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STUCK IN THE MIDDLE: IS FISCAL POLICY FAILING THE MIDDLE CLASS?

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UNCORRECTED TRANSCRIPT

MR. LINN: We are happy to welcome Danny Leipziger of the PREM vice-presidency in the World Bank. We also have with us Antonio Estache, who is the -- I'm not sure if I'm pronouncing this right -- Bernard Van Ommeslaghe chair, Economics Department, *Université Libre de Bruxelles* in Brussels, obviously. He also was at the World Bank, I'm told, for about 25 years. So, they are the two co-editors of the book and also contributors.

We also have, very fortunately, Carol Graham, who's also a contributor in the book, and well-known certainly in Brookings, but also beyond, for her work on happiness. So, she contributed a chapter on happiness or life satisfaction. She has herself a distinguished academic career, a career at Brookings. She’s a senior fellow and Charles Robinson chair at the Brookings Institution, but also is a professor at the University of Maryland, professor of economics.

These are the three authors, coauthors, editors that are participating in the book. We also have two very distinguished commentators, and I’m very happy to see them both here.

Vinod Thomas, who is the director general of the Independent Evaluation Group of the World Bank. Again, he has many years, and I don't know how many years, we go back, way, way back together at one way or another to early incarnations of the World Bank on the research side, on the operational side, including a stint as the country director for the World Bank Brazil, which, of course, is a interesting particular case of development of middle income group.

Finally, Santiago Levy, who we know well here in the Wolfensohn Center of which, by the way, I’m the executive director here at Brookings.

I forgot to introduce to introduce myself. My name is Johannes Linn, but Santiago Levy is now the vice president for Sectors and Knowledge, which seems an ambitious job, Santiago, at the Inter-American development Bank, but also non-resident fellow at the Global Economy Development Program at Brookings.

He was with us at the Wolfensohn Center as a non-resident fellow for, I guess, about two years and produced two outstanding books, that I would recommend to you, while he was working with us. One on *Progresa-Oportunidades,* the conditional cash transfer program in Mexico, which he, in a sense, together with then-president Zedillo in Mexico initiated and saw a long way into a successful and exemplary, in many ways, program to assist the poor. But he also wrote a book on the social protection system in Mexico, which is actually directly relevant to the topic we're talking about, and I think he will refer back to that, perhaps, off and on in his comments.

With this, let me welcome you all again. We will have at the end, of course, a question and answer session, so, I would ask my colleagues to be reasonably brief. They've been asked to speak for 7 to 10 minutes. So, after 10 minutes, we'll all get a bit restless here, to get them along and get the next one on, and then have time for discussion.

So, again, welcome, and especially welcome to our panelists. I think, Danny, you're the first one to start. Thank you for coming.

MR. LEIPZIGER: Thank you, Johannes, and thank you to our commentators, who, hopefully, will be kind at the end of this.

The important thing about this book, of course, is the title, because having learned through many decades of low-selling books, you have to have a provocative title. So, "*Stuck in the Middle*" we hope will catch you attention.

By way of background, a few of us in the PREM part of the World Bank, Antonio and I in particular, started a project a few years back which was aimed at looking at how economic policy affects the entire income distribution, and even though the World Bank is known as the bank that's out to fight poverty, that's much too narrow a focus for any development agency, and we thought that looking at fiscal incidence was important and somewhat undervalued.

So, the basic idea was to look at fiscal incidence from an economic and political point of view because political sustainability of policies requires looking at who wins and who loses from economic policies, and can provide a certain social cohesion for economic policymaking.

Another point that I think is quite interesting from an economic point of view is that some of the policies that you would like to institute which are pro-poor, if you want to put it that way, require a consensus in society that goes beyond obviously the political interests of either the elite or the poor, who tend not to have much power to begin with. So, there’s a coalition that’s possible between the middle class and other lower deciles of the income distribution that actually can be quite valuable.

To give you a sense of what's happening in the world, if you look at the bottom quintile of the income distribution, you see that except for Italy and Mexico, income shares are either stable or declining for the poor, but if you look at the middle three quintiles, so, the 60 percent in the middle, you can also see that for most of the OECD countries, the welfare situation or the income situation is either stable or more likely in moderate decline, and, obviously, the U.S. is one of those cases, and it has political ramifications.

So, looking at this middle of the distribution, whether we consider it the deciles 4 through 9 or the middle 60 percent is important for policymaking. And it’s also important in developing countries because between 1990 and 2005, there have been more than 1 billion people, 1.1, that have actually moved into what we consider for developing country purposes to be their equivalent of a middle class, which is per capita incomes between $2 and $13 a day, more of the 1.1 billion are actually between $2 and $9 dollars a day.

These are not big numbers. I recently gave a talk in Europe, and I said that if you live on $9 a day, that’s the cost of an average vacation for

Europeans, so, these are middle class only in the sense of developing countries, and they now constitute almost half the population of the developing world, this group between $2 and $13 a day.

This kind of work, looking at fiscal incidence, basically what does fiscal policy do distributionally, is not new, but it comes in waves, and, obviously in the recession that we're in, it takes on a lot of importance these days, but there've been other researchers looking at various aspects of it, including Carol and others who contributed to this book.

Let me tell you quickly because I only have 7 to 10 minutes what we're looking at. Overall, we think that the importance of the fiscal side of the story is that growth that polarizes the income distribution tends neither to be sustainable, nor actually good for long-term growth because the middle 60 percent are the core of those that are generating employment and income and also political stability in many of the societies that we look at.

So, we have papers in this book that deal with the economics of the story and we have papers that deal with the politics of the story, and we have Carol's paper, which she'll describe herself, which deals with happiness, which is why I'm sure all of you are here on a Friday.

(Laughter)

MR. LEIPZIGER: Seeking happiness.

The second area that we look at is: What can you expect from tax policy? And, to put it in a nutshell, the answer is you should not expect taxes to provide the progressivity that you would like to see in terms of income. They might be progressive in generation, but, essentially, tax is the generator of resources and the expenditure side is the one that matters for redistribution.

So, if you look, for example, at European distributions of income, you see that prior to tax and subsidies, a number of European countries are quite unequal, they're actually quite similar in some respect to the U.S. But when you look after tax and expenditures, the story is quite different.

Now, the ability to generate taxes obviously rises with income. For more advanced countries, we're talking about tax takes that are in the 30, 35, even 40 percent range. For lower-income countries, the only one we have here is an emerging market economy in Mexico. Even this 20 percent is an overestimate, I'm sure. Santiago will have views on this because we have to take out the transfers from PEMEX and a number of other things.

So, in general, there's less, the tax machine is less efficient in generating the resources that you need for redistribution, but, as you can see, for the more advanced countries, the tax take has gone up over the last couple of decades. The question is: What has happened to these taxes?

So, that takes us to the expenditure side, and, essentially, we are focusing very much on who benefits from various categories of expenditure. There's a good paper by Antonio and Markus Goldstein on subsidies, and we know that there's a large element of mis-targeting of expenditures, but we don't exactly know in most countries by how much because most fiscal policy instruments are not designed and analyzed for their incidence. When a country institutes a new electricity tariff or institutes a new charge of some sort, we don't usually do the fiscal analysis that should be done behind it.

And what's the risk of not looking at incidence? Well, there are at least a couple.

One is that you get backlashes against policies that you think are in the national interest. I think the discussion on globalization in the last couple of years is very indicative of this because most people that we're losing in terms of incomes shares, let's say, ascribe that loss to globalization. So, if you lost a job somewhere, you imagined it was globalization, in some cases, perhaps true, but, in many cases, not true.

But hard to know because it's hard to disentangle the various aspects of fiscal policy.

The second reason why it's important to look at who wins and who loses from fiscal policy is that there is a bit of what's called in the literature paradox of redistribution, which is that if you focus too much on trying to redistribute to the lower end of the distribution, you may actually not be helping the poor. Why not? Well, one of the reasons is that you need growth to redistribute. So, redistribution policy that is very one-sided and only focusing on the poor rather than the lower middle-class and other parts of the distribution can actually lead to a smaller pie, so, there'd be less to share at the end of the day.

The second is that you need political support for a lot of policies, and for the sustainability of growth redistribution needs to look at more than the absolute poor.

And, thirdly, because the incentive effects, which is that you would like to see people having upward mobility prospects. So, at least prior to this crisis, the comment in the United States was that everyone considered themselves to be middle class, even if they lived in the trailer in West Virginia, they consider themselves to be middle class.

Now, maybe that perception has changed as a result of the crisis, but it was a positive thing insofar as people saw upward mobility and the possibility of reaching into a different part of the income distribution in their lifetime.

So, these are all various aspects of the middle class story that we think are important, and which is why we put this set of papers together. We were very happy that Brookings was willing to publish it because actually one of the inspirations for this work was the work of Joe Pechman from Brookings, who in the 60s and 70s actually did very close to what we think is the right thing to do, which is to look at the expenditure incidence of various policy interventions so that if you look back some of Pechman's work with colleagues here, you would see what was the incidence of Social Security, what was the incidence of tax, what was the incidence of subsidies to education, et cetera, et cetera.

The real key here is to be able to add them, add so that you know when you look at the panoply of policies that government puts in place what is the impact on this quintile or that decile, or, in our case, the middle of the distribution, which we think is a group that is often ignored, and, as Johannes said, there's a middle income taskforce now in the United States looking at this because if you look at income shares in the U.S., except for the top decile, income shares have actually gone down and real income has actually fallen for a large part of the distribution. So, this is not a trivial point.

So, to conclude, we have a number of papers, and Antonio will follow me in describing what these papers are. They try to look at the economics and the politics of the middle class, both from what they contribute to economic activity and how they benefit or do not benefit from various government interventions.

We have papers that deal with developed countries and we have papers that deal with emerging market economies. Obviously, the data is a lot better for the former, but I think the consequences for the future are much greater for the latter, which is the pattern that I described of more than 1 billion people moving into what we now call the lower middle class in the world. It's only going to increase.

So, if we look at the projections to 2030 and 2050, this is the group whether it's in India, China, or in Latin America, that is going to be very important for policymaking and very important for economic activity in the future.

So, with this, we want to leave you with the thought "*Stuck in the Middle*." That's the book of the year, in our view. So, thank you very much.

(Applause)

MR. ESTACHE: I was reading a review this morning in the *Washington Post* of a new CD by a very good, American band called

Green Day, and it's about the book, actually. It's called "21st Century Breakdown," and it's about the fact that the U.S. society will no longer have working class heroes, and that's part of the message that we're trying to look at.

I think it's interesting to see it's not just economics or policy centers, that this concern is coming up as a major concern. That if you look at the young generation at what they sort of express in the way they look at their future, this topic comes in a very strong way.

So, I'll try to tell you how academics and researchers think about those issues, but I think it's important to remember that these things are anchored into very real concerns that we see in the younger generations, including my daughter, for instance.

So, the big picture in the book is that we have a new review chapter, in which Danny and I sort of try to bring together lots of the ideas, but also try to fill in some of the gaps because not everything could be covered in all of the chapters. And then we have two chapters on basic stylized facts. One of them by Solimano sort of looks at the place of the middle class in the economy and another one by Maurizio Bussolo looks at the fast growth of the global middle class. I mean, he takes a global perspective on the topic, just not a national one. So, it's an interesting contrasting of data on the topic.

Then we have three policy chapters. One on the scopes and limits of subsidies in the creation of the political coalitions that we sort of expect for the middle class, and that's by Markus Goldstein and me. Then we have one chapter which we thought we needed which not only looks at income distribution, but looks at wealth distribution. Davies was actually one of the coauthors of a major U.N. report on the topic, and tried to sort of recenter the data he had collected within the framework we have for this book. And Carol did a chapter on happiness and what is it that we can get out of the happiness research to try to guide a little more specifically fiscal policy. We had lots of debate on that topic when she was writing the chapter, and something came out of it.

Then we have a chapter written by political scientists because we had a workshop on the book, and one of things that came out is that politics were completely underestimated by economists, so, we asked three, really good political scientists out of North Carolina to try to look at that those issues, and I'll tell you more about their conclusions.

So, what this presentation is all about is how all of those things sort of fit in together, and there is some logic, luckily.

(Laughter)

MR. ESTACHE: So, the first point that came out in the discussion we were having when we were preparing the book and we were having the seminars, not everybody agrees on the definition of the middle class. There is no scientific definition. I mean, take five books, and you're going to have five different definitions. That's part of the problem. But the good news is that it doesn't really matter because the message has actually come across the analysis come across in a fairly robust way, however you take the definition within a certain set of limits.

I mean, it used to be that people would focus on deciles and from the 3rd and 9th decile, and now, increasing with (inaudible) in the flow, with Ravallion and with Goldman Sachs publications, actually, a couple of years ago, also, they started putting some figures on what the income meant in terms of PPP, and, roughly, we're talking about $2 to $13 a day. It could be a bit more, a bit less, but that's the order of magnitude that people are playing with.

So, once you know that you have a sort of rough definition that you can play with, it's sort of interesting to start to look at what does it truly mean in terms of the economic place of that middle class. And what we look at what's actually and Solimano looked at there's a bunch of things that people have as, I guess, get a feeling in terms of what the middle class should be or should have as an economic (inaudible) so he tested assumptions. Mostly correlations because we didn't have a lot of good data, but, I mean, the correlation tell fairly interesting stories because then he was explaining there is a link between the size of the middle class and level of development, there is also a link between income and wealth and equality in the size of the middle class. So, these are quite fairly robust.

Then there is a lot of research that talks the importance of the middle class in the context in which you have a very large government. So, we test this assumption, and that assumption doesn't hold that well. Actually, the correlation between the size of the government and the size of the middle class is not that robust.

There are some important dimensions that the political scientist brought us back to, but in terms of the macro picture, it doesn't hold, and the fact that the middle class could be, in a sense, concentrated into a very large, small, and medium-size business sector did not hold either. I mean, there is a much, much larger variance that we had anticipated in terms of their economic presence in the industry of the world, and, so, that's another assumption that we had to reject.

And, finally, the idea that keeps crawling back in this discussion is that as democracy grows up, you would expect to have the middle class to have an increasing role, and you would have sort of a two-way causality in that business. Well, very simple correlation suggest that it's not simple relationships, so, it doesn't mean that there is no relationship, but at least we know that the relationship is not linear. I mean, you have plenty of non-linearities in the way these variables interact for the middle class, and that's maybe the point, and that's the interest of some of the other chapters actually.

So, that's Maurizio's contribution, it tells us, well, if you look at the middle class, it's quite important to look at what it means at a global level, not just at a country level, and, so, what comes out of that picture is that, indeed, the size of the middle class will grow tremendously when you look at it a global level, but, mostly in emerging economies.

I know it's impossible to read the slides. I mean, what you have is a list of countries, and what I wanted simply to report is the fact that the relative importance of the middle class in the way OECD countries is going to be declining, well, the relative importance of the middle class in emerging economies, and, clearly, China and India are major actors, and it's going to be exploding.

For the story at the global level, it's likely to lead to major changes in economic activity and distribution of economic activity as a result of this evolution that was documented. So, these are just similar figures that give you a sense of the crucial importance of the middle class and the tremendous role of China and India because you see that the story really is driven by East Asia story.

The good news is that it brings a little bit of reduction in global income inequality, but not as significant as some of us had expected.

So, let's revisit some of the results that Danny was talking about earlier, and what does the book specifically tell us about some of those results?

Well, initially, we thought we were going to have a tax chapter, and we saw that the tax chapter didn't tell us anything we didn't know, so, we couldn't have a tax chapter because the result was so similar to whatever had been said before that we couldn't really push for that. But the punch line really is that when you look at all of this research that, for now, the only instruments we really have, which can be used for progressivity purposes, is direct taxation.

In most countries, their taxation is fairly regressive, and it doesn't help the middle class in any way. It doesn't help social mobility, and if you want to have some degree of social mobility through the tax instrument, of course you need revenue, as Danny was saying, but you need to have a design, which is much, much more progressive than the one we had in most of the countries in which we looked at in the context of this non-published chapter.

The expenditure policy was a lot more interesting. There's a lot more business going on in terms of the expenditure policies, and the two major ticket items on this side were clearly subsidies. It's a big part of the story when you try to promote social mobility as to think in terms of the design and the use of these subsidies, given the revenue that you have, of course, and given that limitation, of course, you're going to have a lot more margin to play with subsidies the richer your country is, so, it's a sort of a perverse situation in which when you want to promote social mobility and you're poor, you can't use the instruments that are designed to generate that social mobility.

But what's interesting is that we have a new instrument we can play with. I mean, people like Davis, for instance, through the UN, have been pushing a lot for the use of wealth taxation and the management of wealth, actually, as a instrument to promote social mobility, and I think we have an interesting story to report at that level.

So, what do we have to say about subsidies? Well, the punch line maybe in the title is that, I mean, we can't live with them, because most of them are regressive for now, but we can't without them, because that's the main instrument we have actually to the social mobility. So, we have an issue at that level.

So, the story is that the surveys that are emerging now, and thanks to a lot of efforts by the Poverty Group at the World Bank, we now have a large set of data that allows us to check more carefully the incidents of those subsidies, but the story that sort of comes up is that, ideally, we would want to have the support of the middle class to target subsidies better to the poor, but it doesn't happen that way. Why is it that it doesn't happen that way?

Well, if you look at how they're implemented, right, these subsidies are mis-targeted, so, who gets them? particularly the rich, and then there is some trickledown effect for the middle class. So, if you try to reform them in order to bring them down to the poor, well, the middle class is going to say well, if you do it and you take it away from me, I'm not going to be happy, so, you have a natural correlation between the rich and the middle class, which is anti-poverty.

So, we need to sort of look for something else, right? So, we need to figure out a way in which we -- I mean, the lesson that we get in that chapter is that we need to find a way of designing the subsidies so that we have enough leakage from a well-targeted subsidy, which favors the poor, but we have to have a leakage that favors the middle class in order to be able to get that correlation that currently sort of tends to support the subsidy that helped the rich. Why? Because the rich are allowing leakages towards the middle class. So, we need to revert that kind of stuff.

The point that Danny was making earlier, and this is the case of Mexico, is that it's quite crucial to look at the two sides of the story. I mean, if you look at the blue line on the graph, this is distribution across these sides of the benefits, and you don't see a lot of progressivity in there. I mean, it's fairly well-distributed, and, so, clearly, the expenditure side in this case study has not been very effective in terms of using the expenditure side of the equation to redistribute and to promote social progress. But they've compensated by a very effective way of using the revenue side.

So, the story is really that you need to look at the two sides of the equation in order to be able to assess whether this fiscal policy is working well or not in terms of promoting social mobility.

So, now, the second instrument that we looked at in some details is wealth, and what the Davies chapter does is document fairly well the four main policies which have worked quite well in the OECD countries in order to promote social mobility by simply focusing on this wealth variable. So, the support to owner occupied housing is clearly a good policy, land ownership and titling has proven to be very effective also in ensuring this redistribution that way you want it to be in order to promote this social mobility. The increased access to finance by the poor and the tax shelter personal account in pensions.

I mean, these four policies have worked quite well for a wide range of countries. Of course, there is large variance, and there other things which are very typical to specific countries, but the big picture is this one. And what Davies argues is that there is little reason to believe that these policies should not work for poor countries.

The main issue is that we need to invest a lot more on institutions that will implement those policies, and that's where the problem comes from. I mean, countries come up with very creative solutions which are fairly robust, which are fairly consistent from a political point of view, but they don't really develop the institution capacity to implement those policies or they come up with very fancy policies, which are inconsistent with the institution capacity that the countries have. So, that's what comes out of the Davies chapter, if you want.

I want to talk a lot about Carol's chapter because she's there and probably she's going to tell me that I'm wrong about whatever it is that I'm saying. But I think what I got out of it is that, the first thing is that the happiness research does not yet generate strong enough policy conclusion in terms of what kind of tax handles, expenditure handles we have in order to be able to generate fiscal policy that sort of generates happiness. We’re not there yet. We’re getting there probably, but what I did get out of that, what I did get out of the regressions that she was sort of summarizing is that education matters, Social Security matters, employment and income protection and redistribution matter to the poor.

So, if I’m a policymaker, I mean, I have four variables which I can certainly focus on in order to be able to set up and to define the fiscal policy that I want to define. So, in that sense, I looked at the happiness research certainly as a way to generate, to reveal preferences by the people, including the middle class because we can generate the information per income classes.

So, now we get into the politics of this thing and what the political scientists are telling us. And this is Huber and her colleagues had a good time looking at all the economics chapters and led us to the following conclusions. And since I’m being expelled from the chair.

So, they looked at the drivers of the paradox, and they said there is some logic to the way the Nordic countries do things in Europe, and there is a way of making sure that by using the design of fiscal policy, you promote that social mobility.

So, what is it that we could sort of do in order to be able to have a more general application of the model?

The first thing is that they bring back this correlation thing, so, they look at the (inaudible) and they said if you look at the actual distribution of the income classes across the different countries, you realize that without a strong coalition between the white collars, who are very often civil servants, and a bunch of other groups, you will not get the policies that you want in order to be able to generate the redistribution that you want.

So, what could be a system that does this well? Well, I mean, they have a series of suggestions which are quite reasonable, I think.

So, they suggest that you could have a basic flat rate family allowance paid to the lower 60 percent of the income-earners, which you fade out, actually, as people become richer. And you should have a family allowance which is designed in a very careful way, and they argue that conditional cash transfers offer a good option to do this, like we did in Mexico to a large extent. They think about pension because you need to think about the aging population, as well, and they have some specific views of the role of pensions, which needs to be thought through carefully, as well. And this is not just about developing countries, the British research currently has a very strong point, they emphasize brutally the investment in public, pre-school education and primary education.

All of this, they sort of say we need to focus about the reforms of the tax sector. I worked for 25 years the World Bank, and I don't think I can report seriously on any country that did a serious tax reform. A lot of motions, but tax reform was never -- like in 1986 in the U.S., for instance.

Anyway, the point is that with that kind of framework, what they look at at the countries that have followed sort of this guidance, you come up with a story that generates the social mobility that we want.

So, to conclude, it's clear that we have some gaps in the book, but a lot of the gaps were driven by the data we didn't have. In the last two years since the process of book subsided, data has come up, and, so, we should be able do some follow-up work, and I think a crucial component of the additional research that needs to be done is to look at the composition of public expenditures because we worked at (inaudible) macro levels, and I think composition matters a lot more.

Lopez and Torero are doing some work on this. And because we have this new information, actually, it makes it easier to come up with robust results. The fact is that I think it's a hot topic. I mean, I'm quite happy about the fact that a lot of the discussion that we were thinking about two or three years ago are now part of Obama's commission.

I'm working with the CPR in a similar book for Europe, and it's driven by political demands. So, I think it's an interesting topic, but I think it's also important to recognize that economists don't have a monopoly over the dimensions of that matter in terms of generating social mobility.

In France, there is a guy called Chauvel who does incredibly interesting research that compliments what we do. So, political scientists, theologists, and economists have a common interest, which should generate interesting items.

Thank you.

(Applause)

MS. GRAHAM: Okay, well, thank you. It's a pleasure to be here, and this is a result of Antonio asking me what can happiness research tell us about fiscal policy and the middle class? And his answer is sort of accurate, which is not much, but I think it can tell us a bit. Maybe it tells us more about the concerns of the middle class than actually what our fiscal policy choices should be, although, I think it signals what they might be.

So, first of all, what is happiness economics and why would we be applying happiness or the concept of happiness to anything like the concept of fiscal policy because it seems like sort of a non-sequitur.

But, anyway, happiness economics is a new approach that combines the tools and the methods of economists and the large-scale survey data sets of economists with the questions that are typically asked by psychologists. And the idea is that we're trying to get at some broader dimensions of welfare than just income data alone provide. And, for years, economists wouldn't use survey data under the assumption that you couldn't believe what people say because what people say has no consequence. In other words, you can say anything, but there's no consequence to saying it, so, it's not reliable data, and you could only believe what people did based on revealed preferences or revealed choices, and, so, economists used primarily income or consumption data.

But it's very clear, first of all, that what people consume or their consumption choices are, at times, perverse. They may not actually be real indications of their welfare, and, secondly, that there are lots of situations when people don't have a choice, so, they may not be making optimal choices not because they don't want to make those choices, but they're constrained in some way.

So, happiness economics is particularly well-suited for answering questions where revealed preferences don't provide much information, and if you think about, for example, the welfare effects of macro and institutional arrangements, individuals are powerless to change. It's a good example of an area where revealed preferences don't tell us very much.

Take the issue of inequality and think about a poor peasant in Bolivia. Well, what can he or she do to reveal her preferences if she's made unhappy be inequality? Really nothing, but you can find this out in a happiness survey.

And, in other areas, the explanation of behaviors that are not the result of optimal preferences, but of norms addiction or self-control.

So, for example, low expectations among the poor, take somebody in a lower caste in India who's not making certain choices, not investing in the education of their children, that may not be an optimal choice, but merely the result of a norm, a low expectation norm. Or other things, obesity, tobacco addiction. Other things we've been able to look with happiness surveys and measure the welfare effects of these behaviors by basically departing from the assumption that you can only look at revealed preferences information.

So, in terms of this topic, the book, and in the whole area of the sort of fate of the middle class, there are a couple of things that stand out.

One is the disconnect between support from market reforms among the middle class, in particular, but among the public, in general, and the sort of aggregate assessments of their benefits by economists, and we find surprisingly low support for market reforms, globalization. Danny mentioned that people often blame globalization for a lot of ills that globalization may or may not have caused. But happiness surveys can help us understand this disconnect.

And then in terms of fiscal incidents, the surveys give us insights into the relative importance that respondents attach to different things. It might be education versus unemployment insurance or whatever it might be, and I'll give you some examples of this.

And then, finally, if you're just thinking about attitudes about globalization, about the market, about all kinds of things, one of the things that really clearly stands out in my research on happiness, and this is really research around the world, I have my own book coming out actually in a couple of months called *"Happiness Around the World: The Paradox of Happy Peasants and Miserable Millionaires,"* and what we find is that sort of the most consistent levels of unhappiness and frustration are not among the poor in most parts of the world, but rather among the middle class.

And the "middle class," again, is roughly defined as Danny and Antonio both mentioned, it's hard to define it, but within each country, you can sort of tell who's poor and who's near poor and getting to the middle, and, certainly, it’s in that latter group that I find a lot of unhappiness and frustration, and, instead, among the poor, you find a tremendous amount of sort of optimism or adaptation to adverse circumstances. It’s the middle class that have made some gains, that are risk adverse, and that have rising expectations, where we find the most frustration.

So, let me give you some examples. First of all, there’s something in the happiness literature called the “Easterlin Paradox,” which is that Richard Easterlin showed in the 1970s and it’s been repeated several times over that, as countries grow wealthier over time and across countries, across income levels, there’s no clear link between average per capita incomes and average happiness levels.

So, if you look at this chart, it’s rather small, but the blue dots over to the far end, the sort of developed countries up on the top-right of the graph, they’re certainly happier on average than the poorer countries in the bottom-left. But if you look among the developing countries, certainly, you see the wealthier countries over to the top-right are happier, on average, than the poorer countries at the bottom-left, but if you look among the groups of countries, there’s no clear relationship.

So, take Latin America, where I did the first region-wide study of happiness in a large sample of developing countries, there’s no link between wealth and happiness, and some of the wealthiest countries, that's pre-crisis Argentina, are much less happy than say Panama, Guatemala, Honduras.

The whole point is, as countries get above the very absolute poverty line, the plot thickens, and the relationship between income and wellbeing or happiness becomes much more complicated, and it becomes complicated for a lot of things that have to do with the difference between being very poor and moving into the middle class.

And let me give you some other examples. I'm going to skip this for time. It's basically a table that shows that the determinants of happiness are incredibly similar among individuals within countries. And that's the U.S., Russia, and Latin America, and the consistencies across the countries and across regions are dramatic.

Income, on average, makes people happier, but there's linear effect. So, you need some money to be happy, but you don't need a lot of money, and more money doesn't make you happier.

There's marriage makes people happier, employment makes people happier. The unemployed, everywhere, happiness have been steadier less happy on average. Education typically makes people happier, health is a huge issue. Health and happiness are very closely linked.

I could say more about this, but I really want to get to the middle class.

So, this is some work where we were looking at social mobility, a topic that both Antonio and I share, I think, a strong interest in, and peoples' perceptions of their past mobility.

So, we have data on how much mobility people had, and then how they think they've done for the same period. This is Peru, where I'm actually from, and this is a 10-year period where there was a lot of growth and a lot of mobility.

And what did we find? Well, we found that the left axis is objective mobility, percent income change, so how people did, and the right axis is how people said they did, and without trying to disentangle the chart, because it's going to be difficult, it's far away. Over or about half of the people that had the most upward mobility said their situation today was negative or very negative compared to the past.

So, here are people that are having mobility, and they're just saying they're doing badly. For awhile, we thought it could be the day of the survey, we repeated the survey. My coauthor, Richard Webb, is also Peruvian, and we thought maybe it's Peruvians, maybe we're weird. We repeated this in Russia, and we got an even higher percentage of people who had the most levels of upward mobility that said they had done badly.

So, we called these people our "frustrated achievers." So, here they are. They're moving out of poverty, they're moving into the middle class, and, yet, they say they're doing badly.

Well, what explains this? What do we know about the "frustrated achievers?" Well, we know they're at about middle levels of income, they're at average levels of income in both Peru and Russia. They had slightly more income volatility in Russia. That's not the case in Peru. So, even though they moved up the income ladder, it was a rather unstable climb so that if you imagine people being afraid of losing, if their movement into the middle class is full of volatility, you can imagine that might affect their happiness, and if you think of both Russia and Peru, very volatile in the macroeconomic context, that story makes some sense. These "frustrated achievers" are less satisfied with their lives, so, they're less happy. They're less satisfied with democracy and market reforms. They have lower prospects of upward mobility, so, they report their future will be less optimistic, and they have a higher fear of unemployment. And, finally, they were more likely to want to restrict the incomes of the rich.

So, if you think about this, it could be a policy story. Right here, people who are less favorable about democracy and the market, they're less favorable about their future, they fear becoming unemployed, and they want more redistribution. It sounds like a story of an uncertain, sort of newly-prosperous group that is very concerned about inequality, and it's also very concerned about falling back into poverty.

And if you think about the middle class in most emerging markets, that's a story that makes a lot sense. If you've made it to the middle class, there's usually no good social insurance, there are no good safety nets, they're usually, at least in Latin America, but, in many other emerging market countries, there's a fair amount of top driven inequality so that inequality driven by the wealth of those at the very top of the distribution. And you may want to restrict the incomes of the rich. That was the response from Russia, but, as Antonio mentioned, it's not very effective to do so. Most tax systems in emerging market economies aren't very good at effectively redistributing.

So, it could be that out of this happiness research comes a policy story of a frustrated middle class, but let me give you just one warning. Maybe that has nothing to do with it, and there's just a curmudgeon effect. So, every sample of respondents has some distribution of positive and negative responses, regardless of what's on the left side of the axis. So, you're always going to have people that say things are very negative.

Well, indeed, the story is somewhere in the middle. If you looked at a distribution of happiness responses for almost any population sample, you will have some distribution of curmudgeons. I mean, they are going to be, but I think you wouldn't always find them always in the middle class. So, I think there are both a policy story and a happiness story going on.

And, then, finally, these frustrations do matter. We've done some work where we show that happiness is linked to better labor market performance and better health in the future, and unhappiness is linked to less good performance in the labor market and lower health in the future. There's sort of a two-way causality, but these frustrations do seem to matter.

And, then, finally, and most recently, at the macro level, the unhappiness of these "frustrated achievers" is matched by something that we call the paradox of unhappy growth. It's something that Eduardo Lora and I worked on at the Inter-American Development Bank, and then also my colleague here at Brookings, Sumi Acheta Patine and I have worked on, and we find that controlling for people's own income, if they live in a faster-growing country, they're less happy, on average. Now, that seems crazy, doesn't it? But if you think about these "frustrated achievers," who had upward mobility, and, yet, they report they're unhappy. What makes them unhappy? Fast growth often comes with rising levels of inequality, it may come some volatility attached, it may come with changing rewards to different skill sets, all kinds of things that could make groups who have newly-acquired wealth feel very uncertain about that stability.

So, let me show you two, quick slides, and then I'll conclude, that sort of drum home this story.

One is the inequality story. When you think about in the United States all the studies of happiness and inequality show that inequality doesn't make Americans less happy. That was pre-crisis United States. I'd like to see that redone now, but for many, many years, there was this myth of the U.S. of the land of upward mobility and inequality signaled social mobility to most people. In fact, the only group in the United States that's made unhappy by inequality are left-leaning, rich people.

(Laughter)

MS. GRAHAM: So, the U.S. is, indeed, exceptional. But the story is quite different in Latin America, and it's not because mobility levels are that much lower in Latin American than they are in the United States; it's because of what inequality signals. In Latin America, there's still the sense that inequality signals persistent advantage for the rich and persistent disadvantage for the poor.

So, we did a study where we measured the affects of differences in wealth on people’s happiness in Latin America, and we found that the average wealth level for the country in where you lived really didn’t matter to your happiness. It makes sense. That’s kind of the average for your country. But it’s your distance from the average that matters to your happiness.

And, so, what does that mean, just to try and give you a sense of the orders of magnitude of this, if you take this graph, it’s comparing somebody in the bottom quintile in Honduras to somebody in the bottom quintile in Chile.

Now, somebody in the bottom quintile in Chile is twice as wealthy as somebody in the bottom quintile in Honduras, and, yet, they’re made much more unhappy or they are less happy because the distance between their wealth and the average wealth for Chile is much greater than the distance between the poor Hondurans and the average wealth for Honduras. So, that inequality is actually undermining what the potentially positive affects of much higher average level incomes.

And here’s another issue, and it’s a whole issue of unemployment and fear of unemployment. And what we find is that, first of all, as I mentioned before, just being unemployed is a bad thing for happiness. It’s a terrible thing for happiness anywhere it’s been studied.

But the other thing we find, and the charts are sort of too complicated to go through, is that if you're unemployed in a country with more inequality, in a country with a higher Gini coefficient, and this is Latin America data, you're still less happy because you're unemployed, but you're less unhappy if you're in a higher inequality country, and I think there's something about these higher inequality countries where there's more unemployment, and we find that the unemployed are less unhappy when there are more unemployed around them. It's sort of it's more people to play backgammon with, I guess. There's less stigma attached to being unemployed.

But we also find when we divided up our sample into education levels, that the people that were made most unhappy by being unemployed were people with either incomplete secondary education or completed secondary education, and that's pretty much the profile of the middle class in Latin America.

And why would that be? Because if you have university education and you become unemployed, you're probably quite likely to get another job. And if you have sort of incomplete primary education or primary education and you lose your job, again, there are probably lots of sort of low-skill jobs you can move into. But if you have completed secondary education, say you're a public sector worker and you lose your job, you don't have many places to go. There is an insecure middle class in Latin America, and it shows up in their fear of unemployment.

And then, finally, interestingly enough, there's a health story here, too, which I'm not going to go into because I know I'm over time.

And I'll just conclude with a couple of thoughts.

So, one of the things we're finding is that happiness surveys do show us that there's a insecurity, that sort of the data about what's going on in terms of the size of the middle class is sort of matched by a story of an unhappy middle class or an insecure middle class that's concerned about volatility, inequality, that's got a lot of global information. In fact, we find in our studies that people with more access to the media are more likely to think the income distribution in their country is unfair. And it's also that these frustrations may also be a result of rising expectations that accompany, or the growth process.

And, then, if we think about what do these frustrations mean, they do have implications for how we allocate public expenditures. Simply targeting the poor, which may be the most effective public expenditure approach for poverty reduction, may be a very ineffective, long-term tool if it undermines political support for both markets and democracy among the middle class. So, it makes the story more complicated.

Now, a couple of sort of notes of caution before concluding, there are a lot of reasons why whatever we get from happiness surveys shouldn't be applied directly to policy. One is that the success of happiness as a survey instrument hinges on the fact that we don't define it, so, respondents in China and Central Asia and Afghanistan, where I last studied happiness, defined it for themselves, and that's, I think, why we find very consistent results in the determinants of happiness. But if we're thinking about happiness as a policy objective, then we do care how we define it. I mean, if we define it as simply contentment, I'm not sure that many people would think that that was a satisfactory policy objective. There's a definition of happiness as contentment, welfare, and dignity, which is sort of a Zen-like distribution. It seems the more appropriate policy objective, but that's a normative question that we haven't resolved.

A couple of other problems: cardinality versus ordinality, if we're thinking again on enhancing the happiness of all. Well, happiness surveys are just categorical, people put themselves in categories going from very unhappy to very happy, but if we think about policy, do we care more about making somebody who's miserable slightly less miserable or somebody who's already happy very happy? Again, an unresolved normative question. A note of caution about inferring when we find unhappiness among certain groups, translating that directly into policy.

Finally, two other problems, one is something I've called the "happy peasant problem," which is you often have rich people with high expectations, and, perhaps, naturally, unhappy characters, who report they're miserable, and then you can find a very poor peasant, who's living in extreme adversity in Afghanistan, who reports he or she is very happy. How do we compare those data points? I think they're incomparable. So, that's another problem.

And, then, finally, very relevant to fiscal policy are applying happiness research, the fiscal policy is a whole issue of inter-temporal issues. So, policies and behaviors that can make people happy in the short-term, such as inflationary spending or overindulging in junk food, may be very bad for their long-term welfare.

So, risk aversion, natural risk aversion and hyperbolic discounting mean that most reforms will cause unhappiness in the short-term, including fiscal policy reforms. And, so, again, a note of caution about just gauging policy based on people's unhappiness. It may be important for policymakers to know people are unhappy, but that's different from making the leap into basing policy on happiness surveys.

So, I'll stop.

(Applause)

MR. LINN: Thank you very much. (Off mike.)

We now welcome our commentators. I think, so far, we've gotten a good sense of why we'd want to read the book.

(Laughter)

MR. LINN: I think now, for those of us who haven't read the book yet, we want to get a sense of maybe the kind of questions that we would have.

I would turn first to Vinod Thomas, and then to Santiago Levy.

MR. THOMAS: Thank you very much, Johannes, and let me start by congratulating Danny, Antonio, and also Carol for the book, and for focusing our attention on the questions so far, the middle class on income distribution, and the fiscal incidents of policies, all of which come and go, but putting them together, I think, is absolutely timely, a lot of food for thought already, so, my comments complement these points that have been made, and also some additional observations for us to take away.

First, maybe let me just start with the questions that relate to the international, financial organizations since that's a quick point of departure for me. The key question is: Who are the poor, and if the focus on poverty is the fundamental objective. And the question that has been raised, which is absolutely central, is what poverty is defined as and what do we mean by that, and how, even if the focus is on the narrow definition of poverty, which is income poverty or a broader definition of poverty, which is more encompassing, what kind of actions lead to a better outcome, and is it just the focus on certain aspects that are directly connected with the poor and the composition of poverty? Is it focused only on certain income distributions? Or is it broader across sectors and (off mike) groups, which both bring out better developed effectiveness, and, also, improve the poverty situation indirectly, as well.

So, a strong point I want to make here is in very strong support of the book's sense, if not an explicit conclusion, that the broader approach makes sense. It makes sense even from the narrow point of view of greater developed effectiveness for the poor. You can also think of this from a low-income, middle-income perspective. Low-income countries often make the point that the link with the middle-income countries is every bit crucial in terms of improving their policies, institutions, learning across them as much as lessons from industrial countries.

So, from all these angles, and, again, I had many other reasons, my first point would be that the focus on a broader understanding of poverty and the focus on low and middle-income countries make imminent sense, and I lend support to that view first.

Second, there has been some discussion of what do we mean by the middle class? And I think that is kind of important, and it's not something to be dismissed too easily in the sense that what you come up with at the end, and I'll come back to this in a minute, does depend on what definitions you are using.

Using a relative definition of middle class, like relative definition of poverty, you always have a middle class of a certain range in the quintiles. Using an absolute definition, you can get very, very different results, and depending on that, for example, one can say that the OECD countries are witnessing a squeezing of the middle class in some countries. You can think of the *"Stuck in the Middle"* picture relating to that. At the same time, using an absolute definition, you could see the expansion and the explosion of the middle class, you can bring in analogies and images of the dynamic, the growing, the innovator, the taking advantage of the globalization, the reaching out, the reform-minded, all of those sort of images of a middle class.

So, it does matter, and, so, that's where I think on the book's take on it, I would say pushing further on that to see what difference it makes and how that makes a difference would be important.

Now, I kind of slid from middle class to middle-income countries, and that's part of the (inaudible) jargon, but let me just spend just a minute on the middle-income countries.

Are they the middle class of the world? Not really, because they are poor, et cetera, as well, but, in a gross or more aggregate sense, you could think of the low-income, middle-income, and high-income countries. And, in this quick review, you will see the growth patterns quite interestingly looking like an inverted U curve that the low-income countries have grown less fast than the middle-income. The middle-income countries have grown not only faster than the high-income countries and also the low-income.

Now, if you take the view that if you're away from the production possibilities and possibilities of growth, the chances of growing a faster theory would suggest on that basis that growth of low-income countries would be the highest, middle-income countries less high, and then high-income countries lowest.

So, why are the middle-income countries growing fast? Of course, statistically, this is dominated by China, and, more recently, India, but there is something there about, on the one hand, the greater opportunities that you can capture if you're away from where you could be, but, on the other hand, the capacity and the ability of countries to take those opportunities into hand, and that is where the openness of countries coupled with the investments that they make in taking advantage of their opportunities make all the difference.

So, middle class, well, it's not exactly the same as the middle-income countries, but are there some aspects of innovation, growth possibilities, ability to deliver on reform, all of that that can be associated with the middle part of the story, and, in that sense, again, it's a strong support for the line taken in the book that, from various angles, ignoring this group, is at one's own peril.

This is not very legible, but I just put a spotlight on the so-called bricks, including Korea, plus Mexico, that it's not very clear, but there's one point I did want to make, and that is that the one on the Gini coefficient here, you will see that Brazil has dramatically improved income distribution between 1988 and 2008. This is a snapshot of these countries in three decades. So, the third panel is on the income distribution, which is a center part of the book.

In the same period, China and India, to a lesser extent, went exaclty the opposite direction. In this period, the latter countries were growing very, very fast. Brazil also improved growth, although it doesn't come through in this particular panel, but, from a slightly earlier period.

So, worsening of distribution going with the higher growth in East Asia and improvement in distribution not only in Brazil, but also Mexico, so, generally a bit in Latin America is something that we have seen. In this period, the East Asians have seen a dramatic increase in the middle class, as well, so, this raises the question about the income distribution side and the growth side.

So, for a moment, the question is: How has income distribution then been featured across the countries? Inside countries, in the majority of the middle-income countries, income distribution has worsened over the last 15 years. In the same period, across countries, if you think of a country as a unit, the income distribution across countries also has worsened in the sense that a few countries have had high growth, a lot of countries have had low growth, so, the differences across countries has worsened. However, if you look at the world as a whole in terms of the people and you line everybody up in a straight line and see how the income distribution has failed, that has improved in the same period, and that's strongly the effect of China and India, a lot of people have come out of this.

Relating to the book, the question then would be: What do we say about income distribution and growth? I think this graph just shows how to see very clearly that, in Asia, despite the story I told you about China, over a long period of time, growth and distribution have not been conflicting goals as one would have imagined if you had looked at Latin American data more generally. A number of those cases that you see here have had high growth without worsening of income distribution.

Okay, so, let me just leave that there, that there is something to be pursued on distribution and growth, and the size of the middle class, if I were to draw on the East Asian experience, you have a story of growth and distribution going together, you have the more exceptional situation or the more recent high-growth phenomenon, but, in any case, the strong presence and the dynamism of the middle class is what comes through in the high-growth episodes of East Asia.

Then, finally, on the fiscal policy, which is, I think, a key piece of the work, I think the real contribution here is to focus our attention on policy actions as they relate to the questions of distribution and the questions of middle class and welfare outcomes.

On expenditures, quality of cause makes a difference. Targeting, I think some Santiago will probably talk about that makes a big difference, but there is one other thing I wanted to just quickly mention, which is shown in this slide, that the composition of expenditures and who that reaches makes a huge difference. The book has a lot on that, but, in this table, what we have is a ratio of spending on those things that you can call public goods divided by those that you call more private goods.

So, the question is: Where does the expenditure go? Who does it benefit at the end of the day? So, where this ratio of public to private is high, in some sense, it’s got more of a neutral implication on who it benefits, but if the private is high compared to the public, here, and we have looked at this in some greater detail, there is a sense that the public expenditures have a regressive effect.

So, Brazil doesn’t do well in this graph. China does pretty well in this graph in the set of numbers. And, so, the distributional effects of public expenditure is a big deal, it’s not just how much you spend, but who you benefit. This is one cut at this in terms of the use of the public expenditures for supporting public goods versus private goods, and there is quite a lot more that one can say about how that makes a difference to the benefits.

From that, let me go to my final point, and, here, I question to the authors the tone is that the middle class is very important, and you can’t ignore them for a number of reasons, and policies affect in very differential ways. What is the implication of that?

As a way of quickly getting to my conclusion, my sense would be that targeting to the poor has a role, has a huge role, but what is problematic is, I'm setting the taxes aside just for brevity, public expenditures, if either because of the private-public share that I showed or a variety of subsidies that benefit them directly, if they benefit the elite at the cost of the middle class, you have a problem.

And, so, the implication may be less that one has to do something special for the middle class through expenditure policies, but, rather, take away the distortion, the heavy, heavy distortion in some instances that one finds from public expenditure, in the end, being directed to the elite, and, of course, improve their efficiency with which they have reached the poor, which is something on which Santiago has worked a great deal on.

So, just to summarize, Johannes, my main points would be, one, great kudos for focusing on the definition of poverty and the fact that including the middle segment is a very, very important way to proceed, implications for the World Bank, for example, big time.

Number two, distribution matters. I would have gone further to say distribution matters even for the growth rates that you will get, but it does matter, and, so, one needs to look at the policies and their effects on distribution. A very different story from East Asia and Latin America.

And, number three, that fiscal policy is a key ingredient of how you get at this, and there, my sense is that the argument would be in favor of greater neutrality in the efficiency rather than special policies to promote the middle class.

Thank you.

MR. LINN: Thank you.

(Applause)

MR. LINN: Santiago?

MR. LEVY: So, good morning, everybody.

Let me begin by thanking Brookings, and, in particular, Johannes for inviting me here. It's a pleasure to be back again here. Thank you. And congratulating Danny and Antonio for a very nice book. The editors put together a very nice book, very timely. I'll come back at the very end to talk about the crisis and what this implies, but the book is very, very timely, and a book in which I read and actually learned a lot.

So, the first thing I wanted to say is you should read it. I was skeptical of the concept of middle class. I have a lot of difficulty with the concept of middle class, so, when I saw the title, my first reaction is I'm not sure I want to read the book, and then I said, well, I should read the book, and when I read the book and I went through the chapters, I was happy that I did.

My one complaint with the book is a complaint that Vinod already mentioned before, which is this concept of the middle class depends on how you measure it and exactly what you make of it, and whether you take an absolute definition or a relative definition, and in a relative definition, there's always going to be a middle class. They're always going to be stuck in the middle because, by definition, they're in the middle.

(Laughter)

MR. LEVY: So, they're going to be stuck there. There's always going to be somebody between the third and ninth decile of the distribution if that's how you construct the distribution.

In a more sense, so, there's a more subtle notion of middle class that the book actually, I think, does be able to go through, which says the middle class is important because it is the glue of social policies, and, depending on how the middle class behaves, they can either, in some cases, side with the poor and provide more glue to some social policies, in some cases, they might not, and, therefore, might make some redistribution politically unviable, and, therefore, focusing on the middle class is an interesting thing.

So, I actually think the book is successful in doing that, and I think it's not only successful in doing it, but it brings up a very important point.

These are two books in one. There are really two books here. There is a book about the political economy of the middle class and fiscal policy within countries, and then there's another book, there are two chapters about the world distribution of income and the role of countries in sort of the middle class within countries. So, they're really sort of two books in one. I'll speak only about the first book.

I wasn't much acquainted with the literature about sort of the world distribution of income. There are really interesting concepts on how you measure it and what it implies. The two chapters, I learned a lot. But the other chapters, the remaining five chapters of the book, are kind of a self-contained, own little bit.

Antonio mentioned the chapter by Solimano. I want to mention it again because it's a very interesting chapter. It's an interesting chapter in the sense that what it does is it challenges your preconceptions. You think that the middle class is very important because they're very strongly associated with democracy, but Solimano doesn't find empirical evidence to that effect or sort of it's ambiguous. You tend to think that the middle classes are tied to entrepreneurship, but Solimano doesn't find evidence that that's much the case. And you tend to think about this big, public sector unions and the big states and all this stuff, and, again, Solimano doesn't find a lot (inaudible).

So, it's an interesting chapter worth reading because if a book is to challenge your preconception, this chapter does it, and it sort of forces you to think a little bit more deeply about what is the middle class.

The next part of the book are two chapters, one by Antonio and Goldstein, and the other, the last chapter by I think it's Huber, Pribble, and Stephens on the political economy of subsidies. The two chapters are very, very nicely done.

The first observation by Goldstein and Antonio is most subsidies are regressive, so, why are they there, and why would the middle classes support them?

So, they say well, one explanation is the Olsen explanation. Those who pay are distributed all over the society, but those who gain are very concentrated, they have a lot of (inaudible) capabilities, like the (inaudible) in the United States, and they extract all these big rents.

But they introduce another very interesting concept, which Antonio did not mention in his presentation, which is a very nice concept, which is just look, economists have this very narrow idea of things being regressive. If of the total expenditures of the subsidy a bigger share of the subsidy is captured by the higher deciles of distribution relative to the amount of the subsidy captured by the lower deciles of distribution.

Maybe we should think about a concept of relative regressivity, which they introduce in the chapter, which is interesting. He didn't mention it, and I want to highlight, which is subtle. It's nice, it's just look, it doesn't matter. That might not be the best way to think about the redistribution of subsidy, it might be more interesting to think about it in the sense of what share of the income of that household does the subsidy represent? And a subsidy can be regressive in the sense that a bigger share is captured by the upper deciles, but perceived by the lower deciles or even by the people in the middle as very important because the share of their income that the subsidy represents to them matters a lot, and they will provide political support for that subsidy, even if the subsidy is regressive. So, that, I thought, was sort of a very nice explanation worth bringing.

That explanation then says a concept that they didn't say, but I think is implicit in the book, says look, if now you're going to be deciding subsidies and you're interested in the poor, but not only the poor, but sort of the middle classes in this broadly-defined way, leak here is sturdier. That's their point. A leaky subsidy is going to be a more sturdy subsidy because a leaky subsidy is actually going to have political support from greater groups.

Just by the way, I recently read a note by Ravi Kanbur, which is arguing about social responses to the crisis, and Ravi was trying to make the same point, don't try to be too final in the targeting side because if you do that, the political coalition defending that subsidy is going to get smaller, and if you spill it over a little bit, share a little bit with the fourth decile and the fifth decile, push it up a little bit, don't be so stingy you guys in the finest ministry, you're going to be able to pull together a coalition that's going to make the subsidy sturdier, and, therefore, less risky to be cut.

So, that's, I think, the point to make. Not obvious to me. It's interesting, it's an interesting concept, but it's not obvious to me.

And I can only speak from the experience of Latin America, and Vinod talked a little bit about the experience of Asia. I can't really compare, but, from the experience of Latin America, what you have actually seen is, over the last decade, a transition to some subsidies, as generalized food subsidies and other generalized subsides were removed into more focused subsidies that have actually been able to transit from one administration to the other administration to the other administration.

My explanation is actually that the reason that these targeted subsidies, particularly in the poor have been able to sustain politically is that, at the end of the day, they're really not that much money. It's kind of a sad explanation, but it's a true explanation, I think. At the end of the day, Brazil is not redistributing more than .5 percent of GDP. Progress in Mexico is not redistributing more than .4 percent of GDP. It's not that much money. So, it's sort of sustains as long as it's that amount.

The chapter by Antonio and Goldstein makes a very important point, which is the fact that the subsidies are not regressive does not certainly mean that they're redistributive. And this is an important point. We tend to look at the expenditure side of the budget and try to determine whether the net effect of all these subsidies is regressive or not. I think we have to look at the tax sides of the budget, as well, because it's inevitable to ask the question: Who's paying for these subsidies? Unless you do that, you will not come with an accurate answer to the question: Is there really redistribution going on? Because if you only look at the expenditure side of the budget, and all these subsidies are being paid with debt, you're not really redistributing that much or at least you're not redistributing from high-income households to low-income households, you're redistributing from future generations to present generations.

You're doing a lot of from the future to the present, or, important for Latin America, if these are societies with rents, if I am Chile and I have a lot of corporate rents out of Mexico and I have a oil rent with Venezuela or Ecuador, and I'm just redistributing the rents that come from the resource, I'm not really taking away resources from the higher-income households. You are channeling those rents to the lower-income households, but you're not really distributing that much. So, the tax side links need to be looked at a little more.

Let me quickly finish with two comments on the Huber, Pribble, and the Stephens paper, which is a very important paper. The paper deals with what correlations sustain effective redistributions, and they briefly touch on, Antonio did at the end, the question of the broader you make them, the more you make them.

In fact, in my own work now, I'm now more convinced that universality is the way to go, not only because of the political sustainability of these policies, but because many of these subsidies really are not only trying to redistribute income, many of these are associated with the provision of a particular good, health pension that the government wants you to consume, and there are reasons behind the government wants you to consume that. Because you're constrained because of moral hazard, because there are all sorts of behaviors behind them, and these behaviors are distributed evenly across the entire distribution of income, therefore, you must make them universal.

I think the case for universality is stronger when you think about the sort of goods that are being provided by the government. They're not just pure money that is being distributed; it's associated with a particular good. A pension, a health insurance, (inaudible) with the insurance, and I think that strengthens the case for universality.

One minute on Carol's paper because Carol's paper is actually part of the first book.

Carol's paper, in a way, questions the other chapters of the book. Carol's paper, really, the way I like to read it provocatively, you say look, it's really the middle class, it's not really what matters that much. It's the way the population perceives the policies and the way they express their happiness about the policy in particular. And that might be associated with regressive income distributions or they might not, and the contrast between the United States and the perceptions of inequality versus the perception of equality in America is very interesting.

So, Carol's angle on the issue is actually very enriching because it says it might not necessarily be the case (off mike) are there, the poor will support them because they might not feel happy that, and they might not think that this is something that they want.

So, if you went to a Mexican right now and you said look, I have good news for you, the government is going to provide you a pension 30 years from today, the guy would say oh, my God, don't because he doesn't trust the government to do that, he doesn't trust the government is going to deliver that 30 days from today, and because he wants something else.

So, the perceptions of the population of (off mike) are really interesting, and I think the line of research that Carol is doing in terms of understanding other (off mike) political coalitions that support policies beyond looking at the impact of income is a very interesting line of research.

I'm close to the 30 seconds. The book is relevant for the immediate right now, and that's why I think Danny and Antonio did a very good job. Most countries are going to come out of this crisis on a much more difficult fiscal position, and that is going to inevitably force governments to revisit the issue of transfers and to revisit the issue of transfers and to revisit the issue of social networks and the amount of redistribution. And unless the considerations that the book is bringing forth are put on the table in designing policies, you might not end up where you want to. I think taking into account the sort of considerations about the political sustainability, the support to the middle classes, the leakiness of the subjects, and the perceptions of households about these programs will be essential as we move ahead and as talk core issues that literally are on the table in most countries as of today.

So, congratulations, Danny and Antonio, great book.

Thank you.

(Applause)

MR. LINN: Thank you, Santiago. Thank you, everybody. I'm the only one who's done a terrible job here today because I squeezed out the question session. However, I will tax everybody by saying let's add another at least 10 minutes to our program since we started 10 minutes late, I feel relatively entitled to do that, and give you all a quick opportunity to raise questions if you want to, and then leave just one minute for I think our three panelists to respond to your question, as well as to sort of some of the key points they've heard from our two commentators because I think it'd be good to have a bit of a discussion, even though many of your questions may only really come up when you've read the book.

So, I see a hand here. Could you please introduce yourself? And depending on how many questions you get, two or three in a row, and then we'll draw to a close.

Yes?

MR. MORALES: Hi, I'm Cecilio Morales, and I'm with the Employment and Training Reporter.

And one of the things I notice here in all the presentations of the book is it's very timely, but all of you are talking about pre-crisis, and I'd like to hear what would you say about the situation right now, and even about the situation right here in the United States? What would you tell someone on the vice president's panel in the middle class, for example? What has your research told you about that?

MR. LINN: Thank you. Good, challenging question.

Yes, in the back?

MS. KOTIA: Thank you. My name is Nandanie Kotia, I'm an independent consultant, and my question is for Carol.

Why is happiness economics called a new approach to economics because economics has always been rooted in psychology and the notion of utility and wellbeing is very central to economics? The law of (inaudible) utility is a law of psychology, and that underlies the law of demand, which you know is very central in economics.

MR. LINN: Thank you. Anyone else who'd like to chime in?

Yes, in the back?

MS. SARIDE: Hello, my name is Tina Saride, I'm from the World Bank.

I wonder if you have considered the importance of labor unions because I'm from Norway and one of the experiences--100 years ago, Norway was a society with huge income differences, and labor unions were so important to turn a trend, and, if not, I just wonder are labor unions outdated in this setting or could they be part of a solution to create a political environment where redistribution is possible?

MR. LINN: Thank you.

Anyone else? Yes? Thank you.

MS. OSPINA: Thank you. My name is Gloria Ospina. I am a PhD in politics.

I find it a little bit difficult to have the concept of a middle class like a worldwide concept because if you define middle class for developing countries as people having earning from $2 to $13, how would you define middle class in developed countries, mostly America? And the point that I would like to make is, at this moment of the crisis, the implications of the crisis on the American middle class must be much higher than on any developing country middle class.

So, I would like any of you -- I think that Santiago made a similar comment, and also the other person, but I would like some of you just to explain how do you deal with a concept of a middle class which is so much different between an American middle class and let's say Bolivian middle class or even a Mexican middle class and the effects of the crisis?

Thank you.

MR. LINN: Thank you.

And I see one more, and then I'll hand off back to the panel to come back to the comments, as well as some of your questions.

SPEAKER: Hello. I'm from the World Bank. The question is: Where do you see the entry points for these arguments in the development debate because I can see experts in the Bank, in international, financial institutions being very friendly to these kinds of concepts, but I think that in the context of the crisis in particular, donors debates have been focusing a lot, sharply focused on the poor. And the question is: How can these ideas influence that broader debate not just in the Bank, because of the friendliness we have on this topic, but in the broad, donor debate?

MR. LINN: Thank you. Here, I don't know whether Vinod wants to come back to it, but I've seen a few of his reports that his department has produced where they criticize the World Bank's projects and programs quite heavily for not adequately focusing on the poor, and, so, if say health and education (inaudible) aren't actually generating broad gauge growth and are supporting mobility and supporting perhaps also political buy-in by the middle class, you might want to put that maybe more explicitly into your evaluations.

(Laughter)

MR. LINN: Anyway, that you may or may not want to come back to, but let me then turn back to our panelists, particularly the presenters and authors of the book. I think we had a few pervasive questions, and maybe you can focus around them, and then pick up a few others as you see appropriate, given time constraints.

I think the definition issue deserves perhaps a response from one or two of you. Maybe one to start with. I think the question of sort of the entry points of the policy and especially of the crisis right now, you raise specifically in terms of the issue for the U.S. right now. I think you were sort of harking back to that, also, but then the broader question for donors. So, what are we supposed to do right now? Should we focus and target as the donors seem to be doing?

There was this specific question on labor unions, and maybe one of you could address that, and a specific question for Carol.

If two commentators want to come back on anything, we will give them a minute each. But we will now basically give you the last word over here.

MR. LEIPZIGER: I'd like to respond to two of the questions, one about the crisis, and then your question about -- I think in the U.S. context, if I were on the Biden taskforce, one question I would want to look at is what is the incidents of current expenditures, both federal and state by some definition of income, whether it's quintile, decile, whatever. Obviously, some expenditures have no distributional consequences, military, whatever. But I would like to know what that is because, as Santiago said, the fiscal situation in the U.S. can still be worse going forward.

So, we're going to have to be much more efficient in terms of expenditure and we're going to have to generate more taxes. So, at the end of the day, I would have liked to be, as part of this Biden taskforce, able to tell the American public, you sitting here at this part of the income distribution, you currently are paying X in terms of all your taxes, you're currently receiving Y in terms of all government expenditures, and this is how it's going to change, and probably it's going to change for the worst for a large part of the distribution, but you have to be able to explain how you are fairing relatively, particularly if pensions in the future are going to be less or if health expenditures are going to be more, et cetera. People want to know how they fair, and that's where the happiness literature fits in well.

There's some very interesting work on behavioral economics, which shows very interestingly to Carol's work, that people care about their absolute situation, but they care even more about their relative situation. And the classic example is you'd rather have a smaller house if your house is the largest in that neighborhood rather than a bigger house, but everyone else's is even bigger. It seems irrational, but a lot of behavioral economics shows this, that irrational things, actually people believe in.

So, I think the main point there is you have to know who's going to bear the burden, and I don't think we have that well analyzed. Certainly, the public doesn't see that, and there are a lot of subsidies that we don't see, which I think comes to your question.

I think on the middle class on the OECD countries and as one the slides that I showed is different in the sense that this middle 60 percent in most of the OECD countries before the crisis is seeing their relative situation either unchanged or worse. If we impose upon it now the depths of the recession that we're going through, they're going to be more countries in that middle bracket of the chart and they're going to be more that are losing rather than just being even.

Okay, so, I think you are right, that the big change is people in OECD countries whose economic circumstances are worsening. For developing countries, it's a little bit different; it's that your opportunities have just not gotten any better. Okay, so, if you're in the 60th percentile of Bolivia, you're not going to suffer the way the 60th percentile in the U.S. will suffer, but it's, nevertheless, a development issue.

So, the last point I would say on the development and donors question, I think the answer is we need to look beyond the poverty line. I mean, we are focused way too much on getting people from below the line to $1 above the line.

It misses two great flaws, which, of course our poverty people know. One is that people below the line, you can be $1 below the line or you can be a hell of a way away from the line, and it makes a big difference. We have measures of that, but, certainly, in the popular vernacular of work, we look at how many millions went from below to above. We had this recent work that Deepa Narayan did, "Moving Out of Poverty," which shows that there's a hell of a lot of churning going on so that if you look at net numbers, 36 percent in an African country rose above the line, 34 percent over this number of decades fell back below the line, the net is 2 percent.

So, most economists will say well, the poverty numbers haven't changed very much. Well, but, actually, there's been a lot of movement. So, I think from the World Bank's point of view, looking at distribution analysis in the way that Antonio and Markus Goldstein and others have done is relevant because we shouldn't be focused only on this group near the poverty line. If you are in the 50 or the 60th percentile of a country above the poverty line, your circumstances will determine in large measure how affective development will be in this country. So, I think that's the policy lesson.

But I think Antonio and Carol want to --

MR. LINN: Okay. Carol, do you want to go?

MS. GRAHAM: Oh, okay. Just a couple of points. Getting at the crisis and maybe the definition of the middle class question at the same as sort of a funny way to go about it, but I've done some work looking at wellbeing during crisis, and, typically, happiness falls a lot and then recovers over time. The happiness of people that become permanently unemployed doesn't recover very well, but usually sort of average levels come back up.

But I think one issue in particular for this crisis and what it implies for say the middle class in the U.S. versus the middle class in other countries, this brings me to the definitional question. In most emerging market countries, you have a fairly insecure middle class that's used to crisis. It's accustom to volatility, that's lived with changing growth rates and it's just much more of a fact of life if you live in Argentina or in Peru than it is if you're in the United States.

So, I think the impact of this particular crisis on the middle, at least a psychological impact for the average person in the middle class in the United States is probably greater just because they haven't adapted to this kind of uncertainty. They've never had it. So, I think you can look at whatever changes there are in peoples' absolute income levels, you can look at employment changes, and all kinds of other things across the board, and those would have a wellbeing impact, but I think there's also this question of kind of the psychological impact of not having had this kind of insecurity before.

And then the question of happiness, is it new? No, it's not new. I mean, it's Benton and Adam Smith and all kinds of people long ago thought about happiness, and happiness used to be sort of central to economics when it was a more philosophical science, but in sort of the height of neoclassical economics, I think you've had a move to really make the concept of welfare very parsimonious so that you could quantify that. And then I think that involved taking the psychology out of it and sort of you had rational man versus homosapiens, and I think you've had a movement with behavioral economics and happiness economics, a movement back to incorporate psychology back into economics, and I think it's both an interesting and a healthy one.

And then, finally, just to speak to the question of unions, this isn't a topic I know a great deal about, but if you just look at unionization trends in Latin America over the past two decades, unions have gone from being major players to being insignificant players. They're just a percent of the labor force that's unionized with the exception possibly of public sector health and education unions. It's just they're just not relevant players anymore, at least not in Latin America and in most emerging market countries.

MR. LINN: Thank you.

Why don't we draw to closure with your comments? Go ahead.

MR. ESTACHE: Let's start with the union thing. I think the evidence for conditioned economies is very similar, and, in Europe, as you know, the role of the unions, and increasingly focused on very specific activities except for a few countries, including France. But, by and large, I mean, they're no longer the actor they used to be, no way define (off mike).

In terms of the definition, I'm originally from Spain. The unemployment rate, expect to be around 20 percent there soon, so, I think the middle class in Spain is going to be hit quite a bit by this crisis. It's not just the U.S. I think the working class heroes are going to die everywhere. I mean, it's a fairly high condition of cost.

On a more scientific sense, I mean, all of the research that has been done, people like the paper Halian for instance, recently, suggests that the crisis ends us being significantly costlier for the middle class in turn because it increased the volatility of the income in the wealth that I can have.

So, it's a really big issue across the board, in a sense. And the specific definition that you're using, two broad directions of research right now which are taking place, one is one the definition in order to be able to identify the number of people that fit into the middle class. The specific definition that you're using between the broad range of 2 to 13 for developing countries is not that big. The only problem that you have is that you have a huge concentration of people between 2 and 3 than you were seeing earlier. So, there is a story there.

Like within Europe, for instance, that's the second story, CPR is financing a study now on the incidents of fiscal policies in Europe, and the definition of the middle class is also a problem there, and all of the simulations that have been done actually sort of come up with fairly robust studies. I mean, results in terms of incidents of the middle class for a very wide range of definition of the middle class. Why? Because the top decile is so much richer than the rest, and the bottom decile is so much poorer than the rest, I mean, they're disturbing the middle, and it doesn't change a lot.

There's one correction that I would like to place on one of the comments that was made, and it's a recurring theme. I think the incidents analysis of the composition of public expenditures, which is something that Vinod was pointing out to, it's quite essential. I think there are lots of preconceived ideas to what is it that helps the poor and the middle class. It's not social expenditures. Administrative expenditures in the public sector, then to be heavy employers of the middle class, and, hence, generated source of revenue for the middle class.

So, I mean, the highest payoff the help the middle class is not social expenditures, it's education expenditure, to a large extend, but a lot of non-social expenditures, which tend to generate lots of jobs for the people in Europe, for instance.

MR. LINN: Well, thank you very much, Antonio. Thank you to all of you for staying extra. I appreciate it, but I think I don't regret having listened to all of you guys and lady. So, I think you share that perception since you stayed around. Thank you for your questions, and I think it was a well-worth event to have witnessed and been part of. Thank you very much.

(Applause)

MR. ESTACHE: Thank you.

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