

## The Macroeconomic Foundations of Inclusive Middle-Class Growth

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Nancy Birdsall

**G**rowth that is shared—so-called inclusive growth—is now widely embraced as the central economic goal for developing countries. But inclusive growth can mean different things to different people. In this essay *inclusive growth* is defined as growth that builds a middle class. Macroeconomic policies can shape the environment and incentives for inclusive growth by working toward three important goals: 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

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income). The focus on pro-poor growth implicitly recognized 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 semiskilled 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 defined here as including people with incomes at or above the equivalent of US\$10.00 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.

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 and 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\$2.00-a-day poverty line), notable declines in income inequality, and a doubling of the proportion of people and income in the middle class. This situation 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 have 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). For example, in mature market economies it is the secure middle class 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\$10.00 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 annual income of less than US\$1,500.00 or so per capita have virtually no middle class by the definition used here because their daily income per capita at the 90th percentile is below US\$10.00. That is the case for India 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 be more difficult in some cases. Heavy aid inflows can, for example, complicate efforts to limit real exchange rate appreciation, which could undermine the 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 types of infrastructure. By reducing costs, these investments can help avoid pressure on the exchange rate, allowing for the expansion of small business and increasing competitiveness in manufacturing, agroindustry, and services for export.

### Three Macroeconomic Policy Goals 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 ones promoting 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 countries rich in natural resources, 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. Past fiscal laxity meant that 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 inter-

est 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 semiskilled.

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 high borrowing in the past means that debt service is still high. This debt must be financed, reducing the scope for new public expenditures. 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 that for developed countries—the IMF suggests no more than 30 percent for emerging markets.

History hurts in another way. Given the existing debt, Latin American and other developing-country governments that are 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. This situation has reduced the fiscal space for public investment in roads, schools, health care, police training, and so on—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 that of countries in East Asia.

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 the 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 results in long-lasting transfers of wealth from the poor and middle class to the upper class. 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 had liquidated during severe downturns.

#### A "Fair" Tax and Income 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 reduces 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. Tax revenue averages just 18 percent of GDP, well below what might be expected given average per capita income. Low revenue generation combined with admirable fiscal discipline in Latin America 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 shows that the most inefficient, noninclusive 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 (the 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; this pattern occurred 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 through 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 is the result of several 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 had hurt exports for the two prior decades.

#### Conclusion

In all economies, the middle class 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 pays taxes to support universal and adequate public services. 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 Brazil and Mexico, the two countries in Latin America that have sustained cash transfer programs for the very poor, have seen the ranks and the economic weight of the middle class double. It is hard to imagine that this progress would have been possible without more than a decade of sustained, tough fiscal and other macroeconomic policies.