Do Middle Classes Bring Institutional Reforms?

When the middle class grows in size, social policy becomes more active and the quality of governance improves

The question of how the middle class affects institutions and the social contract has received wide attention. Most empirical analyses have focused on the middle class as a relative position in the income distribution, demonstrating that lower inequality and a larger "class in the middle" lead to better institutional outcomes. Yet middle-class status is defined as much by people's absolute income and ability to escape poverty as it is by their relative position. Indeed, many of the positive effects of middle-class societies emphasized in the theoretical literature depend on people exiting poverty and earning higher incomes rather than on their relative position in the income distribution.

Theoretical models postulate a positive effect of a larger middle class on economic and social outcomes through two main channels. A first channel emphasizes the effect of middle-class endowments and preferences on economic growth. Some studies suggest that members of the middle class are less vulnerable to the credit market imperfections and fixed costs in physical and human capital accumulation that prevent poor people from investing and building up assets. Others highlight the importance of domestic markets for industrialization and the importance of a higher demand from the middle class for quality goods.

A second channel of the theoretical literature directly explores the link between the size of the middle class and institutional outcomes. Particular attention has been given to the "modernization theory," which looks at the extent to which more affluent societies favor the creation and consolidation of democracies and good institutions. Conceptually, higher incomes may reduce conflict over the distribution of income, and citizens with higher human capital may be more effective in sustaining good institutions.

A new paper by Loayza, Rigolini, and Llorente makes two contributions to the literature. First, it presents a new panel data set that contains information about inequality, the mean income and expenditures of households, and headcount indexes for several income and expenditure thresholds. The data set, which spans 672 yearly observations across 128 countries, complements existing large cross-country data sets reporting poverty and inequality measures. To build the data set, the authors drew both from a collection of nationally representative household surveys and from parameterized distributions of income and expenditures using parameters from the World Bank's PovCal database. Second, the authors use this new data set to test the extent to which policy and institutional outcomes are affected by an expansion of the middle class, which they measure as the share of the population who have achieved income above $10 a day (adjusted for purchasing power parity).

The effect of a larger middle class on social policy and governance appears to be more robust than the effect on the same outcomes of lower poverty, lower inequality, and higher GDP per capita

The joint endogeneity of the size of the middle class (and of the income distribution in general) is a concern. So is the likely presence of unobserved country-specific effects. The authors use an econometric methodology that, by taking advantage of the panel nature of the data, attempts to gauge the causal effect of expansions of the middle class while controlling for country-specific effects.

The authors estimate the effect of the middle class on policies and institutions in three broad categories: social policy relating to public expenditures on health and education, market-oriented economic policy on international trade and finance, and quality of governance relating to democratic participation and absence of official corruption. The analysis thus also relates to the literature investigating the association between poverty, institutions, and growth.

The findings show that when the size of the middle class increases, social policy on health and education becomes more active and the quality of governance relating to democratic participation and official corruption improves. This does not occur at the expense of economic freedom, as an expansion of the middle class also implies more market-oriented economic policy on trade and finance. The effect of a larger middle class appears to be more robust than the effect on the same outcomes of lower poverty, lower inequality, and higher GDP per capita. Overall, the findings suggest that the expansion of the middle class can play a part in reforming government policies and institutions to promote economic development.

Norman Loayza, Jamele Rigolini, and Gonzalo Llorente. 2012. *"Do Middle Classes Bring Institutional Reforms?" Policy Research Working Paper* 6015, *World Bank, Washington,* DC.