries and living standards.

We can already see this phenomenon today. The imbalance may be temporary but the effects on particular segments of workers are permanent and extreme. Young people enter the labour market and low-skilled workers are already experiencing much lower salaries compared to normal and are facing substantial underemployment.

In the medium-term, rising unemployment will bring serious social problems if this is not properly addressed and contained.

Being a high-income economy will not help by itself and if the market alone is not able to provide an efficient solution for this problem, the public sector has to intervene with social market economy policies to remedy the market failure.

The second implication of lower potential growth is the further contraction of fiscal space. When the government targets a fixed level of debt and deficit to GDP, lower potential growth constrains their resources available for economic and social interventions. We estimate about RM20 billion per year will be lost in terms of capacity for further intervention, which is very significant.

While lower potential growth is inevitable in the long run and is typical of mature economies according to World Bank analysis, fresh thinking by mature economists outside of the World Bank suggests that this effect need not and must not happen now and to such an extent. Proper public policy can and will be able to reduce the decline in underlying growth drastically.

The two conditions necessary to create a positive impact are to act immediately and to act with a specific package to promote investment. This must support existing capabilities and promote new IR4.0 technologies.

Focusing only on IR4.0 will miss opportunities in existing industries and businesses that resist this technology. On the other hand, any delay in exploiting new technology will damage competitiveness and lead to a loss in the share of international export markets.

That is why it is so important to act now on the urgent concerns of lower underlying growth instead of focusing on a high-income target which will happen anyway.

Paolo Casadio is an economist at HELP University and Geoffrey Williams is an economist at Malaysia University of Science and Technology.

The views expressed are those of the writers and do not necessarily reflect those of FMT.