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Overview: Fiscal Policy, Distribution, and the Middle Class

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The economics of distribution has long dominated economic policy debates. The issue of income distribution in rich countries has centered on the question of who gains from public expenditures and who pays for them. In the United States, this discourse was aided analytically by the path-breaking work of Joseph Pechman more than thirty years ago.[1] His research at the Brookings Institution helped us understand not only who benefited from what kind of expenditure but also how they stacked up when aggregated across expenditure categories. Work on fiscal incidence has long been a central part of the economic policy debate as well, beginning long before, but aided by, Arnold Harberger and Richard Musgrave and others.[2] One of the outcomes of this analysis in the United States has been a recurring concern for the fairness of the system and, in particular, concern for the extent to which the middle class was being effectively disadvantaged by fiscal policies.

This concern for greater equity in fiscal policies has been a very high profile issue in Europe as well, where the advent of the European Union has placed a huge premium on the reduction of income disparities among members. It may be said that a large share of the significant gains of new entrants is attributable to the expenditure policies of the European Union. This income convergence

1. See, for instance, Pechman (1985).
2. See McClure (1975) for an overview.

within the EU has been mirrored by distributional changes within countries as well.

The incidence of tax and expenditure policies across income groups has had a profound effect on disposable incomes. The Luxembourg Income Study (LIS) reports very large differences between the ex ante and ex post income distributions for the full spectrum of the income distribution.[3] The net result is that while the pretax and transfer distribution of income in France is quite similar to that in the United States, for example, after government intervention, the distribution in France, like much of Europe, is seen to be much more egalitarian.

In a political economy sense, there is a strong argument that the validity of the underlying economic model requires broad public support in democratic societies and that wide disparities in income may give rise to questions about the course of economic policy. Populist policies and populist regimes emerge during periods when large portions of the public feel that they have little stake in the system because of basic unfairness of government policy and economic outcomes that dramatically favor the privileged.

This fundamental preoccupation with distribution has an even greater significance in developing countries, where the gap between the haves and the have-nots is larger and where many of the have-nots have tended to be below the poverty line or other measures of basic economic subsistence. The issue of how the quality and distribution of growth mattered for development was pioneered by Hollis Chenery and others and has remained a core feature of the development discourse ever since, although with some fluctuations of the intensity with which these concerns were recognized as important.[4]

There is currently an intensive discussion in policy circles on the inclusiveness of growth as seen in the cases of very rapid growers, like China or Vietnam, as well as in those countries stuck in low-growth traps, such as Bolivia or Nepal, as well as much of sub-Saharan Africa. Research on the theme of pro–poor growth, perhaps a misleading term, has shown that poverty reduction is clearly unattainable without high and sustained growth performance. However, it also shows that the degree of poverty reduction attainable per unit of growth depends very much on the underlying distribution of income.[5]

3. The Luxembourg Income Study (LIS), a research center and microdata archive, was founded in 1983 by Timothy Smeeding, Lee Rainwater, Gaston Schaber, and a team of multidisciplinary researchers in Europe. With support from the Luxembourg government, LIS and its staff became an independent nonprofit institution in 2002. LIS now includes data from thirty countries from Europe, North America, Australasia, the Middle East, and Asia. The database contains over 150 datasets, organized into five time periods (known as waves) spanning the years 1968 to 2002. See (www.lisproject.org).

4. Chenery and others (1974); Thomas (2000).

5. Bourguignon (2004); Commission on Growth and Development (2008).

The inability of many countries to match the growth, poverty reduction performance, and consequent welfare gains of China has led to renewed discussion of the fairness of the rules of the game, as seen in the collapse of the Doha Round of trade negotiations, the failure to meet the Gleneagles development assistance targets, and the slow progress, particularly in Africa, in meeting many of the Millennium Development Goals (MDGs).

Global as Opposed to National Concerns for Income Disparities

Behind these debates is the central policy question of whether global income disparities are narrowing or not. The convergence hypothesis still has strong adherents; however, the evidence is not overwhelming when the megacase of China is excluded. On balance, researchers do find a case for some modified form of convergence between the rich and the poor nations; yet, the speed is uncomfortably slow. This reinforces the view that globalization is not working for many countries and that the global distribution of income and wealth is not only terribly skewed, but it is also leading to negative economic consequences, be it in the area of illegal migration stemming from Africa, abandonment of market economics in some parts of Latin America, or economic instability in areas of the Middle East and South Asia. This has led to a reexamination of some models of economic development and to a new debate on development orthodoxy.[6]

Recent evidence points to a dual phenomenon of slowly improving income distribution among countries, namely, some global convergence combined with increasing income disparities inside countries (that is, greater inequality among income groups within countries). A recent World Bank report makes a persuasive case that by 2030 global income disparity will increase unless specific global redistributive actions are taken.[7]

Ultimately, what these debates point to is a widespread failure to see the limits of market outcomes that are underregulated, undersupervised, or underscrutinized. Commentators like Joseph Stiglitz have pointed out glaring examples of government inaction, and events surrounding the subprime crisis and its aftermath bear this out in an unprecedented way.[8] It may well be argued that it is a basic function of government to decide whether increasing income inequality is a socially and politically desirable outcome and then to deploy various aspects of fiscal policy to deal with this economic reality. Yet there is a sense that, too

6. See Dani Rodrik's 2006 article "Goodbye Washington Consensus, Hello Washington Confusion? A Review of the World Bank's Economic Growth in the 1990s: Learning from a Decade of Reforms."

7. World Bank (2007a).

8. Stiglitz (2002).

often, governments only pay lip service to this function or deal with it only as crises emerge. New research by Ricardo Paes de Barros and others takes a look at economic opportunity in Latin America in the form of a human opportunity index, which reflects the view that economic disparities arise because of initially unequal, and some would say unfair, endowments (for example, access to education and basic health care) and because of unequal possibilities of the market.[9]

What makes this observation highly relevant today is the interrelationship, real or perceived, between global and national determinants of income distribution. In today's globalized world, many see international events as key drivers of domestic distributional outcomes. Indeed, globalization, according to opinion polls such as the 2007 47-Nation Pew Global Attitudes Survey, is seen by many as the cause of rising income inequality, leading to national opposition to free trade.[10] Additional spillover effects are emerging as opposition to foreign ownership of domestic assets, be they ports and utilities in the United States or national industrial champions in France. The emergence of new sovereign wealth funds adds to the debate.

Thus the link between rising inequality at home and attribution, rightly or wrongly, to international commerce is fueling a current of discontent with globalization that goes beyond the global inequities raised by Stiglitz and others.[11] This discontent threatens to put a brake on further globalization efforts that are positive in a net welfare sense.[12] The policy lever that is missing is the ability of national governments to deal effectively with the "losers" or those adversely affected not only by international forces, such as highly competitive exports, but more generally by firm destruction in a Schumpeterian sense that is essential for dynamic economic progress. If this process of industrial "churning" as termed by Paul Romer were to be slowed by the politics of the disaffected, global welfare gains would actually diminish, shrinking the overall pie and limiting the ability of governments to provide effective economic offsets to the dislocated.[13] Avoiding this outcome is a basic function of fiscal policy, broadly defined to encompass tax and expenditure policy and political economy concerns with distribution. In our view the important proposition is that those we loosely call the middle class are not only affected by economic policy but also are indispensible for any solution to these policy challenges.

9. The Human Opportunity Index (HOI) measures the percentage of available opportunities needed to ensure children's universal access to basic services and their equal allocation. The index ranges from 0 (absolute deprivation) to 100 (universality). See Paes de Barros and others (2009).

10. Pew Research Center (2007).

11. Stiglitz (2002).

12. Spence and Leipziger (2007a, 2007b).

13. See Romer (2007) for an overview of his views (www.stanford.edu/~promer/Economic Growth.pdf).

The Central Policy Role of the Middle Class

For our purposes, the middle class makes up the biggest proportion of the income distribution, those between the 4th and the 9th income deciles, that is the majority of the population, the largest segment of the working public, and the largest group of voters. How this 60 percent of the income distribution fares is central to society's political and social stability. It is also essential to the direction of economic policy. In the roughly fifty years between the end of World War II and the end of the Clinton administration in the United States, the gains of robust economic growth and increased international openness were dominant enough to deal effectively with the job losses in declining sectors. Job creation during the 1990s, for example, was spectacular in the United States, and the additional benefits of expansion reaped enormous welfare gains on EU members. The job of fiscal policy was to provide slight to moderately progressive taxation (for the United States and Europe, respectively) and to finance programs that aided poorer households in the United States and the poorer countries and regions in Europe.

Evidence since 2000, however, shows a disturbing trend, at least in the United States. The rich are getting richer, the poor have seen their circumstances improve, and the middle class has lost ground. In Europe this has not been the case because of large-scale redistribution. In developing countries, there is a large distinction between the rapid growers, where a new and burgeoning middle class has emerged, and those regions where growth has been slow and the distribution of income has either stagnated or worsened. In regions like East Asia and, more lately, South Asia, very rapid growth has created a dual phenomenon of increasing ex post inequality with rapidly declining poverty and movement inside the income distribution toward greater gains for the middle class. Gains are not equal as economic opportunity is unevenly seized—and a strong case can be made for leveling the ex ante playing field by investing more in education and access to economic assets such as land and credit that can provide for better income opportunities. In Africa, Latin America, and the Middle East, however, the overall economic gains have not been sufficient either to alter dramatically the plight of the poor or to offset the inherent advantages of ruling elites, which has led to uneven gains of income growth and distrust of market solutions, domestically as well as globally.

In a wide range of countries, it can be argued, government policy interventions need to be calibrated better to determine who gains and who loses. This is as true for tax incidence as it is for the benefit incidence of subsidies or the distribution of basic government education or health services. Such analysis is exceedingly important for the fate of the poor, the disadvantaged, or those affected negatively by economic change, so that policy design takes their circumstances duly into account. The main drivers of that economic change may well be domestic in origin, based on the advent of new technologies and changing preferences. But the perception of the majority of the population (and certainly the perception reported by the mass media) is different, namely, that globalization is to blame for negative economic impacts of almost any reform.

The competitive forces that destroy jobs are seen by the public to be driven by global supply chains; cheap, and in some cases subsidized, exports; and uncaring governments that allow this to happen. Rather than deal with issues in the context of unfair trade or suspicions of foreign investors, it would be far preferable for governments to deal with these dislocations through effective, well-designed, and distributionally sensitive fiscal policies. This is the basic thrust of this volume of essays.

Policy Choices

Although the theory of public economics tends to be quite clear on the ideal normative approach to the design of fiscal policies, the adaptation of these approaches to the real world may be one of the most underestimated challenges faced by policymakers and politicians. There is no off-the-shelf guide to address some of the basic questions of fiscal policy design, and the policy trade-offs can be daunting.

Should governments spend more on social expenditures or on infrastructure? Should they focus on expenditure and tax policies that support growth or on policies that create jobs or both? Should they make tax systems more progressive or focus on being efficient revenue generators? Should governments deliver public services, or should they privatize as many services as they can? These concerns continue to dominate the political discourse in any developed country. Increasingly, however, the issue of fiscal policy design is becoming a preoccupation in developing countries as well.[14]

One of the important and complex challenges facing fiscal policy is how to manage concerns for redistribution and the associated equity-efficiency trade-offs. How do the choices on the composition of public expenditure influence these trade-offs? The honest answer for now is: we do not really know. While we are able to assess trade-offs at the level of a specific electricity rate change or water regulatory revision or in the design of a specific education voucher program, we do not usually have a very good grasp of the sum of these actions for groups of the population. The cumulative impact of individual programs as they affect the overall distribution is posing a significant challenge to governments as the citizenry expects efficiency and equity.[15]

14. See Adam and Bevan (2005); Perotti (2007).

15. See the World Bank's *Global Monitoring Report* (2007b) and the International Monetary Fund's *World Economic Outlook* (2007).

In practice, much of the debate on fiscal policies boils down to the identification of the winners and the losers. The importance of this identification has significantly increased with the spread of democratic election processes around the world.[16] The democratization process is not the impetus to delve more strategically into fiscal policy choices; however, it does highlight the importance of greater policy transparency.[17] One major concern is the lack of independent studies that analyze the redistributive effects of a given policy, particularly in a world of sound bites, partisan lobbying, and frankly, considerable disinformation.

Political Accountability

From a policy perspective, a key challenge stems from the fact that the desire for stronger political accountability fostered by increasingly democratic processes is often impeded by short political cycles. Typically, these cycles are shorter than the time span needed to realize the payoffs to many fiscal policies.[18] These short cycles force politicians to pay much more attention to the voice of the short-term losers of policies than to the long-term winners. Moreover, because the choice of fiscal policies matters to their election or reelection chances, politicians have strong incentives to focus on individual economic interventions rather than on more comprehensive welfare outcomes. This implies that long-term public policies have to be built around short-term policies, which will get the support of the majority.

Consistency between short-term policies and the desirable long-run policies is essential. Consider the desire to reduce poverty and to redistribute, which is central to many of the political debates across country groups. Time-consistent policies imply that fiscal policies aimed at helping the poor in the short run also have to be helpful to them in the long run. If short-run policies give the wrong incentives to the poor, poverty will continue to prevail, notwithstanding any transitory arrangements that may be adopted by well-intentioned policymakers. Energy price subsidies, for example, tend to gather considerable public

16. Clearly, as pointed out by Haggard and Kaufman (2008), the dynamics of democratization are different across countries. The way democracies emerged in eastern Europe, Asia, Latin America, or even western Europe differ and are bound to influence policy preferences. But these questions are not new. Hirschman and Rothschild (1973), for instance, already were concerned with the political viability of policies under increased democracy and recognized the breadth of experiences that researchers had to account for.

17. See Iversen and Soskice (2006).

18. The election pressure does not come from the national elections only; it also comes from subnational elections. In some countries with a high degree of decentralization, an election at some point can take place almost every year. Brazil offers plenty of evidence of the consequences for policy choices of such a frequency.

appeal, although they are inefficient and, since normally universal in their application, not particularly beneficial to lower-income groups relative to other policy alternatives.

Although the importance of time consistency is generally well understood in policy circles, it is not often central to the decisions of politicians. For many, the decision to do the right economic thing often is driven largely by the political support for these policies. In practice, this means that the long-run viability of some key fiscal policies is likely to be driven by the political process.[19] Recognizing this reinforces the need to be able to analyze the distributional impact of tax and expenditure policies in a coherent and consistent fashion. Populists are able to do this rhetorically, while others face greater difficulties in countering claims with serious precision.

Recognizing the importance of the electoral process in this context, social scientists have started to look for a "representative voter" to assess the viability of specific policies. A standard result in that literature is the widely used "median voter theorem." It suggests that if voters can be ranked along a single dimension (for example, for or against redistribution), if they essentially have a choice between two parties (that is, left and right), and if they have single-peaked preferences in a majoritarian democracy, political preferences will converge toward programs favored by the median voter.[20] In a wide range of circumstances, the median voter represents the middle class. This middle class exists in a wide range of forms around the world, reflecting differences in the relative importance of income, status, or education across countries. With the changes in political regimes observed in the post–cold war period, including the increased power of emerging large majorities in the developing world, it is hard to ignore the important role of this middle class.[21] It is also important to focus on the extent to which the middle class often may own, collectively, the swing vote that will make desirable policies sustainable.

Despite its appeal, the median voter hypothesis is not without problems, particularly in the context of a developing country. In some settings, the decisive

19. See Moller and others (2003) for a discussion of the determinants of the relative poverty and related redistribution experiences in fourteen developed democracies. Their study shows a lot more variance in experiences than expected. See Haggard and Kaufman (2008) for a wide range of experiences of developing economies. See also Iversen and Soskice (2006) for an interesting model of redistribution that explains why some democratic governments are more prone to redistribute than others.

20. See Gruber (2007).

21. One lesson of the twentieth century is that there is a strong correlation between the development of a middle class and a country's economic success. The prospect of becoming middle class has been a major incentive for the poor in the United States since the New Deal, and for the poor in Europe since the Marshall Plan, was adopted. In developing countries, economic success has often been measured as the growth in the income level of the middle quintiles of the income distribution.

voter in developing countries indeed may often be in the richest quintile. In others, the masses of voters may be more unpredictable than assumed by the median voter model, allowing for the emergence of populist governments in which the preferences are not skewed in favor of the middle class. This divergence from the standard result does not imply that the middle of the income distribution is not relevant; rather, it argues for a broader definition of the average voter and a better understanding of the interests of the various actors and of the coalitions they may support. Simply looking at the data for developing countries, for instance, suggests that there could well be a natural coalition between the poor and at least the lower-middle class who together are likely to represent well more than 50 percent of the population and hence be a potent voice in new democracies.

This essential role of the middle class has been recognized by politicians in many regions.[22] It is a recurring theme in the United States or in Europe, but it is also an essential concern in many developing regions.[23] Moreover, it has emerged in a wide range of contexts such as trade, privatization, and pension reform as being critical to public acceptance of reforms. Indeed, many observers blame the recent policy reversals in Latin America on a shrinking middle class.[24] Research on the role of the middle class in East Asia in the context of the post-1997 crisis comes up with similar conclusions, and current estimates of 400 million Chinese joining the ranks of the middle class within a generation add to the topic's policy relevance.[25]

The Middle Class in Fiscal Policy

It is somewhat surprising that the role of the middle of the distribution has not yet been documented systematically in studies assessing the distributional implications of fiscal policy. In spite of a robust literature relying on general equilibrium models to assess the incidence of a wide range of policies, there is relatively little evidence on how the differential effects of various sectoral expenditure policies are shared among various income groups. At the aggregate level, which is relevant when considering the political support for policies, this gap in our knowledge is most pronounced.

22. Although there is a wide range of definitions of the middle class, from economic to sociological, we focus here on the most traditional economic definition that defines the middle class in terms of the income decile the population belongs to. As discussed later in this book, this is itself a subject of debate since there is no consensus on the specific deciles that define the middle class.

23. See Frank (2007) for the United States or Chauvel (2006) for France and Europe. In developing countries, there is a recurring concern for this class; Birdsall, Graham, and Pettinato (2000) provide a useful overview of the economic and political role of the middle class in developing countries for long-term, sustainable market-oriented growth and poverty reduction.

24. See Gaviria (2006) for a recent overview in the context of an assessment of social mobility.

25. Shiraishi and Phongpaichit (2008); Hattori, Funatsu, and Torii (2003), for instance.

Most of the research of the last fifteen years has improved our collective knowledge of the relation between the support for specific policies (in particular redistribution policies), the possible coalitions between the various classes, and the possible veto rights available to the richest income classes.[26] Some of this research has also provided excellent insights on the nature of the middle class, the determinants of its income level, and the other socioeconomic characteristics that define the middle class over time and across countries. However, there have been relatively few studies that have analyzed the interactions of these various strands of research and the design of key fiscal policies.

The expectations of the poor and the lower-income groups of their chances of climbing the economic and social ladders are particularly important. Roland Bénabou and Efe Ok have emphasized the empirical relevance of this idea by testing the prospect of upward mobility (the POUM hypothesis).[27] For the United States, they found that only one-fourth of the households had real incomes above the mean, yet two-thirds had expectations of earning above average incomes. Although the recent deterioration of income distribution in the United States may have altered these positive perceptions, the authors argued that this optimism about mobility should lower the demand for redistribution because individuals with expectations of upward mobility, even if currently poor, anticipate the losses (for themselves and for their descendants) of any future attempt to transfer income from rich to poor. This means that the demand for redistributive fiscal policies is more likely to dominate when the prospects for upward mobility are low for a large spectrum of the distribution. Although this scenario is more likely to happen in a developing country, it is also a clear concern in Organization for Economic Cooperation and Development (OECD) countries as suggested by Robert Frank for the United States, Louis Chauvel for Europe, or Carol Graham for Latin America.[28] All of these authors raise the need to account for distributional concerns of the potential middle class to ensure the support for key fiscal policies in the various countries they study.

The general point of the most recent research may be that while tolerance for inequality seems to be higher where there are perceived prospects for upward mobility, it is very low when there is a perceived risk of downward mobility. These worries about downward mobility are for many observers one of the main engines of the policy reversals observed in many parts of the world. This concern strengthens the argument for governments to invest in comprehensive assessments of how individual fiscal actions and programs collectively hurt or help prospects for the well-being of various income classes. Analysis of fiscal

26. See, for instance, Acemoglu and Robinson (2006); Bourguignon and Verdier (2000).
27. Bénabou and Ok (2001).
28. Frank (2007); Chauvel (2006); Graham (2005); Graham and Felton (2005).

incidence is at the core of a government's legitimacy in the eyes of the public; yet it is not currently a central feature of policy analysis, much less policy decisionmaking.

What Needs to Be Done, especially in Developing Countries?

As is well known, incomes and standards of living depend on individual household decisions, public investments and their distribution, the range of opportunities that society offers (frequently limited by class and caste discrimination, geographical disadvantages, or gender), and overall country prospects.[29] In attempting to raise standards of living, governments often favor segmented approaches, which more than likely are encouraged in the poorest countries that are aid dependent by donors wishing to measure the impacts of individual programs. Countries are pushed even more strongly to follow such an approach when they are guided by an ever increasing list of Millennium Development Goals, well-intentioned international efforts to raise economic and social indicators of well-being.[30] Although impact effectiveness is terribly important for program design, what frequently gets lost in the desire to measure inputs, outputs, and even outcomes is the overall impact on individuals and firms of a myriad of economic policies. The key to determining the overall impact of public policy is having an integrated view that can be provided by distributional analysis that integrates the influences of various interventions that are distributionally non-neutral. The essential first step, of course, is good distributional analysis at the microlevel.

There are many examples of distributional analysis that have served to inform policy decisionmaking. One such example is the reform of the fuel price subsidy program in Indonesia in 2005, in which a general national subsidy that was consuming an ever-increasing share of public expenditure was reduced and replaced by a household income transfer to poor families. After having conducted an extensive campaign to identify poorer households and monthly consumption estimates, the authorities were able to effectively target the income transfers. In other countries, governments have opted to help create wealth for the emerging middle class, a segment of society that might normally have to wait for many generations to generate household assets—Korea, Hong Kong (China), and Singapore have offered subsidized housing to the middle of the distribution, principally the emerging urban middle class. Furthermore, poverty mapping provides a good indicator of where to target essential public services

29. See, for instance, Lewis and Lockheed (2007) for a discussion of how this plays out in the context of girls' education—and overall country prospects.

30. For an unconventional view of MDGs and counter arguments, see Easterly (2007); Leipziger (2008).

and allows governments to avoid the salami approach to the provision of services that has been shown to be less effective than a combination of services in reducing poverty.[31]

There are also numerous examples of poorly targeted programs that have had disappointing results. In Chile, a promising and well-targeted program of education vouchers has failed to demonstrably affect educational outcomes among the lower deciles of the income distribution because of other sectoral and societal barriers that dominate education. Free social services that are not means tested often waste scarce public resources; others that are of poor quality or involve informal payments to ration free services have also failed.[32] Privatization that has not properly dealt with distributional concerns and has focused either on maximizing public revenue collection or even on improved overall efficiency without concern for tariff design has yielded poor outcomes and a harsh backlash to a promising policy idea.[33]

In attempting to integrate the distributional impacts of a variety of programs, methodological challenges arise; however, these can be overcome with the use of, for example, appropriate models (see MAMS [Maquette for MDG Simulations], a new generation of computable general equilibrium [CGE] models, and so on).[34] But a bigger constraint perhaps is the tendency to bifurcate the population into rich and poor. This misses the middle of the distribution that is key to economic success and political support. Hence our concern for those "stuck in the middle" of the income distribution. The middle of the distribution, called for convenience "the middle class" with the necessary caveats added, was key to the successful development experiences of Korea, China, Malaysia, and Vietnam, as well as other fast-growing economies.[35]

Successful politicians and technocrats have used multiple interventions to affect economic outcomes and also have focused on the emerging middle of the distribution. In the same way that economy-wide policy packages were adopted to yield success in international markets, the fast-growing economies of East Asia focused attention first on the middle of the distribution in terms of access to jobs, housing, and education, later moving to health, pensions, and other social goods.[36] Even if a formal integration of fiscal actions may have been lack-

31. See Chong, Hentschel, and Saavedra (2004); also Bedi, Coudouel, and Simler (2007).

32. See Lewis (2006) on informal payments in health.

33. See Estache, Gonzalez, and Tujillo (2007).

34. Bourguignon (2004) offers a very readable overview of these various methodologies. MDG is Millennium Development Goal.

35. Country case studies for the Commission on Growth and Development are available at (www.growthcommission.org), including Hoffman and Wu (2008) on China, Yusof and Bhattasali (2008) on Malaysia, and Rama (forthcoming) on Vietnam. See also Leipziger (1988, 1997).

36. See Rodrik and others (1994).

ing, there was implicit recognition of the role that expenditure policies, if properly targeted, would have on the standards of living of the bulk of the population. Much of this was dependent on robust tax collection efforts, which are a sine quo non for distributionally sensitive expenditure policy.[37]

The integration of tax and expenditure policies with distributional analysis is a challenge in developed and developing countries. In developed countries, the integration of policies with analysis is a main driver of political outcomes, as the most exposed populations expect to benefit from public expenditures and to be protected from economic shocks. That is only possible if redistribution from rich to middle-income groups and to the vulnerable exists. If the middle pays a lot in taxes and the rich benefit, as is the perception in the United States today, then one element of social cohesion, not to mention support for economic change, is eroded.[38] In developing countries, in which the main challenge is to lift the majority of the population to a higher standard of living while also directing special attention to the poor that are left behind in any sea change of economic fortunes, the support of the middle class oftentimes is unsought by the ruling elites. This is a grave error in the long run and can lead to serious political reversals. Smart fiscal design and implementation are key drivers, in our view, of successful economic policy formulation.

The Politics of the Paradox of Redistribution Once More

Because the prospects of the middle class appear to be so central to the sustainability of policies aimed at supporting the poorest, there is a need to document more systematically the extent to which governments respond to the concern of the middle class. It is important that public documentation focus on the overall effectiveness of fiscal policies in meeting the needs of the various income groups.

In analyzing developed Western economies, Walter Korpe and Joakim Palme argued that the risk is that the more government targets benefits at the poor and the more concerned the government is with creating equality through equal public transfers to all, the less likely government will, in the end, reduce poverty and inequality.[39] According to them, this paradox is the outcome of three basic circumstances: the size of the redistribution budgets tends to depend on the welfare state institutions rather than on the needs; there is often a trade-off between the extent of low-income targeting and the size of redistributive budgets; and when large shares of the population, in particular the poorest, do not want or do not have access to private insurance, market-dominated distribution tends to be even more unequal than that found in earnings-related social

37. See Moreno-Dodson and Wodon (2007).
38. See Frank (2007).
39. Korpe and Palme (1998).

insurance programs. So even if the intention is to help the poor, real-world institutions and incentives have been such that they have failed to deliver on their initial intentions to help the poor, and often possibly some of the middle class as well. Of course, the specifics will vary across countries since they have different budget constraints, different institutions, and different capacities. Nevertheless, we would argue that there is a risk that for those societies that need it most, because of their relatively high levels of inequality, adequate support for redistributive measures is lacking, particularly if the middle-class role in building the necessary political support is ignored.

This paradox of redistribution is to some extent a core concern of this book. A substantial body of research suggests that the standard policy recommendation to target social policies to low-income groups is not proving effective; at the same time, very little research looks at how policies aimed at protecting the poor and, at the same time, the most exposed middle class can be coordinated for the good of both groups. In fact, very little attention is given to the degree to which the demands from these two groups converge. Somehow, the analysis of the role of the state has been dominated by normative concerns and has ignored some of the most relevant positive evidence that tends to drive or should drive policy decisions. When accounting for fiscal constraints, politics, and institutions, how can governments respond to the widest range of needs in a sustainable way? One argument running through this volume is that expenditure incidence across the full spectrum of the income distribution needs to be explicitly undertaken, and the results need to feed directly into policy formulation.

As public assessments of policy performance become more widespread around the world, the vote of this forgotten middle is bound to become more important to the design of policies. In that case, policies that are good for long-term growth and long-term poverty reduction should, we argue, also be pro–middle class. This is one key assumption that underlies the analysis of much of the research in this field, including each of the chapters of this book.

The challenges in testing this assumption are not minor. The first concern is the absence of high-quality, comparable data. This impedes rigorous diagnostics and also encourages partial assessments of fiscal incidence policies. The second is the large disparity in initial economic conditions and economic potential across countries, both developed and developing, which sometimes forces simplifications in interpretation that are unfair to the local circumstances. The third challenge is the large heterogeneity of political preferences for either efficiency or equity, preferences that tend to drive the support for specific policies but that lack the sort of aggregation that we advocate in assessing real impacts on target income groups.

The final challenge may be the diversity of views among social scientists on the relative importance of the middle class. We believe that the economic and political importance of the middle class and its evolution is a central research area for economists, political scientists, and sociologists. We are of the view that the sustainability and effectiveness of fiscal policies will affect a broad class of national and global policy strategies. We believe that globalization trends and the future trends in trade, flows of ideas, and migration will revolve in large measure around the manner in which nations deal with domestic equity and economic opportunity. The role of the middle class in setting this course in developed and developing countries will strongly determine the future pace of globalization and indeed will often drive it.

Being able to leverage the global economy is one of the key findings of *The Growth Report,* recently released after a two-year study of an independent Commission on Growth and Development led by Professor Michael Spence. For the vision of sustainable and inclusive growth to take hold, societies must believe that their investments will pay off and that government will deliver a higher standard of income in the future. Thus government must be credible to the majority of the public, and a good deal of that credibility will come from broadly available social services, job creation for a new industrial sector, and visible symbols to underpin future income expectations. The key instruments involve fiscal policies, and these cannot in the view of the commission be divorced from growth dynamics. Indeed, this volume proceeds from the premise that fiscal incidence analysis is necessary to create the political and economic underpinning of viable growth strategies.

This Volume's Contribution to the Debate

The book starts with an overview of stylized facts on apparent winners and losers of fiscal policies based on a simple review of basic statistics on aggregate government expenditures. Unless governments develop some sense of how the individual fiscal programs collectively hurt or help the well-being and the prospects of various income classes, they will have a limited ability to generate the necessary support for long-run policies that are beneficial to the nonelites. This is simply because they will not be able to assess the risks of rejection by some income classes, pressure groups, or coalitions who, on average, do not benefit from fiscal programs.

Looking at aggregate programs can, however, be deceiving. Although there are commendable efforts underway to improve assessments of individual programs using impact evaluation techniques, the ability of societies to look at the big picture is not as coherent. As observed in many countries, governments design specific programs that provide support for specific populations on specific needs (for example, local jobs, education, or health vouchers). However, these necessarily do not improve overall well-being very much, since the interventions are partial in nature and do not take interaction effects sufficiently into account.

Consideration of the overall effectiveness of aggregate programs is needed, however. Increasingly, governments are indeed being held accountable for the success of their individual and collective fiscal programs as well as for the degree to which programs are fair, as perceived by their citizens. All this argues for a broader look at public policy impacts across programs and across income groups.

In chapter two, Andrés Solimano focuses on the main dimensions of the role of the middle class in the development process. The chapter analyzes simple correlations, but it generates a very powerful picture of the main empirical regularities of the behavior of the middle class across countries. It focuses on its size, its role in the labor market, and its role in determining the size of the government. Ignoring the complex issues associated with the definition of the middle class, he suggests, given the evidence reported, that the more recent evidence validates and reinforces previous statistical assessments of the role of the middle class.[40] The stylized facts reviewed by Solimano show that, overall, the middle class appears to be more than ever an essential feature of politically sustainable economic development. This assessment results in a strong case to argue for a central role for the design of fiscal policy—even if it is not clear whether the middle class *leads* the process of economic development or rather *follows* it (or whether both evolve jointly). However, Solimano also shows why it is easy to underestimate this role. For instance, simple correlations find only limited entrepreneurial power (in a Schumpeterian sense) of the middle class, particularly so in low-income nations, or only a limited association between it and the evolution of the labor market, which may explain why many policymakers may have ignored the middle class. They also fail to recognize, for instance, that the income–middle class relation with per capita income is stronger (higher coefficients of correlation) for the lower-middle class than for the upper-middle class.

That hints at the need for policymakers and politicians to better recognize the heterogeneity of the middle class and hence government's ability to work on a broad range of coalitions to raise well-targeted policy concerns. For many fiscal policies considered while in crisis and at lower stages of development, the coalition between the poor and the lower-middle class is often the most likely one among all possible coalitions. That is because in these situations their economic interests are relatively aligned. In practice, that coalition would range from the percentiles 1 to 60 and hence represents a significant potential voting majority.

But this political leverage cannot be managed simply through government spending in an effort to buy votes. Indeed, Solimano, as well as Evelyne Huber, Jennifer Pribble, and John Stephens in their chapter, also shows that the correlation between the share of the middle class and the overall size of government, in

40. See, for example, Birdsall, Graham, and Pettinato (2000).

general, is not very strong and varies across countries ordered by income per capita levels. Moreover, an analysis of the composition of public expenditures reveals that categories of social expenditures, such as education, health, and perhaps housing, are in general not as redistributive as often claimed. As discussed in Markus Goldstein and Antonio Estache's chapter, all too often, only small proportions of these expenditures reach the lower-middle class and the poor. The main policy instrument to support that broad coalition seems to be more encompassing social protection programs.

In chapter three, Maurizio Bussolo, Rafael De Hoyos, and Denis Medvedev offer an interesting twist on the debate of the importance of the middle class, focusing on its importance at the global level. The interest of this approach is that it recognizes that globalization has increased global awareness, which in turn makes people more aware of income disparities at the global rather than at the national level. This is bound to result in political pressures on government policies. With that concern in mind, the third chapter presents projections of the global income distribution likely to emerge under the most likely GDP and population growth scenarios. Their simulations validate the need to consider the political economy arguments in assessing the role of the middle class and its importance for targeting fiscal policies. They show that three-quarters of total world income is controlled by only one-quarter of the world's population, implying that three-quarters of the population are likely to be unhappy with their fate unless they see credible prospects for some upward mobility. These political concerns are all the more likely to matter if one believes that even in a fairly optimistic growth scenario for the next two decades, during which, as a result, global inequality will drop, *within*-country income disparities are very likely to widen. And this is likely unless specific policy actions are taken to avoid this deterioration in income distribution. The authors suggest that this result may point to the need to revisit the balance between global and country agendas and to emphasize the case for an increased recognition of the importance of the shrinking middle class at the country level at a time when the middle class seems to be growing at the global level.

The risks are high since specific groups of people within countries may not be able to adjust to the resulting new wave of globalization and may be left further behind. Worsening in-country inequality can increase the risk of social alienation of people at the wide bottom of the distribution and hence the rejection of policies desirable to promote sustained, shared, long-term growth.

The effort to stimulate or reinforce the emergence of the global middle class in the transition to this long-term goal may be an effective solution to mitigate the risk of rejections of otherwise desirable policies. Bussolo, De Hoyos, and Medvedev suggest that under current policies, the share of this class in the global population is likely to more than double in the next twenty years. Since they will move closer to the median voter in many of today's developing countries, they potentially will play a much more important role in fiscal and international policies.

Ultimately, the main message in their chapter may be that governments cannot afford to ignore the need to address equity concerns when designing efficiency-oriented policies. Although trade-offs will inevitably arise and often these will be country specific, the necessity of equity-enhancing policies is likely to increase with the increased global power of the middle class.

In chapter four, Goldstein and Estache offer an overview of how effective subsidies in general have been at dealing with these growing distributional concerns. The chapter also offers an overview of what subsidies are and how they are designed to work, in particular to help specific income groups, and concludes with some advice on how to pick subsidies under a wide range of informational and capacity constraints. The experience reviewed suggests that subsidies continue to be one of the most common instruments used to implement targeted support to specific social groups, as suggested by Bussolo and his coauthors.

However, Goldstein and Estache show that although clear rationales for subsidies as an essential fiscal policy instrument to address redistribution concerns exist in economic theory, the practice often does not deliver on the promises. Many of the subsidies in the developing world are indeed often regressive, and many in the developed world have an unclear incidence. They argue that political economy is the major driving force for this unclear or undesirable incidence.

Although many subsidies are indeed regressive in an absolute sense, when viewed from the point of view of the pocketbooks of poor and middle-class voters, they are, however, often a relatively important source of income as well. This is why these groups will continue to provide political support for these subsidies. Moreover, in spite of their regressivity, politicians seem to recognize that some amount of leakage to the middle class likely will continue to be necessary to sustain support for a subsidy that actually does target the poor disproportionately. Well-targeted subsidies that only favor the poor will not get the political support of the middle class unless they get some of the benefits as well. In other words, the political logic will often give a significant role to the middle class in ensuring that the poor get their fair share of the subsidies, even if this share is lower than the economic logic would have expected.

In chapter five, James Davies reviews the evidence on the global distribution of wealth and discusses whether there is potential for policies that will build household wealth for the poor and the middle class. He looks for policies that will win majority electoral support, recognizing that middle-income groups in low- and even most middle-income countries are not truly middle class. Davies's contribution is to show that although subsidies—in particular for health care and education—are essential, there are far better interventions to deal with the concerns of the middle class, and in particular to build up middle-class wealth, than subsidies. His review of the international experience suggests that fiscal policies and institutions that allow the middle class to build and maintain wealth are instrumental in coalescing support for policies and programs that in the end are effective in fighting poverty.

Although his survey is wide ranging and generally optimistic, he points to the challenges caused by deficiencies in land administration, underdeveloped financial institutions, and a lack of mortgage insurance and loans for home buying or building that allow people to acquire the quintessential middle-class assets such as private housing.

Davies also makes the case for further development of savings opportunities and mortgage finance. He argues that fostering competition among financial institutions and making certain that microfinance organizations are not impeded is very important, as is ensuring that tax-sheltered savings vehicles are available for the full range of saving purposes. To make housing finance effective, it is important to have effective land administration (and in many countries land reform), the possibility of mortgage foreclosures that are not too expensive to enforce or too long delayed, and a system of mortgage insurance to make possible low down payments without threatening the stability of the lending institutions.

In chapter six, Carol Graham offers some insights on the scope and limits of the recent research on "happiness economics" that is conducted to get a sense of the demand, and hence the support, for public services by the population. This innovative area of research offers unique new insights that have the potential to guide policy decisions. By understanding the preferences of voters, politicians may be directed into particular aspects of taxation and expenditures that are most highly valued by the public. Even if pure distributional analysis yields different rank orderings of interventions, actual societal preferences can explain why some European economies, for example, seem to attain greater social content.

Graham's contribution to this volume is to show that the limitations of happiness surveys—and economics—are stronger than their potential to guide fiscal choices. Happiness studies can provide critical insights into the determinants of human well-being, in areas ranging from income, poverty and inequality, public health, and fiscal policy. The studies thus provide a tool to assess the relative weights that particular populations—and socioeconomic cohorts, including the middle class—attach to various public expenditures, such as health, education, and social insurance, which can, indirectly, help inform the design of fiscal policy. They also highlight high levels of frustration, particularly about insecurity and inequality.

However, for a wide range of reasons reviewed in her chapter—data, techniques, and theory—caution is necessary before directly applying the results of happiness surveys to policy and, in particular, applying them as a basis for the design of fiscal policy. For instance, she shows that because people are loss averse, more expenditure on social insurance and safety nets may result in higher reported happiness. However, because of intertemporal problems, the same surveys cannot yet guide how much policymakers should *trade off* these kinds of expenditures for those with longer-term returns, such as children's education or retirement savings.

Although the previous chapters were written by economists, the main reason why the middle class should matter to the design of fiscal policies is their steadily growing political importance at the local and global levels. The need to recognize that politics should drive some of the choices of which economic instruments to use seems to be the main message so far. The last chapter is the only one written by political scientists.

In chapter seven, Huber, Pribble, and Stephens offer a political take on the design of fiscal policies. They first survey the literature comparing the political sustainability of welfare systems and then assess the viability of welfare policies that are targeted to the poor but that ignore the middle class.

In the Latin American context, they argue that an effective redistributive social policy regime that is politically sustainable and that would build up the right coalitions would consist of basic flat-rate family allowances paid to the lower 60 percent of income earners, which are then slowly faded out between the 60th and 80th percentiles. Thus they define the middle class as having a fairly wide range of income.

However, Huber, Pribble, and Stephens also argue that money transfers alone will not serve their intended purposes. They argue that allowances should be tied to compliance with other important social concerns. For instance, tying allowances to school attendance and medical checkups for the children or to job training for unemployed recipients and integration into public sector jobs would have desirable social payoffs. It would include basic flat-rate "citizenship pensions" for the same income categories, supplemented by a mandatory public earnings–related notional defined contribution system for the entire population. It would further include investment in public preschool and in free, high-quality public primary and secondary education, as well as a unified public health care system with free access for the lowest three quintiles and an income-related fee structure for the other two quintiles. If all of this is financed by proportional taxation, it will be massively redistributive, as demonstrated in the appendix. This is true even if the benefits accruing to the second and third quintile are somewhat higher than those for the first quintile, and even if benefits reach into the fourth quintile on a declining basis.

The key, then, is to build social programs that are effective at reaching the poor, but which do not become "poor people's programs" because they entail basic rights to transfers and quality social services for lower, working, and lower-middle classes. This is not an easy task. Moreover, factors such as campaign finance, the media, and interest groups strongly shape the behavior of politicians and parties as well and may threaten the sustainability of some reforms.

Challenges Ahead

This collection of papers makes a strong case for a return to past efforts to spend more time thinking about the composition of public expenditure rather than simply focusing on levels of expenditure. Recurring fiscal crises often tend to focus concerns on the need to cut aggregate expenditure levels. The research reported here suggests that the popular support for desirable efforts to cut aggregate expenditure levels will often require a much better awareness of the political importance of specific expenditure categories. This support is needed to ensure the long-run sustainability of fiscal reform packages covering a wider range of public sector activities. In particular, the authors in this book make a strong case for the political importance of social expenditure in that context.

Ultimately, what the various chapters show is that because politics will drive the sustainability of fiscal policies, fiscal policies need to recognize the politics of distribution up front. In particular, policies need to recognize the coalitions that currently drive and will increasingly drive the politics of distribution. All evidence points to an acceleration of the central role of the middle class as a driver of these coalitions in developed and developing countries. The economic importance of the middle class will be such that it will not only drive local politics and hence policies, but that it will also increasingly drive global politics and policies as well. The adage of thinking globally and acting locally may well require an additional reverse perspective, namely, that to act responsibly globally also requires responsible local actions as a prerequisite. If those who feel "stuck in the middle" are indeed underserved by public policies at home, their voice will carry a clarion antiglobalization cry that will diminish economic welfare for them and others. This is the outcome that needs to be avoided.

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