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THE MACROECONOMIC FOUNDATIONS OF INCLUSIVE MIDDLE-CLASS GROWTH

Nancy Birdsall

Growth that is shared—so-called inclusive growth—is now widely embraced as the central economic goal for developing countries. But definitions and empirical characterizations of inclusive growth vary widely. In this brief, inclusive growth is defined as growth that builds a middle class. Macroeconomic policies can shape the environment and incentives for inclusive growth in three important areas: fiscal discipline, the more rule-based the better; a "fair" fiscal policy with respect to revenues and expenditures; and a business-friendly exchange rate. Although these policies are not underlying causes of growth, they are conducive to growth. The analysis here relies heavily on the experiences of the mostly middle-income countries in Latin America.

From Pro-Poor Growth to Inclusive "Middle-Class" Growth

In the past several decades, pro-poor growth emerged as a gentle counterpoint to a singular concern with growth alone (measured in terms of increases in per capita income), while implicitly recognizing that growth, if not always sufficient for poverty reduction, is almost certainly necessary. Inclusive growth includes and extends pro-poor growth, on the grounds that growth that is good for the large majority of people in developing countries is more likely to be economically and politically sustainable. Sustained growth matters because many low- and middle-income countries that have had long growth episodes—of 8 to 10 years—have subsequently suffered prolonged growth collapses before achieving real gains in human development and general well-being.

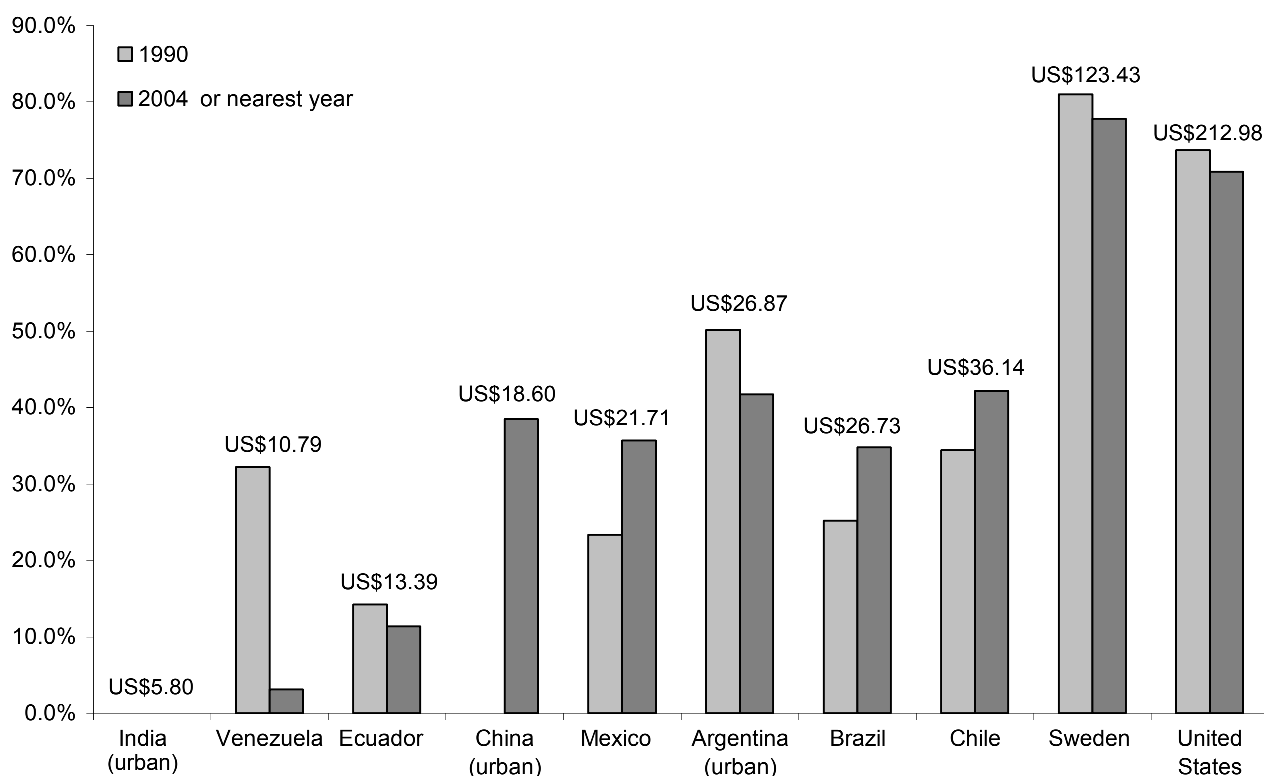
Is there a meaningful distinction between macroeconomic policies conducive to pro-poor growth and those conducive to inclusive growth? Sound fiscal and monetary policies that are pro-poor are also likely to be good for the middle class, but whether that commonality extends to medium-term tax, expenditure, and transfer policies is less obvious. In the case of macroeconomic shocks, middle-class small business owners or semi-skilled workers may face greater relative losses of permanent income than poor subsistence farmers.

In the end, the possible tensions or trade-offs between strictly pro-poor and more inclusive "middle-class" growth policies cannot be generalized. They must be assessed policy by policy in each country and are likely to change over time as circumstances change. Policymakers in developing countries (and their international supporters and advisers) should more systematically consider weighted welfare outcomes when selecting and fine-tuning macroeconomic policies, rather than relying solely on unweighted growth outcomes or overly weighted poverty outcomes. Where there are no trade-offs, all the better. The medium-term benefits of good macroeconomic policy for building a middle class argue all the more for what are sometimes painful macroeconomic decisions in the short run.

Defining the Middle Class

Inclusive growth implies an increase in both the proportion of *people* in the middle class (implying that some people exit poverty) and the proportion of *total income they command* (implying gains at the "expense" of either the initially poor or the initially rich). The middle class is here defined as including people at or above the equivalent of US$10 a day in 2005 and at or below the 90th percentile of the income distribution in their own country. This definition implies some absolute and global threshold below which people are too poor to be middle class in any society, and some relative and local threshold above which people are, at least in their own society, "rich." With this definition of middle class, an increase in that group's size and economic power is likely to signal that the underlying growth is based on wealth creation and productivity gains in private activities and is thus self-sustaining and transformative as opposed to being driven largely by exploitation of natural resources, remittances, or infusions of external aid. Figure 1 shows the economic

Figure 1—Proportion of Income Held by the Middle Class, Selected Countries, 1990 and 2004 (%)



Source: Calculated by author using data from the World Bank's PovcalNet <http://iresearch.worldbank.org/PovcalNet/jsp/index.jsp>.
Notes: Countries are shown in order of increasing average annual income per capita. The middle class is defined as individuals with at least US$10 a day in each year (US$7.20 in 1993 purchasing power parity, or PPP, terms), who are at or below the 90th decile of the income distribution in their own country. Dollar values for each country indicate 2004 daily per capita income at the 90th decile of the income distribution.

command of the middle class, so defined, for selected countries in 1990 and 2004. There is no obvious association between the change in the size of the middle class and change in the Gini coefficient over that period. Middle-class growth is associated with a rising Gini coefficient in China and a declining one in Brazil and India. The same is true for other measures of inequality (not shown).

Latin America has for decades been the region with the highest inequality in the world. Latin America also has a history—until about 1990 in most countries—of high inflation, high public debt, volatile monetary policy, and, in part because of inflation, overvalued exchange rates. But in the past few years Brazil and Mexico have experienced substantial declines in poverty (using the US$2 a day poverty line), notable declines in income inequality (measured by the Gini coefficient), and a doubling of the proportion of people and of income in the middle class (Figure 1). This sharply contrasts with middle-class growth reversals in Argentina, Ecuador, and Venezuela. One reason may be that the latter countries have hewed less closely than Brazil and Mexico to standard International Monetary Fund/World Bank macroeconomic policies. Ecuador and Venezuela, with their dependence on oil exports, may have been more vulnerable to currency appreciation, which tends to be unfriendly to increasing employment and small business development. Middle-class growth in Brazil and Mexico, where macroeconomic policies have markedly improved in the past decade, suggests that eventually—with a long lag—better macroeconomic policy (combined with a benign external environment and a commodity boom) can contribute to inclusive growth.

In the Background: Open Economies and Volatile Global Markets

The discussion here assumes that developing countries will continue the trend of the past two decades of maintaining or increasing their openness (though more cautiously with respect to capital) in an effort to fully exploit the potential benefits of integration into the global economy. But because more open economies are more vulnerable to global financial and other shocks, and because the integration process produces losers (at least in the short run) as well as winners, maintaining good macroeconomic policy in an open economy can be politically difficult. The challenge is even more complicated where the middle class is relatively small and has little

command over total income (and where it is heavily made up of households dependent on state and state-protected sectors). It is, for example, the secure middle class in mature market economies that is most likely to support policies that favor openness, maintain price stability, and help ensure a competitive exchange rate. In contrast, the poor and near-poor (living on less than US$10 a day) are at more risk of losing out with integration because they generally lack sufficient education or financial assets to exploit global good times and are vulnerable in global bad times. They also have sufficient political voice to generate self-defeating populist pressures or, in immature democracies, to support short-term patronage arrangements that betray their long-term economic interests.

The Missing Middle Class in Low-Income Countries

Countries with purchasing power parity income of less than US$1,500 or so per capita have virtually no middle class by the definition used here because daily income per capita at the 90th percentile is below US$10. That is the case for India (shown in the figure) and most countries of Sub-Saharan Africa. Many such countries are highly dependent on aid, which can account for as much as 40 percent of all government spending. The discussion of macroeconomic policies in the next section does apply to them, but the trade-offs may in some cases be more difficult. Heavy aid inflows can, for example, complicate efforts to limit real exchange rate appreciation that could undermine expansion of small business. Donors as well as country policymakers should ensure that aid flows include adequate support for key investments in power, ports, roads, and other infrastructure. By reducing costs, these investments can help avoid pressure on the exchange rate, allowing for expansion of small business and increasing competitiveness in manufacturing, agro-industry, and services for export.

Three Macroeconomic Policies That Matter for Inclusive Growth

Fiscal Discipline—the More Rule-Based the Better

Developing countries, especially those with a bad history of inflation and poor debt management, need to accumulate a credible record of good fiscal management if they are to ensure growth that is inclusive. Most emerging markets and low-income countries have dramatically improved their macroeconomic management since the early 1990s. They are accumulating "good" history. To lock in good history now requires institutionalizing a budget process that is transparent and rule-based, thereby ensuring that habits and citizens' expectations, as well as legislation and regulatory systems, support fiscal policy conducive to inclusive growth. Examples of good rules are legal ceilings on indebtedness relative to gross domestic product (GDP); a truly independent source of published estimates of revenue and expenditure; rules to lock in additional fiscal effort during booms; and for natural resource–rich countries, fiscal contingency funds that set aside unexpected revenue. Countries where the middle class is large and growing are more likely to have the political support for adherence to such rules, in what could be a virtuous cycle of inclusive growth and good rule-based fiscal policy.

With the exception of Chile, most countries in Latin America have run fiscal deficits for years and still do (Table 1). Past fiscal laxity meant governments either printed money, fueling inflation, or issued large amounts of debt, driving interest rates to onerous levels. The resulting inflation hurt poor people because of their limited capacity to protect their earnings, for example, through indexed savings. High interest rates also undermined the growth of a middle class by limiting the expansion of creditworthy small firms (which generally have no alternative to the local market for their financing needs) and thus of private investment and of jobs for the unskilled and semi-skilled.

Table 1—Fiscal Deficits of Selected Countries, 1995, 2000, and 2003 (% of GDP)

Country	1995	2000	2003
Argentina	1.15	2.28	0.13
Bolivia	2.32	3.33	7.40
Brazil	6.09[a]	Not available	Not available
Chile	–2.58	–0.14	Not available
Colombia	2.30	6.72	4.91
Ecuador	1.01	–0.30	1.36
Guatemala	0.48	1.96	1.95
Mexico	0.53	1.25	1.30
Nicaragua	0.31	3.85	2.92
Peru	1.11	1.84	1.91
Venezuela	3.61	1.65	Not available

Source: International Monetary Fund, International Financial Statistics CD-ROM (Washington, DC, 2007).
Notes: Negative values indicate budget surpluses.
[a]This value is for 1994.

Fiscal indiscipline is no longer the rule in Latin America. Average inflation fell from close to 600 percent in 1990 to just over 7 percent between 2000 and 2006. But past high borrowing means that debt service is still high. This debt must be financed, reducing the scope for new public expenditures (Table 2). In 2003 Brazil was

spending 10 percent of its GDP on interest on its public debt. To the extent the debt stock must be rolled over (which depends on the extent to which overall spending can be reduced to pay off debt), public borrowing will keep interest rates higher than otherwise, crowding out private investment and job creation. Real interest rates were very high in Latin America in the 1990s, reaching more than 10 percent on average for most countries, compared with 6 percent on average in Southeast Asia and about 5.6 percent in the United States. Since 2001 interest rates have fallen against a backdrop of fairly low inflation in most Latin American countries, but they remain well above those in other regions. Of course some public debt (to finance small deficits) is reasonable, especially when economic growth ensures that the ratio of debt to GDP does not continually rise above a safe range. But emerging market economies with a history of inflation and volatility (including some outside of Latin America such as the Philippines, Thailand, and Turkey) should probably meet a tougher standard of net public debt to GDP than the standard for developed countries—the IMF suggests no more than 30 percent for emerging markets.

Table 2—Total Debt Service and Total Debt Stock for Selected Countries, 1990 and 2005

Country	Total Debt Service (% of Exports of Goods, Services, and Income)		Total Debt Service (% of Revenue, Excluding Grants)		Total Debt Stock (% of GDP)	
	1990	2005	1990	2005	1990	2005
Argentina	37	21	64[a]	46[b]	44	62
Brazil	22	45	8	27[c]	26	23
Mexico	21	17	28	68	40	21
Peru	11	26	14	40	76	36
Malaysia	13	6	37	39[d]	35	39
Indonesia	33	25	46	43[e]	61	48
Thailand	17	15	54[f]	53	33	29

Source: World Bank, World Development Indicators and Global Development Finance (Washington, DC, 2007).
Notes: "Exports" refers to exports of goods, services, income, and workers' remittances; "total debt stock" refers to external and domestic debt.
[a]Data are for 2003.
[b]Data are for 2004.
[c]Data are for 1998.
[d]Data are for 2003.
[e]Data are for 2004.
[f]Data are for 2003.

History hurts in another way. Given high existing debt, Latin American and other developing-country governments determined to avoid new bouts of inflation have had to maintain tight fiscal policies in the past decade in several cases even in the presence of primary surpluses as high as 4 and 5 percent of GDP—that is, fiscal surpluses net of interest payments (Table 3). This situation has reduced the fiscal space for public investment in roads, schools, health care, police training, and so on—services on which the poor rely heavily. In an unhappy combination, past high public borrowing in Latin America may be contributing to the crowding out of private investment while high primary surpluses to finance debt service on current and past borrowing may be reducing public investment compared with countries in East Asia (Table 4).

Table 3—Primary Surpluses in Selected High-Debt Emerging-Market Countries

Country	Year with Highest Primary Surplus since 1990 (% of GDP)	Primary Surplus in 2002 (% of GDP)
Argentina	1.5 (1993)	0.9
Brazil	3.9 (2002)	3.9
Bulgaria	9.2 (1996)	1.5
Costa Rica	2.9 (1993)	−0.3
Ecuador	7.1 (1990)	4.5
Egypt[a]	Not available	2.6
India	−1.2 (1997)	−3.7
Indonesia	3.8 (1990, 2002)	3.8
Jordan	Not available	−1.2
Lebanon	3.0 (2002)	3.0
Malaysia	10.2 (1997)	3.1
Morocco	3.4 (1992)	−0.2
Nigeria	10.5 (1990)	1.6
Pakistan	2.8 (2001)	2.4
Panama	7.2 (1992)	2.0
Philippines	5.9 (1994, 1996)	−0.6
Turkey	5.5 (2001)	4.1
Uruguay	2.9 (1992)	0.3

Source: K. Derviş and N. Birdsall, *A Stability and Social Investment Facility for High Debt Countries*, Working Paper 77 (Washington, DC: Center for Global Development, 2006).
[a]Data are for 1999.

Table 4—Average Public and Private Investment in 1990s (% of GDP)

Country	Public Investment	Private Investment	Gross Domestic Investment
Brazil	4.53	15.77	20.29
Mexico	3.58	17.69	21.28
Argentina	1.98	15.70	17.68
Venezuela	9.93	7.10	17.03
Peru	3.47	17.74	21.22
South Korea	7.82	27.95	35.77
Malaysia	12.33	25.79	38.12
Indonesia	7.92	20.96	28.89

Source: World Bank, Global Development Network Growth Database, 2001 <http://www.econ.worldbank.org>.

Another consequence of past fiscal indiscipline is the inability to implement countercyclical fiscal spending during economic downturns. During recessions in developed countries, governments increase spending on unemployment, food stamps, and other safety net programs. The resulting increases in public spending protect the poor and help insulate the middle class, while helping to stimulate a sluggish economy. Such countercyclical measures, however, rely on the confidence of (domestic and external) market creditors in the government's willingness and ability to honor the new debt and on the local financial sector's ability to absorb new debt. Except for Chile, countries in Latin America have not been tested on this score since the 2001 debt crisis in Argentina.

In short, Latin American countries are still paying for fiscal indiscipline that mostly ended more than a decade ago. With the recent global economic boom, most have grown fast enough and kept overall fiscal deficits low enough to get ahead of the destructive debt dynamic in which the burden of past debt undermines aggregate growth. But continued progress relies heavily on more years of very tight fiscal policy (unless growth rates jump to Asian levels) and perhaps too heavily on a continuation of an unusually benign external environment, particularly for commodity producers.

Fiscal probity also helps limit the volatility that hurts the poor and the productive middle class. The poor and middle class gain less during booms and are the first to lose jobs during busts (those who already have real and financial assets gain most). When volatility leads to financial crisis, it also involves inequitable wealth transfers that create enduring adverse distributional effects. Evidence from the financial crises of the late 1990s in Asia and Latin America shows that many poor and middle-income households did not recover assets they liquidated during severe downturns.

Volatility is the outcome of many factors, including fluctuations in commodity prices and foreign capital inflows over which governments in developing countries have limited control. Latin America's past patterns of stop-and-go spending (driven sometimes by periods of populist governments) have been a factor too, however. By accommodating this fiscal indiscipline, monetary policy further undermined investor confidence, raising interest rates and limiting job creation. The region's stronger fiscal position today, along with more flexible exchange rates and improved financial regulation and supervision, bode well—but the recent calm may also rely mostly on ample global liquidity (itself at risk at this writing in August 2007) and buoyant export markets.

A "Fair" Tax and Redistribution System

Inclusive growth requires not only keeping aggregate spending in line with aggregate revenues, but also adhering to generally progressive tax systems and expenditures. The experience in Latin America is discouraging. The value-added tax, which is generally regressive, accounts for 60 percent of total revenue in Latin America, compared with 30 percent in Europe. More progressive and higher overall taxation in Europe reduce income inequality, and probably the burden on the middle class, much more than in Latin America, where loopholes and exemptions tend to reduce the tax burden on the rich, and tax evasion is rampant. Finally, high payroll taxes discourage job creation, hurting the poor and middle-income groups more than the rich, whose income comes relatively more from capital. Revenue generation averages just 18 percent, well below what might be expected given average per capita income. Low revenue generation combined with admirable fiscal discipline constrains public investments and expenditures that could otherwise be deployed to reduce inequality and induce more inclusive growth. Equally to the point, more visibly fair tax systems would not only encourage inclusive growth, but also make higher ratios of taxes to GDP more politically acceptable, including to the rich who now easily justify evasion (more efficient public spending and less corruption would also have this effect). In Argentina the effective average tax rate for the top 10 percent of households was estimated at 8 percent in the late 1990s. (In Africa the problem is heavy reliance on trade and other indirect taxes; relatively high taxes on imports raise input costs for businesses and keep consumer prices higher than otherwise.)

Greater spending—on health, education, and public infrastructure—as long as it is minimally efficient, is one key to more inclusive growth. Experience in Latin America also shows that the most inefficient, non-inclusive spending occurs in poorly designed and politically driven pension programs. In Latin America, the richest quintile of the population receives on average about 60 percent of net pension benefits (full benefit amount received minus total contributions), whereas the poorest quintile receives only 3 percent.

A Business-Friendly Exchange Rate

A competitive exchange rate is helpful to inclusive growth because success in manufactured exports is almost always associated with investment in new enterprises and creation of jobs for the semi-skilled—in Japan and then Korea and Taiwan in the 1950s and 1960s, and more recently in

China, Mauritius, and Vietnam. When Latin American countries monetized their high fiscal deficits, the results were inflation, persistently overvalued exchange rates throughout the 1970s and even in the 1980s, and excessive borrowing. Countries then attempted to protect local industries via tariffs and other barriers, reducing competitiveness. Over the past two decades, Chile, with a longer history of fiscal rectitude, has been best able to manage its exchange rate to limit appreciation.

Fiscal discipline does not guarantee a competitive exchange rate. Governments can get away with high deficits while avoiding currency appreciation if, as in India until recently, capital markets are closed, private savings to finance public debt can be captured, growth prospects are especially good, and people have confidence in the currency. But in most developing countries, maintaining a competitive exchange rate is likely to help ensure inclusive growth. The increase in the size of the middle class in urban China (Figure 1) is the outcome of multiple factors, including the country's undervalued exchange rate. In Brazil and Mexico, the slaying of inflation in the early 1990s has made it easier to avoid overvaluation, which hurt exports for the two prior decades.

Conclusion: From Pro-Poor to Inclusive, Middle-Class Growth

The middle class in all economies depends on a stable macroeconomic environment. Economic volatility—due to high fiscal deficits, poor monetary policy, unsustainable public borrowing, undervalued exchange rates that temporarily make imports cheap, and inflation—is bad for the incipient middle class. The experience of mature Western economies suggests that poor people benefit when an economically strong middle class insists on accountable government and supports universal and adequate public services, by paying taxes. That experience suggests that inclusive growth as defined here will benefit poor people both directly and indirectly, by helping them escape poverty. Perhaps it is not a coincidence that the two countries in Latin America that have sustained cash transfer programs for the very poor are two where the ranks and economic weight of the middle class have doubled. It is hard to imagine that this would have been possible without more than a decade of sustained, tough fiscal and other macroeconomic policies.

For Further Reading: W. Easterly and S. Fischer, "Inflation and the Poor," *Journal of Money Credit and Banking* (Vol. 33, No. 2, 2001); A. Kraay, "When Is Growth Pro-Poor?" *Journal of Development Economics* (Vol. 80, No. 1, 2006); N. Lustig, ed., *Coping with Austerity: Poverty and Inequality in Latin America* (Washington, DC: Brookings Institution, 1995); B. Milanovic, *Worlds Apart: Measuring International and Global Inequality* (Princeton, NJ: Princeton University Press, 2005); and World Bank, "Income Distribution, Inequality, and Those Left Behind," Chapter 3 in *Global Economic Prospects 2007: Managing the Next Wave of Globalization* (Washington, DC, 2007).

Nancy Birdsall (NBirdsall@cgdev.org) is president of the Center for Global Development, Washington, DC, an independent think tank that works to reduce global poverty and inequality through rigorous research and active engagement with the policy community. The author is grateful to Nora Lustig, John Williamson, Arvind Subramanian, and two anonymous reviewers for their comments on a draft; to Kevin Ummel for his help with data; and to Karelle Samuda and Christine Park for their research support. The brief is based on the forthcoming Center for Global Development Working Paper 130, "Reflections on the Macro Foundations of the Middle Class in the Developing World," which includes full citations to the literature on which the brief draws. For additional work on inequality and on the middle class by Nancy Birdsall, including the middle class in Africa and "fair growth" policies in Latin America, see <http://www.cgdev.org/content/publications>.

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INTERNATIONAL FOOD POLICY RESEARCH INSTITUTE

2033 K Street, NW,
Washington, DC 20006-1002 USA

T: +1 202 862 5600
F: +1 202 467 4439
ifpri@cgiar.org • www.ifpri.org

CENTER FOR GLOBAL DEVELOPMENT

1776 Massachusetts Avenue, NW,
Washington DC 20036 USA

T: +1 202 416 0700
F: +1 202 416 0750
www.cgdev.org

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