

**Reflections on the Macro Foundations of the Middle Class in the  
Developing World**

By Nancy Birdsall

**Abstract**

In this working paper I define inclusive growth as growth conducive to increasing the size and economic command of the middle class. I suggest a definition of the middle class based on absolute and relative measures of country-based income distributions, and present evidence of change in the size of the “middle class” for selected developing countries. I then review how macroeconomic policies shape the environment and incentives for inclusive growth, focusing on three areas: fiscal discipline, the more rule-based the better; a fair tax and redistribution system; and a business friendly exchange rate.

The adoption of macro policies that favor the middle class lays the foundation for more economically and politically sustainable development. While on the whole sound macro policy that is good for the middle class is also likely to be pro-poor, tradeoffs may exist with respect to tax, expenditure and transfer programs and responses to economic shocks. Governments should consider the weighted welfare outcomes of alternative approaches to macro policy, rather than un-weighted growth or overly weighted poverty outcomes.

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## **Reflections on the Macro Foundations of the Middle Class in the Developing World**

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## **Introduction**

Growth that is shared, or 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 I define and characterize empirically inclusive growth as that growth that builds a middle class. I then review how macroeconomic policies shape the environment and incentives for inclusive growth, focusing on three areas: fiscal discipline, the more rule-based the better; a “fair” fisc with respect to revenues and expenditures; and a business-friendly exchange rate. These are policies conducive to growth; I do not mean to imply that they are underlying causes of growth. I rely heavily on experience (mostly unhappy) of the mostly middle-income countries in Latin America. I also refer briefly to the implications of the discussion for heavily aid-dependent low-income countries, most of which are in sub-Saharan Africa.

## **From pro-poor growth to inclusive “middle class” growth**

In the last 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.<sup>1</sup> Inclusive growth includes but 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. Growth that is sustained over many decades matters because many low and middle-income countries that have had long growth episodes – of eight to ten years – have subsequently suffered prolonged growth collapses while still well short of the average per capita income levels which make possible real gains in human development and general well-being.<sup>2</sup>

For macro policies is there a meaningful distinction between those conducive to pro-poor vs. inclusive growth? Sound fiscal and monetary policies that are pro-poor are also likely to be good for the middle class on the whole. But tradeoffs may exist with respect to specific tax, expenditure and transfer policies; and in the case of macroeconomic shocks, middle class households, to the extent their members are small business owners or semi-skilled workers in industry or services, may face greater relative losses of permanent income than poor subsistence farmers.

In the end, the possible tensions or tradeoffs 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. One message of this note is that policymakers in developing countries (and their international supporters and advisers) should more systematically consider weighted welfare outcomes when selecting and fine-tuning macro policies, rather than unweighted growth outcomes or

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<sup>1</sup> Kraay (2006).

<sup>2</sup> Birdsall (2007) summarizes the evidence of this for Africa, based on Hausmann, Pritchett & Rodrik (2004) which summarizes the evidence that many countries that have had long growth episodes subsequently have growth collapses.

overly weighted poverty outcomes. A second is that where there are no tradeoffs, all the better. The medium-term benefits of good macro policy for building a middle class argue all the more for what are sometimes painful macro decisions in the short run.

*Defining the middle class.*

Inclusive growth implies an increase in the proportion of *people* in the middle class (implying some exit of people out of poverty), and the proportion of *total income they command*, implying gains in the middle at the “expense” either of the initially poor or the initially rich.<sup>3</sup> I define the “middle class” to include people at or above the equivalent of \$10 day in 2005, and at or below the 90<sup>th</sup> percentile of the income distribution in their own country<sup>4</sup>. 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”.

The absolute minimum can be thought of as a minimum income for a person or household to have the economic security associated with middle class status in an integrated global economy. The relative maximum, which obviously varies across countries, can be thought of as excluding that portion of the population within a country whose income is most likely to be from inherited wealth, or based on prior or current economic rents associated with monopoly or other privileges, and thus less associated with productive and primarily labor activity than for the non-rich. I set the threshold at the 90<sup>th</sup> decile of income because across almost all developing countries for which we have information on income distributions, Table 1 shows that the ratio of income of the 10<sup>th</sup> to the 9<sup>th</sup> decile ranges from two to more than four and is far greater than the ratio of income of the 9<sup>th</sup> to the 8<sup>th</sup> decile. (For OECD countries the 10/9 ratio also exceeds the 9/8 ratio but is always below two.)

Defined in this manner, an increase in the size and economic power of the middle class 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 (politically as well as economically, as the more powerful middle demands government policies conducive to wealth creation), as opposed to being driven largely by exploitation of natural resources, by remittances, or by infusions of external aid.

Figure 1 (see Appendix table for more detail) shows the economic command of the middle class so defined for selected countries, and the change in that indicator between 1990 and 2004. (There is no obvious association between the change in the size of the middle class and change in the Gini over that period. For China middle class growth is associated with a rising Gini while for India and Brazil it is associated with a declining Gini. The same is true for other measures of inequality (not shown).

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<sup>3</sup> These implications depend in part on the relative gains or declines in income and share of the initially rich; the statements assume that the rich are not losing in absolute terms.

<sup>4</sup> For other recent definitions, see World Bank, 2007; Birdsall, Graham and Pettinato, 2000; and Bhalla, forthcoming. **Defining the top** 10 percent of people in every country as “rich” implies that of the approximate 30 million people in the U.S with 2004 monthly income at or above \$6,059 are “rich”, while the approximate 264 million in China with 2004 monthly income of just \$406.70 are rich.

Latin America has for decades been the region with the highest inequality in the world. But in the last few years in Mexico and Brazil there have been substantial declines in poverty (using the \$2 a day poverty line), notable declines in income inequality (measured by the Gini coefficient) – and in both countries a doubling of the proportion of people and of income in the middle class (Figure 1).<sup>5</sup> These signs of success in poverty reduction and middle class growth contrast sharply with reversals in Argentina, Ecuador and Venezuela, shown for the case of middle class growth in the figure. One reason may be that the latter countries have hewed less closely than Brazil and Mexico to standard IMF/World Bank macroeconomic policies, and in the case of Venezuela and Ecuador with their dependence on oil exports have been more vulnerable to currency appreciation which tends to be unfriendly to increasing employment and small business development.

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. Its experience provides a useful starting point for reviewing the likely effects of poor macroeconomic policies on the inclusiveness of growth. At the same time, the recent increases in the size and economic command of the middle class in Mexico and Brazil, where macro policies have markedly improved in the last decade, suggests that eventually – with a long lag – better macro policy (combined with a benign external environment and a commodity boom) can contribute to inclusive growth both by reducing poverty and increasing the size of the middle class.

“Where, Why and When Inequality Matters for Growth...

If a country (India for example, or China) has lower inequality today than Latin America has had historically, is the latter’s experience relevant? I think so, for two reasons. First, there are lessons to be extracted from the worst case and from any hint of recent progress; and second, many countries, including India and China, are currently experiencing increases in income inequality – in the case of China from a Gini of 0.29 in 1990 to .44 in 2003.<sup>6</sup> In China the rising Gini appears to reflect the Kuznetzian story of initial increases because people are moving from low-productivity sectors (e.g. subsistence agriculture) to higher productivity (e.g. urban manufacturing) activities. On the other hand, it could reflect structural factors which could eventually affect the sustainability of growth itself – politically if not economically. Birdsall (2007) refers to two empirical regularities: countries with per capita income below about \$3000 per capita (in purchasing power parity terms) that have Gini coefficients above .45, are those where inequality stalls growth.<sup>7</sup> In

<sup>5</sup> The declines in \$2 a day poverty are often associated with two large government-run programs of conditional cash transfers: in Mexico Progresa (now called Oportunidades) and in Brazil Bolsa Familia.

<sup>6</sup> Reported Gini coefficients are from the WIDER (WIID2b) database; see <http://www.wider.unu.edu/wiid/wiid.htm>.

<sup>7</sup> Barro (2000) in cross-country regression analysis of the determinants of growth finds that the effect of inequality is negative at incomes at or below about \$3000 per capita, and positive above that level. Cornia et. al. (2004) conclude in their study of growth determinants that the negative effect of inequality kicks in only at high levels – at or above .45 Gini.

the poorest countries, capital and information markets work less well, and the poor and middle strata, with limited collateral, are likely to have limited access to borrowing, reducing a country's growth. Limited access to the capital market is probably the case for the rural poor and even urban middle-income groups in China. (Note that in China inequality has risen within rural as well as urban areas; see Table 1.) And countries with high income inequality are likely to have and reproduce two other kinds of inequality: inequality in the distribution of the underlying assets that generate income (land, education, financial wealth), and sufficient inequality in the distribution of political power that education, credit and other public programs fail to compensate for their unequal asset distribution. Again China may be an example. The asset and political inequality usually mean that a large majority of the population cannot exploit the benefits of deeper markets, since they cannot easily acquire education or borrow to invest in wealth-creating businesses. The risk is that China and other countries where inequality is growing could enter the resulting inequality trap in which Latin America has been for many decades, in which not only has growth been non-inclusive; it has been lower than it might have been because only a minority of people were participating in the productivity increases that fundamentally drive growth.<sup>8</sup>

*In the background: open economies and volatile global markets.*

I discuss macro policies below under the assumption that developing countries will continue the trend of the last two decades of maintaining or increasing their openness (including though with more caution 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 macro policy in an open economy can be politically difficult. The challenge is all the more complicated where the size and command over income of the middle class is relatively small (and still 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 (below \$10 a day in daily income) are more at risk of losing out with integration (generally lacking sufficient education or financial assets to exploit global good times and being vulnerable in global bad times), while having sufficient political voice to generate self-defeating populist pressures or in immature democracies have their long-term economic interests betrayed by short-term patronage arrangements.

*The missing middle class in low-income countries.*

Countries with PPP per capita income below \$1500 or so have virtually no middle class by my definition, because daily income per capita at the 90<sup>th</sup> percentile is below \$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, with aid financing as much as 40 percent of all

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<sup>8</sup> Birdsall (2007), discusses the evidence that high-enough inequality in poor-enough countries inhibits growth.

government spending. The discussion of macro policies below does apply to them. The tradeoffs, however, may be in some cases more difficult. Heavy aid inflows can for example complicate exchange rate management to limit real appreciation that could undermine expansion of small business. The key lesson may be for donors as much as country policymakers, to help ensure that aid flows include adequate support for key investments in power, ports, roads and other infrastructure that by reducing costs 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.<sup>9</sup>

### **Three macroeconomic policies that matter for inclusive growth**

This brings us to the discussion of macro policies that are conducive to inclusive growth.

#### 1. Fiscal discipline, the more rule-based the better

Developing countries, especially those with a bad history of inflation and poor debt management, cannot afford to run U.S., Japanese or European style deficits. They need to accumulate a credible record of good fiscal management if they are to ensure growth that is inclusive – including reduced public borrowing to allow for lower interest rates, and a record of public savings during periods of growth to allow for temporary countercyclical deficit spending to protect poor and middle-income people during downturns.

Most emerging markets and low-income countries have dramatically improved 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, 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 GDP; a truly independent source of published estimates of actual and projected 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.

#### *The long arm of past fiscal indiscipline*

With the exception of Chile, most countries in Latin America have for years run fiscal deficits and still do (see Table 2). 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 the poor, since the poor’s capacity to protect their earnings – through indexed savings for example – is limited. High interest rates also undermined 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. While the direct causal

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<sup>9</sup> This and related issues regarding aid in aid-dependent countries are explored in Birdsall (2007).

link is not clear, high interest rates in Latin America since mid-1990 are probably associated with jobless growth. Despite an annual average growth rate since 1995 of 2.5 percent in the region, measured unemployment rates have risen from 6 percent in 1003 to 8 percent in 2006 (with it reaching 11 percent in 2003).

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 2000-2006). But past high borrowing means that debt service is still high (even taking into account reductions in the debt stock in the last few years) and has to be financed, reducing the scope for new public expenditures (Table 3). In 2003 Brazil was spending 10 percent of its GDP on interest on its public debt.<sup>10</sup> To the extent the debt stock has to 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.<sup>11</sup> Real interest rates were very high in Latin America in the 1990s, reaching more than 10 percent on average for the majority of countries, compared with 6 percent on average in Southeast Asia and about 5.6 percent in the United States 1990-2000.<sup>12</sup> 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.<sup>13</sup> Of course some public debt (to finance small deficits) is reasonable, especially when economic growth ensures that the ratio of debt to GDP is not continuously rising above a safe range. But emerging market economies with a history of inflation and volatility (including some such as Turkey, Thailand and the Philippines outside of Latin America) 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.

History hurts in another way. Given high existing debt, Latin and other developing country governments determined to avoid new bouts of inflation have had to maintain tight fiscal policies in the last decade – in several cases including primary surpluses (i.e. fiscal surpluses net of interest payments) – as high as 4 and 5 percent of GDP (Table 4). That 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, and high primary surpluses to finance debt service on current and past borrowing may be reducing public investment compared to countries in East Asia (Table 5).

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<sup>10</sup> Derviş & Birdsall, 2006.

<sup>11</sup> In the OECD high real interest rates are associated with higher unemployment (Blanchard and Wolfers, 1999). The evidence linking high interest rates to unemployment is less clear for Latin America. The data are however, much “noisier” on real interest rates (due to noncaptured inflation volatility itself), the credit markets are much more segmented, and employment and unemployment data are less reliable. Still it is noteworthy unemployment and underemployment limit the ability of the poor and the near-poor to exploit their key asset, their own labor.

<sup>12</sup> World Development Indicators, World Bank, 2007.

<sup>13</sup> ECLAC, 2006.



One other cost of past fiscal indiscipline that is particularly destructive of inclusive growth 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 program payments. 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 confidence of market creditors (domestic and external) in the government's willingness and ability to honor the new debt, and on local financial sectors able to absorb new debt. Except for Chile, other countries in Latin America have not been tested on this score since the 2001 debt crisis in Argentina. Brazil, Mexico and others have implemented impressive programs of conditional cash transfers to poor households (conditional, for example, on keeping their children in school), which could be expanded in the event of a recession as long as the markets are sufficiently confident to finance larger deficits without interest rate increases that would offset the growth and inclusion benefits of the safety net programs.<sup>14</sup>

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 a continuation of this progress relies heavily on more years of very tight fiscal policy (unless growth rates jump to Asian rates) and perhaps too heavily on a continuation of an unusually benign external environment, particularly for commodity producers. Fortunately the increases in the size of the middle class (using my definition) in Mexico and Brazil suggest that the growth the region is now enjoying may be more inclusive than growth has been since the 1970s. Fifteen years of responsible fiscal policy have almost surely helped.

*Fiscal probity helps limit the volatility that hurts the poor and productive middle class.*

Volatility is the outcome of many factors, including commodity price fluctuations and sudden reversals of foreign capital inflows over which governments in developing countries have limited control. Latin America's past patterns of stop-go spending (driven sometimes by periods of populist governments) have been a factor too, however, and have often been the cause of monetary policy that by accommodating fiscal indiscipline, 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 recent calm may also rely mostly on ample global liquidity (itself at risk as I write this in August, 2007) and buoyant export markets.

Volatility is not only bad for growth; it is particularly bad for inclusive growth. The poor and middle class gain less during booms (when those who already have real and financial assets gain most) and are the first to lose jobs during busts. The frequency of such crises in Latin America has resulted both in sharp increases of poverty in the short-term and hurt longer term growth because of the impact of crises and austerity programs on human

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<sup>14</sup> Lustig, 2000.

capital. The downturn hurts more in developing countries because still underdeveloped credit markets mean that small firms are more likely to cut investments and poor and near-poor households to take children out of school. In the form of financial crisis, volatility moreover involves inequitable wealth transfers that create enduring adverse distributional effects. Evidence from the financial crises of the late 1990s in Asia and Latin America indicates that many poor and middle-income households did not recover assets they liquidated during severe downturns (in the case of Mexico, including middle-class owned homes)<sup>15</sup>, and that many children in Mexico that left secondary school did not return when the economy recovered.

*What about monetary policy?*

As noted above, inflation hurts the poor. It is also the case that without credible monetary policy that preserves the role of the local currency as a store of value, it may be difficult to lower interest rates countercyclically because capital will flee (whereas in Latin America, capital markets are open); and it will be difficult to manage depreciations of the exchange rate without adverse effects on balance sheets. In the past two decades, monetary policy in almost all parts of the developing world has become more responsible and credible, and better insulated from short-term political pressures. In Latin America, poor monetary policy in the past started with and accompanied overspending and overborrowing by the government, implying that sound fiscal policy is necessary for sound monetary policy.

*What about the exchange rate?*

It is difficult to keep the exchange rate competitive (avoiding a real appreciation) if fiscal deficits or public borrowing is high. Yet a competitive exchange rate is critical to development and expansion of labor-intensive manufacturing and service exports. See below.

## 2. A “fair” tax and redistribution system<sup>16</sup>

*The tax side.*

Inclusive growth requires not only keeping aggregate spending in line with aggregate revenues. It generally requires that tax systems and expenditures be progressive.

The experience in Latin America is discouraging. Reliance on the value-added tax, which is generally regressive, is much greater than in Europe<sup>17</sup> (60 vs. 30 percent of total revenue); higher overall and more progressive taxation in Europe reduce income inequality (and probably the burden on the middle class much more than in Latin America).<sup>18</sup> Along

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<sup>15</sup> Lustig (editor), 1995.

<sup>16</sup> This section is based on Birdsall, de la Torre and Menezes (2007, forthcoming), Chapter 4, which includes citations to the relevant facts and analyses.

<sup>17</sup> Tanzi and Zee (2000). Martner and Aldunate (2006) estimate that indirect taxes accounted for about 56 percent of total tax revenues in Latin America and 31 percent of tax revenues in Europe in 2003-04. (Taken from Fair Growth).

<sup>18</sup> Lopez & Perry, 2007.

with loopholes and exemptions that tend to reduce the tax burden on the rich, 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. The overall result is revenue generation of on average 18 percent, well below what might be expected given average per capita income. Low revenue generation combined with admirable fiscal discipline obviously constrains public investment and expenditures that could otherwise be deployed to reduce inequality and induce more inclusive growth.<sup>19</sup> Equally to the point, more visibly fair tax systems would not only encourage inclusive growth; they would make higher ratios of taxes to GDP more politically acceptable, including to the rich who easily now justify evasion (as would, of course, more efficient public spending and less corruption.) In Argentina, the top 10 percent of households' effective average tax rate was an estimated 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.)

### *The expenditure side.*

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 greatest hemorrhage in terms of inefficient, non-inclusive spending comes with 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), while the poorest quintile only receives 3 percent.<sup>20</sup> Appropriate design of pension systems is not a macroeconomic issue – except to the extent pension systems can end up taking so much fiscal space, without benefiting the bottom 80 percent of households, that they undermine fiscal discipline itself. In the case of Brazil, a severely non-inclusive pension system was still costing as much as 3.5 percent of GDP a few years ago<sup>21</sup> – equivalent to the lost fiscal space associated with net primary surpluses – and it has been politically impossible to make anything but marginal changes to the system.

### 3. A business-friendly exchange rate

It is almost a cliché that a competitive exchange rate is the key to growth. It is surely helpful to inclusive growth insofar as 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 Mauritius, Vietnam and of course China.<sup>22</sup> The inflation that resulted in Latin America from monetizing a high fiscal deficit also brought persistently overvalued exchange rates

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<sup>19</sup> Contrary to conventional wisdom, there is no evidence that greater public spending on redistribution (measured in terms of marginal and average tax rates and different types of social spending) is associated with lower aggregate growth (Easterly and Rebelo, 1993). Moreover, even where public expenditure is not progressive overall, it is likely to be more progressive than the distribution of market income.

<sup>20</sup> Lindert, Skoufias, and Shapiro, 2006.

<sup>21</sup> Krueger (no date).

<sup>22</sup> The distinction between a competitive and an undervalued exchange rate may also matter; there is considerable controversy over whether it is primarily the latter that “buys” export success.

throughout the 1970s and even in the 1980s. Excessive borrowing added to the temptations of inflation as a means to reduce otherwise ballooning public debt. Protection of local industries then followed via tariffs and other barriers – reducing competitiveness. Over the last two decades, Chile, the one country in Latin America with a longer history of fiscal rectitude, has been the one best able to manage its exchange rate to limit its appreciation.

Fiscal discipline does not guarantee a competitive exchange rate, and government can get away with high deficits while avoiding currency appreciation – if as in India until recently, capital markets are closed and private savings to finance public debt can be captured, if growth prospects are especially good, and if absent any history of inflation people have confidence in the currency. But in most circumstances of most developing countries, maintaining a competitive exchange rate is likely not only to help growth, but help ensure growth is inclusive. The increase in the size of the middle class as I have defined it in urban China (Figure 1) is the outcome of multiple factors. The exchange rate (which is arguably now more undervalued than “competitive” requires) is one of those.<sup>23</sup> In the case of Brazil and Mexico, the slaying of inflation in the early 1990s has made it easier to avoid the overvaluation which for two prior decades hurt exports.

### **Conclusion: From pro-poor to inclusive, middle class growth**

That inflation hurts the poor is now widely acknowledged.<sup>24</sup> A similar acknowledgement is needed regarding the dependence of the middle class in all economies on other ingredients of 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 - all these along with inflation are also bad for the incipient middle class. The experience of the mature Western economies suggests that the poor benefit when an economically strong middle class insists on accountable government and supports, through their willingness to pay taxes, universal and adequate public services. That experience suggests that inclusive growth as I have defined it will benefit poor people indirectly as well as directly, by helping them escape their 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 there has been a doubling in the ranks and economic weight of the middle class. It is hard to imagine that would have been possible without more than a decade in which those countries stayed the course on tough fiscal and other macro policies.

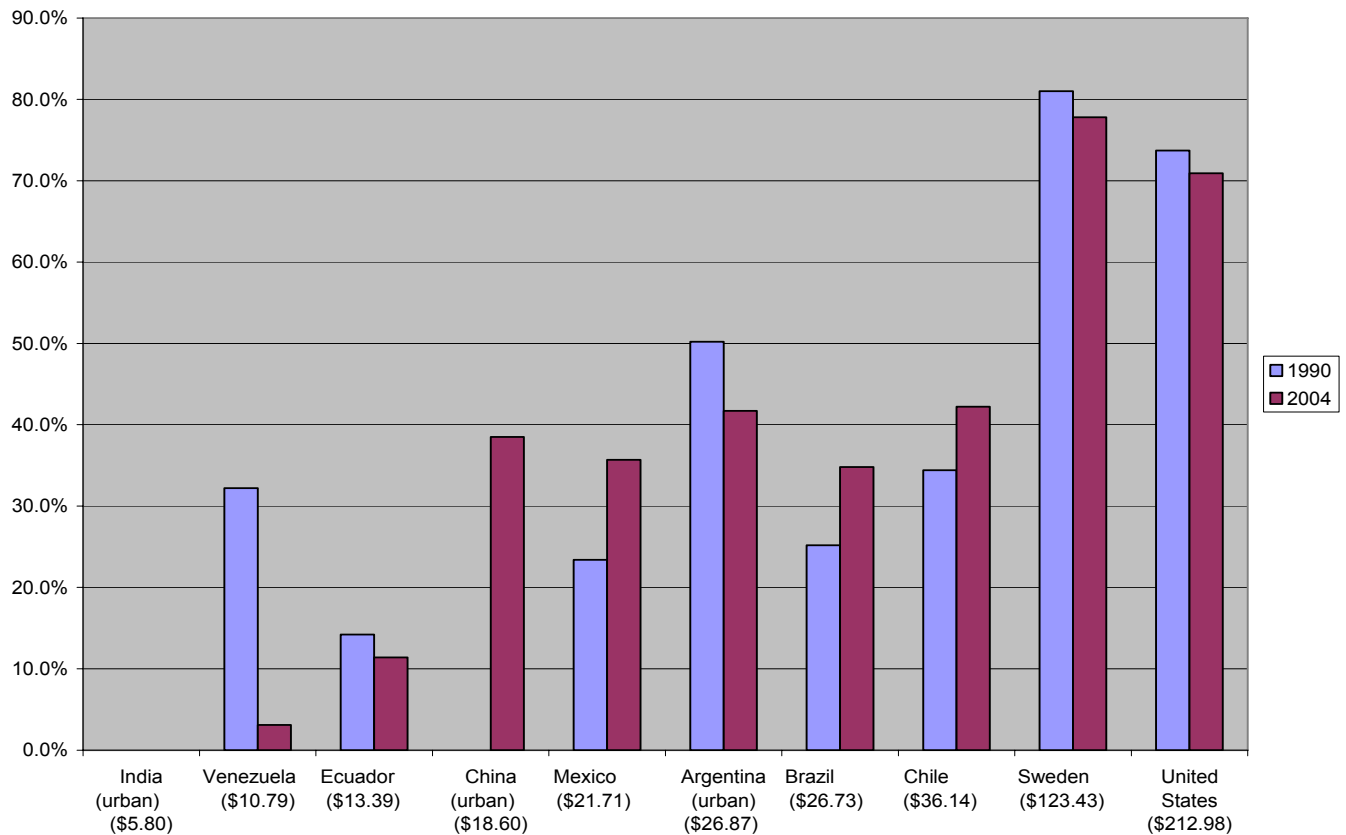
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<sup>23</sup> Some currency appreciation in China and complementary macroeconomic policies to stimulate more domestic demand driven growth are inevitable if long-run and inclusive growth is to be sustained.

<sup>24</sup> Easterly and Fischer (2001).



**Figure 1: Proportion of income held by middle class:  
Selected countries, in order of increasing average annual income per capita, 1990 &  
2004\***



Note:

\* Or most recent available year.

The middle class is defined as individuals with at least \$10 in each year (\$7.20 in 1993 PPP terms), who are at or below the 90<sup>th</sup> decile of the income distribution in their own country.

Figures in parentheses below countries indicate 2004 daily per capita income at the 90<sup>th</sup> decile of the income distribution.

Source: Author's calculations using the World Bank's PovCal data.

**Table 1: Income per capita, Gini coefficients, Income level decile ratios and Share of income of the middle strata  
Selected Countries, 2004**

<b>Countries</b>	<b>Mean Annual Income per capita (2004)</b>	<b>Gini (2004)</b>	<b>Income level ratio between 10th and 9th decile (2004)</b>	<b>Income level ratio between 9<sup>th</sup> and 8<sup>th</sup> decile (2004)</b>	<b>Share of Income of Middle Strata (2004)</b>
Brazil	\$3,470	57.0	2.78	1.51	36.01
Chile*	\$3,571	54.8	3.00	1.48	36.23
Ecuador**	\$1,811	53.4	2.90	1.46	36.62
Argentina	\$3,470	51.3	2.30	1.41	41.14
Zambia	\$492	50.7	4.14	1.54	28.18
Venezuela	\$1,401	48.2	2.04	1.37	45.11
Nepal	\$969	47.3	2.68	1.37	40.96
China***	\$1,730	46.6	1.78	1.35	45.51
Mexico	\$3,044	46.1	2.48	1.41	41.08
Kenya	\$1,206	42.5	2.60	1.42	38.31
Ghana****	\$689	40.7	2.20	1.37	42.97
United States	\$29,723	39.4	1.87	1.30	48.77
India	\$632	34.6	2.20	1.38	48.07
Egypt	\$1,096	34.4	3.07	1.45	36.93
Sweden*****	\$21,009	25.7	1.59	1.16	54.40

\* Data available for 2003

\*\* Data available for 2002

\*\*\* Data available for 2002

\*\*\*\* Data available for 2000

\*\*\*\*\* Data available for 2003

Source: Author's calculation using PovCal & WIDER (WIID2b).

**Table 2: Fiscal Deficits of Selected Countries, 1995, 2000, 2003**

<b>Country</b>	<b>1995</b>	<b>2000</b>	<b>2003</b>
Argentina	1.15	2.28	0.13
Bolivia	2.32	3.33	7.4
Brazil	6.09*	NA	NA
Chile**	-2.58	-0.14	NA
Colombia	2.3	6.72	4.91
Ecuador**	1.01	-0.3	1.36
Guatemala	0.48	1.96	1.95
Mexico	0.53	1.25	1.3
Nicaragua	0.31	3.85	2.92
Peru	1.11	1.84	1.91
Venezuela	3.61	1.65	NA

Source: International Monetary Fund International Financial Statistics CD-Rom (2007)

\*This value is for 1994 since 1995 data for Brazil were unavailable

\*\*Minus indicates budget surpluses



**Table 3: Total Debt Service & Total Debt Stock, Selected Countries, 1990 and 2005**

Total Debt Service (% of exports* of goods, services and income)			Total Debt Service (% of revenue, excluding grants)		Total Debt Stock** (%GDP)	
Countries	1990	2005	1990	2005	1990	2005
Argentina	37	21	64	46	44	62
Brazil	22	45	8	27	26	23
Mexico	21	17	28	68	40	21
Peru	11	26	14	40	76	36
Malaysia	13	6	37	39	35	39
Indonesia	33	25	46	43	61	48
Thailand	17	15	54	53	33	29

\*Exports refer to exports of goods, services, income and workers' remittances

\*\*Total debt stock refers to external plus domestic debt

a. For Argentina, 2003 and 2004 data respectively

b. For Brazil, 1998 data

c. Mexico, 2002 data

d. Malaysia, 2003 data

e. Indonesia, 2002 and 2004 data respectively

f. Thailand, 2003 and 2005 data respectively

Source: 2007, World Development Indicators & Global Development Finance, World Bank

**Table 4: Primary Surpluses in Selected High-Debt Emerging Market Countries**

	Year with highest primary surplus since 1990 (% of GDP)	Primary surplus (% of GDP)
		<b>2002</b>
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 <sup>b</sup>	-	2.6
India	-1.2 (1997)	-3.7
Indonesia	3.8 (1990, 2002)	3.8
Jordan	-	-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: Derviş & Birdsall, 2006.

Notes:

b. 1999 data.

**Table 5: Average Public and Private Investment in 1990's as Percentage of GDP**

<b>Countries</b>	<b>Public Investment</b>	<b>Private Investment</b>	<b>Gross Domestic Investment</b>
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).

**Appendix: Income per capita, Gini coefficients and measures of Middle Class:  
Selected Countries, 1990 and 2004**

<b>Country</b>	<b>Mean annual income per capita (1990)</b>	<b>Mean annual income per capita (2004)</b>	<b>Gini (1990)</b>	<b>Gini (2004)</b>	<b>Proportion of pop. in the "middle class"; between the two bounds<sup>a</sup> (1990)</b>	<b>Proportion of pop. in the "middle class"; between the two bounds (2004)</b>	<b>Proportion of total income in the "middle class"; between the two bounds (1990)</b>	<b>Proportion of total income in the "middle class"; between the two bounds (2004)</b>
<b>Argentina (urban)*</b>	\$4233	\$3470	45.4	51.3	46.0%	34.0%	50.2%	41.7%
<b>Brazil</b>	\$2793	\$3571	60.7	57.0	18.0%	29.5%	25.2%	34.8%
<b>Chile **</b>	\$3801	\$5228	55.4	54.8	31.2%	45.4%	34.4%	42.2%
<b>China (rural)</b>	\$502	\$922	30.6	38.1	0.0% <sup>b</sup>	0.0% <sup>b</sup>	0.0% <sup>b</sup>	0.0% <sup>b</sup>
<b>China (urban)</b>	\$1,194	\$2,856	24.8	34	0.0% <sup>b</sup>	31.50%	0.0% <sup>b</sup>	38.5%
<b>China (combined: urban &amp; rural)</b>	\$695	\$1730	36.0	46.6	0.0% <sup>b</sup>	8.1%	0.0% <sup>b</sup>	14.6% <sup>b</sup>
<b>Ecuador***</b>	\$1894	\$1811	50.5	53.4	8.7%	6.8%	14.2%	11.4%
<b>India (rural)****</b>	\$441	\$538	29.5	30.5	0.0% <sup>b</sup>	0.0% <sup>b</sup>	0.0% <sup>b</sup>	0.0% <sup>b</sup>
<b>India (urban)****</b>	\$653	\$867	34.8	37.6	0.0% <sup>b</sup>	0.0% <sup>b</sup>	0.0% <sup>b</sup>	0.0% <sup>b</sup>
<b>India (combined: urban &amp; rural)****</b>	\$494	\$632	33.2	34.6	0.0% <sup>b</sup>	0.0% <sup>b</sup>	0.0% <sup>b</sup>	0.0% <sup>b</sup>
<b>Mexico*****</b>	\$2,628	\$3,044	55.1	46.1	17.4%	29.0%	23.4%	35.7%
<b>Sweden*****</b>	\$20,086	\$21,009	24.0	25.7	90.0%	90.0%	81.0%	77.8%
<b>United States*****</b>	\$23,868	\$29,723	37.2	39.4	88.9%	90.0%	73.7%	70.9%
<b>Venezuela</b>	\$2634	\$1401	44.2	48.2	23.9%	1.6% <sup>b</sup>	32.2%	3.1% <sup>b</sup>

\*Data from 1992 and 2003

\*\*Data from 1990 and 2003

\*\*\*Data from 1987 and 1998

\*\*\*\*Data from 1988 and 2004

\*\*\*\*\* Data from 1989 and 2004

\*\*\*\*\*Data from 1987 and 2002

\*\*\*\*\*Data from 1986 and 2000

<sup>a</sup> Lower absolute bound: \$7.20 (1993 PPP\$ per capita per day). This represents \$10.00 (2005 PPP\$ per capita per day).

<sup>a</sup> Upper relative bound: 0.90 percentile of distribution

<sup>b</sup> Bounds overlap

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