Economic Mobility and the Rise of the Latin American Middle Class

Overview

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This booklet contains the Overview as well as a list of contents from the forthcoming book *Economic Mobility and the Rise of the Latin American Middle Class*. To order copies of the full-length book, published by the World Bank, please use the form at the back of this booklet.

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Cover design: Naylor Design
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After a decade marked by sustained economic growth—despite the 2008–09 global financial crisis—and declining inequality in many countries in Latin America and the Caribbean (LAC), it is time to take stock of the region’s broad socio-economic trends. Moderate poverty fell from more than 40 percent in 2000 to less than 30 percent in 2010. This decline in poverty implies that 50 million Latin Americans escaped poverty over the decade. But which workers and households succeeded in leaving poverty, and which did not? What happened to those who left poverty behind? Did they all join the region’s growing middle class? What are the implications for public policy?

To address these questions, Economic Mobility and the Rise of the Latin American Middle Class exploits a unique combination of data sources, ranging from multiple household surveys and student achievement tests to surveys of attitudes, opinions, and beliefs, to shed light on the social transformation going on in Latin America in this new millennium. It proposes a new definition of the middle class based on economic security and applies it to most countries in the region. The report also investigates economic mobility, both within and across generations, to understand the drivers of success in escaping poverty.

The result is a nuanced picture. On the one hand, in most countries in the region, while intergenerational mobility has improved, it remains limited: parents’ education and income levels still substantially influence their children’s outcomes, and this appears to be true to a greater extent than in other regions. On the other hand, mobility within generations has been significant. At least 40 percent of the region’s households are estimated to have moved upward in “socio-economic class” between 1995 and 2010. Most of the poor that moved up did not go directly to the middle class but rather joined a group sandwiched between the poor and the middle class, which the report calls the vulnerable class and is now the largest class in the region.

Still, the Latin American middle class did grow and very substantially: from 100 million people in 2000 to around 150 million by the end of the last decade. The emerging middle class differs, of course, from country to country, but there are a number of common threads. Middle class entrants are more educated than those they have left behind. They are also more likely to live in urban areas and
to work in formal sector jobs. Middle class women are more likely to have fewer children and to participate in the labor force than women in the poor or vulnerable groups.

This report will certainly stimulate the debate on the implications of these new trends—for the functioning of the economy, for policy priorities, and for the performance of democratic institutions. While LAC is now on the path to becoming a middle-income region, much remains to be done. Regional leaders will need to continue to devote considerable policy attention to the one-third of Latin Americans who remain poor, while seeking to promote the security and prosperity of those who are vulnerable.

Hasan Tuluy
Vice President
Latin America and the Caribbean Region
This report was prepared by a team led by Francisco H.G. Ferreira, Julian Messina, and Jamele Rigolini, and comprising Luis Felipe López-Calva, Maria Ana Lugo, and Renos Vakis. Important additional contributions were made by João Pedro Azevedo, Nancy Birdsall, Maurizio Bussolo, Guillermo Cruces, Markus Jäntti, Peter Langjouw, Norman Loayza, Leonardo Lucchetti, Nora Lustig, Bill Maloney, Eduardo Ortiz, Harry Patrinos, Elizaveta Perova, Miguel Sánchez, Roby Senderowitsch, Florencia Torche, and Mariana Viollaz. The team was ably assisted by Manuel Fernández Sierra, Gonzalo Llorente, Nathaly Rivera Casanova, and Cynthia van der Werf. The work was conducted under the general guidance of Augusto de la Torre, LCR Chief Economist.

The team was fortunate to receive advice and guidance from four distinguished peer reviewers: François Bourguignon, Gary Fields, Philip Keefer and Ana Revenga, as well as from a panel of advisers comprising Nancy Birdsall, Louise Cord, and James Foster. While we are very grateful for the guidance received, these advisors and reviewers are not responsible for any remaining errors, omissions or interpretations. Additional insights from Barbara Bruns, Michael Crawford, Wendy Cunningham, Rafael de Hoyos, Anna Fruttero, and Alex Solis are gratefully acknowledged.

We are also grateful to the individuals and organizations that hosted a series of consultations undertaken in the spring 2011, including (but not restricted to) Leonardo Gasparini (CEDLAS), Alejandro Gaviria (Universidad de los Andes), Miguel Jaramillo (GRADE), Eduardo Lora (IDB), Patricio Meller (CIEPLAN), Marcelo Neri (CPS-FGV), Rafael Rufman (World Bank), Isidro Soloaga (El Colegio de México), and Miguel Székely (Instituto Tecnológico de Monterrey). Thanks are also due to our hosts of the Institute for Economic Analysis (IAE), Barcelona, where a mid-term conference was held: Joan Maria Esteban, Ada Ferrer-i-Carbonnel and Xavi Ramos. The team would like to acknowledge financial support from the Government of Spain, under the SFLAC program. Book design, editing, and production were coordinated by the World Bank’s Office of the Publisher, under the supervision of Patricia Katayama, Nora Ridolfi, and Dina Towbin.

Last but not least, we thank Ruth Delgado, Erika Bazan Lavanda, and Jacqueline Larrabure Rivero for unfailing administrative support.

This report is dedicated to the memory of Gonzalo Llorente.
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<td>CCT</td>
<td>conditional cash transfer</td>
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<td>ELTI</td>
<td>mobility as equalizer of long-term incomes</td>
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<td>ESCS</td>
<td>economic, social, and cultural status (PISA index)</td>
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<td>GDP</td>
<td>gross domestic product</td>
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<td>GIC</td>
<td>growth incidence curve</td>
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<td>IMD</td>
<td>directional income movement</td>
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<td>IMND</td>
<td>nondirectional income movement</td>
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<td>km</td>
<td>kilometer(s)</td>
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<td>MOI</td>
<td>mobility as origin independence</td>
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<td>OECD</td>
<td>Organisation for Economic Co-operation and Development</td>
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<td>PISA</td>
<td>Program for International Student Assessment</td>
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<td>PM</td>
<td>positional movement</td>
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<td>PPP</td>
<td>purchasing power parity</td>
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<td>SEDLAC</td>
<td>Socioeconomic Database for Latin America and the Caribbean (by the Centro de Estudios Distributivos, Laborales y Sociales [CEDLAS] of the Universidad de la Plata in Argentina, and the World Bank)</td>
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<td>SERCE</td>
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<td>SM</td>
<td>share movement</td>
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<td>USAID</td>
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After decades of stagnation, the size of the middle class in Latin America and the Caribbean recently expanded by 50 percent—from 103 million people in 2003 to 152 million (or 30 percent of the continent’s population) in 2009. Over the same period, as household incomes grew and inequality edged downward in most countries, the proportion of people in poverty fell markedly: from 44 percent to 30 percent. As a result, the middle class and the poor now account for roughly the same share of Latin America’s population. This is in stark contrast to the situation prevailing (for a long period) until about 10 years ago, when the share of the poor hovered around 2.5 times that of the middle class. This study investigates the nature, determinants, and possible consequences of this remarkable process of social transformation. (See figures 1 and 2.)

Such large changes in the size and composition of social classes must, by definition, imply substantial economic mobility of some form. A large number of people who were poor in the late 1990s are now no longer poor. Others who were not yet middle class have now joined its ranks. But social and economic mobility does not mean the same thing to different people or in different contexts. This report discusses the relevant concepts and documents the facts about mobility in Latin America and the Caribbean over the past two decades, both within and between generations. In addition, it investigates the rise of the Latin American middle class over the past 10–15 years and explores the size, nature, and composition of this pivotal new social group. More speculatively, it also asks how the rising middle class may reshape the region’s social contract.

A middle-income region on the way to becoming a middle-class region

Defining the middle class is not a trivial matter, and the choices depend on the perspective of the researcher. Sociologists and political scientists, for instance, usually define the middle class in terms of education.
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(for example, above secondary), occupation (typically white collar), or asset ownership (including the ownership of basic consumer durables or a house). Economists, by contrast, tend to focus on income levels. This study adopts an economic perspective but, to arrive at a more robust—less arbitrary—definition, it anchors the income-based definition on the crucial notion of economic security (that is, a low probability of falling back into poverty). The thresholds chosen for per capita income and economic security arise from the analysis of Latin American data and are therefore broadly applicable to middle-income countries.

The study applies this definition of the middle class consistently across a comprehensive, Latin America-wide set of household surveys. It presents a profile of the new middle class in the region, highlighting both objective characteristics—including demographics, education, and occupation—and subjective values and beliefs. It also asks how this middle class interacts with economic and social policy, both in terms of the past policies that helped shape its growth and in terms of what its views, opinions, and rising political weight might mean for future policy choices. Because policy choices and the growth of the middle class are jointly determined, the study often documents correlations. Only where special data circumstances permit are causal effects between policies and income movements inferred.

The concept of economic security is central to our approach because a defining feature of middle-class status is a certain degree of economic stability and resilience to shocks. We adopt a probability of falling into poverty over a five-year interval of 10 percent (approximately the average in countries such as Argentina, Colombia, and Costa Rica) as the maximum level of insecurity that may reasonably be borne by a household that is considered middle class. To map such a probability to a household income range, we ask—in those countries for which the right kinds of data are available—which income levels are typically associated with that level of insecurity. This exercise yields an income threshold of US$10 per day, at purchasing power parity (PPP) exchange rates, as our lower-bound per capita household income for the middle class. The upper income threshold for the middle class is set at US$50 per capita per day, based primarily on survey data considerations. According to these thresholds, a family of four would be considered middle class if its annual household income ranged between US$14,600 and US$73,000.

Although US$10 per day (or US$3,650 per person per year) may not sound like a particularly demanding requirement for a family to be considered middle class, this income level corresponds to the 68th percentile of the Latin American income distribution in 2009. In other words, according to our definition, 68 percent of the region’s population—over two-thirds—lived below middle-class income standards in 2009. Not all of these people were poor, of course. If we use US$4 per day as a moderate poverty line for the region, as typically done by the World Bank, these 68.0 percent are split into 30.5 percent of the population living in poverty (US$0–US$4 per day) and 37.5 percent living between poverty and the middle class (US$4–US$10 per day). This second group is a segment of the population that is at risk of falling into poverty, with an estimated probability greater than 10 percent.

Above the vulnerable segment, about 30 percent of the Latin American population are in the middle class (US$10–US$50 per day) and some 2 percent are in the upper-income class (living on more than US$50 per day), to whom we will refer interchangeably as the rich or the elite. Figure 1, which draws on harmonized household surveys from 15 countries in Latin America and the Caribbean (accounting for 86 percent of the region’s population and representing 500 million people) depicts the continent-wide income distribution and indicates the three key per capita income thresholds in our analysis: the poverty line at US$4 per day, the lower bound for the middle class at US$10 per day, and its upper bound at US$50 per day.

Figure 1 illustrates one of the key results from this study: if one adopts a middle class definition based on the notion of economic
security—and validated by self-perceptions—as well as a standard moderate poverty line, then there are four, not three, classes in Latin America and the Caribbean. Sandwiched between the poor and the middle class, there lies a large group of people who appear to make ends meet well enough so as not to be counted among the poor but who do not enjoy the economic security that would be required for membership in the middle class.

One might have called this group by various names, such as the near-poor or the lower middle class. Because, by virtue of our definition of the middle class, these are households with a relatively high probability of experiencing spells of poverty in the future, we call them “the vulnerable.”

As shown in figure 1, this vulnerable class includes the modal Latin American household—the household whose income is observed with the highest frequency in the distribution. And as shown in figure 2, it is now the largest social class in the region, accounting for 38 percent of the population.

As poverty fell and the middle class rose—to about 30 percent of the population each during the past decade—the most common Latin American family is in a state of vulnerability.

Yet there is no question that the dynamics illustrated by figure 2 are, on the whole, very encouraging. Being a continent where the vulnerable are the largest segment of the population is much less attractive than being a middle-class continent, but it is clearly much better than being a predominantly poor continent. Moreover, the current situation in the region is as recent as it is unprecedented—it is the result of a process of social transformation that began around 2003, in which upward social mobility took place at a remarkable pace. Before 2005, as figure 2 shows, poverty was still the most prevalent condition in our four-way classification.

In an almost mechanical sense, this transformation reflects both economic growth and declining inequality in Latin America and the Caribbean over the period. Gross domestic
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Product (GDP) per capita grew at an annual rate of 2.2 percent between 2000 and 2010 and somewhat faster over the crucial 2003–09 period. Although these are not East Asian growth rates, they represent a substantial improvement over the region’s own past growth performance: negative 0.2 percent per year in the 1980s and positive 1.2 percent in the 1990s. And whereas in those earlier decades inequality was either stable or rising, the 2000s saw declining income disparities in 12 of the 15 countries for which data are available (as further discussed in chapter 1).

Both of these factors—higher incomes and less income inequality—contributed to poverty reduction and the growth in the middle class. Statistically, however, economic growth (growth in average per capita income) played a much larger role, accounting for 66 percent of the reduction in poverty and 74 percent of the rise of the middle class in the 2000s (with the remainder, in each case, associated with changes in inequality). Yet, as figure 3 illustrates, the average hides significant inter-country variation within Latin America in these decompositions: in Argentina and Brazil, for example, falling income inequality contributed substantially to the expansion of the middle class.

Within generations, remarkable upward mobility

In a deeper sense, the rise of the region’s middle class also reflects substantial upward economic mobility. The growth in mean incomes and the changes in inequality over the past 15 years or so—which are used to account for middle-class growth in figure 3—are themselves aggregate statistics that simply summarize changes in well-being for individuals and families. Behind these accounting decompositions are real individual trajectories, which generally imply significant churning in the distribution of incomes. In any given year, some households earn more than before while others earn less. Behind the net changes in the size of each socioeconomic class depicted in figure 2, there are larger gross flows, with many households moving up while others move down.

To shed light on these dynamics, we adopt a measure of economic mobility within generations (intragenerational mobility) that summarizes (directional) income movement. Put simply, this measure of directional income movement captures the average growth rate in household-specific incomes. This mobility index, which is well known in the scholarly
literature, can be decomposed into “gainers” and “losers” as well as by the original social class of each household. This decomposition allows various versions of the measure to be expressed in terms of transition matrices, such as in table 1. Considering that data following the same individuals (that is, panel data) for long time spans are rarely available in the region, directional income mobility was estimated using synthetic panels, and we report here conservative (that is, lower-bound) measures of mobility.5

Table 1 provides a summary of economic mobility within generations between circa 1995 and circa 2010 for Latin America as a whole. The data are representative of 18 countries in the region. Each cell gives the proportion of the overall population that started out in the “origin” row of socioeconomic class in 1995 and ended up in the “destination” column of class in 2010. For example, the first row tells us that, of the 45.7 percent of the population who were poor in 1995, fewer than half (22.5 percent) were still poor in 2010, while the rest mainly moved up to become vulnerable (21.0 percent) and, to a substantially lesser extent, jumped directly to the middle class (2.2 percent). Analogously, of the 33.4 percent of the population who started out as vulnerable in 1995, more than half (18.2 percent) moved up and joined the middle class.6

Table 1 reveals an impressive degree of income mobility in Latin America. The population shares along the main diagonal represent the “stayers”: people whose income movement over this period, upward or downward, was insufficient for them to cross a class threshold. Because these shares add up to 57.1 percent, we can conclude that at least 43.0 percent of all Latin Americans changed social classes between the mid-1990s and the end of the 2000s, and most of this movement was upward. In fact, only 2 percent of the population experienced a downward class transition, (although this is also a lower bound).

As one might expect, most class movement was gradual: most of the “climbers” moved either from poverty to vulnerability or from vulnerability to the middle class; few made the jump directly from poverty to the middle class during these 15 years. Rags-to-riches stories capture the imagination precisely because they are, in reality, rather rare—even in a high-mobility context such as Latin America in the 2000s.

Naturally, these average statistics once again hide considerable variation, both within and across countries. The extent of economic mobility captured by our measure of directional income movement was much higher in Brazil and Chile, for example, than in Guatemala or Paraguay. There was also variation in terms of where in the distribution the mobility was taking place, often associated with the initial level of the country’s income per capita: whereas most mobility in Ecuador and Peru came from the originally poor, in Argentina and Uruguay—countries with a higher initial per capita income—most of it was accounted for by the originally vulnerable.
Within most Latin American countries, households were more likely to experience upward mobility if the household head had more years of schooling in the initial year. Movements into the middle class, in particular, were much likelier for people who had some tertiary education. Being employed in the formal sector and living in an urban area was also associated with greater prospects of upward movement, and more so for movements out of poverty than for transitions into the middle class.

Across Latin American and Caribbean countries, there was a clear association between faster GDP growth and higher income mobility—not surprising in light of our earlier comments on economic growth as the principal driver of middle-class growth. Overall economic mobility was also correlated with public health and education spending. Interestingly, mobility was not found to be correlated with total social protection expenditures, but when one disaggregates those expenditures by type, mobility turned out to be associated with measures of targeted, progressive social protection programs, including conditional cash transfers. Although the extent of mobility into the middle class was positively correlated with increases in female labor force participation, this was not true of mobility out of poverty. All of these are, of course, purely descriptive correlations. On the basis of the evidence presented in the report, the variables in question should not be interpreted as causes of mobility.

Across generations, mobility remains low

The above evidence does not imply that Latin America is a high-mobility society in every sense of the word. As noted earlier, mobility has different meanings in different contexts, and one important such meaning—particularly in an intergenerational context—is that of “origin independence.” A measure of mobility as origin independence reaches its maximum when information on the original, or initial, period is useless in predicting terminal (or final) position. The measure decreases as the correlation between initial and final positions increases. In the present context, origin dependence would refer to the extent to which the family and socioeconomic conditions into which a person is born determine his or her future income and socioeconomic class. A higher measure of origin independence implies higher intergenerational mobility.

As this discussion suggests, when the concept of mobility as origin independence is applied to an intergenerational context, it is closely related to the concept of equality of opportunity. Equality of opportunity is now predominantly understood to refer to a hypothetical situation in which predetermined circumstances—such as race, gender, birthplace, or family background—have no effect on people’s life achievements. Perfect mobility in an origin-independence sense means the same thing when one looks only at a single circumstance variable, such as parental schooling.7

The main message of this report in this respect is that, sadly, despite substantial upward income movements within generations, intergenerational mobility remains limited in Latin America. Because data on parental incomes for today’s working adults are impossible to obtain (and difficult to estimate) for most countries in the region, most of our analysis of intergenerational mobility—or lack thereof—relies on educational attainment (as measured by years of schooling) and educational achievement (as measured by standardized test scores). In particular, we ask to what extent the education of a person’s parents appears to determine the person’s own level of educational attainment (or achievement). One way to make that comparison across countries is to consider the effect of one standard deviation in parental years of schooling on the years of schooling of the children. By this metric, as figure 4 illustrates, there is much greater intergenerational persistence—that is, much less mobility—in Latin American countries (such as
Brazil, Ecuador, Panama, and Peru) than in most other countries—rich or poor—for which data are available.

A similar, if slightly less stark, picture arises if one considers the effect of parental background (measured by an index of socio-economic status) on student achievement, measured by standardized test scores in Program for International Student Assessment (PISA) exams, illustrated in figure 5. Most Latin American countries for which the relevant data are available also appear toward the right of the distribution of that impact estimate, suggesting that family background is a bigger determinant of student learning in Latin America than in other regions. But there is more variation in those estimates than in the attainment numbers shown in figure 4: in Mexico, for example, parental background appears to be much less closely associated with PISA test scores than in other Latin American countries or in a number of nations in other regions. Crucially, however, most Latin American countries display not
only lower intergenerational mobility in educational achievement but also very low levels of student learning—an unfortunate combination that clearly leaves a great deal of scope for policy interventions in this area.

There is also some evidence on the mechanisms through which the intergenerational persistence of educational achievement occurs. In particular, it appears that sorting—the process whereby children from more-advantaged backgrounds concentrate in the same schools, from which those from less-privileged families are excluded—is a more important component of intergenerational immobility in Latin America than elsewhere. Sorting matters in Latin America because of the usual peer effects and because the schools attended by rich children are much better than those attended by the poor, in terms of their governance and accountability as well as their physical infrastructure and teaching quality. Of course, in addition, parental background also affects children’s cognitive outcomes through better nutrition, exposure to richer vocabulary, differences in cognitive stimulation, material resources at home, and so on.

There is some room for hope that these abysmally low levels of intergenerational mobility in Latin America—that is, high levels of inequality of opportunity—are beginning to change. Intergenerational mobility in educational attainment appears to have been rising over the past decade or so in most of the region. Figure 6 shows estimates of the effect of one standard deviation of parental education on children’s schooling gap (the difference between the highest grade a child could be attending under normal circumstances and the last or current grade

**FIGURE 6** Impact of parental background on children’s educational gap at age 15 in Latin America, 1995–2009

*Source:* Data from SEDLAC (Socio-Economic Database for Latin America and the Caribbean).

*Note:* “Educational gap” is defined as the difference between potential years of education at a given age and the years of completed education at that age. The green and orange bars represent the expected reduction in the schooling gap associated with one standard deviation of parental education in 1995 and 2009, respectively. The red bar is the difference between the two. Other covariates in the regression are children’s gender, living in an urban area, and country fixed effects. The estimated effect of parental education on the educational gap is always statistically different from zero and so are the differences between 1995 and 2009.
actually attended) in 1995 and 2009. The red bars show that the differences are positive and substantial in most Latin American countries, suggesting a generally improving trend. While this is encouraging, the result is restricted to educational attainment. There is no clear evidence of similar improvements in educational achievement and, hence, no room for complacency.

How likely is it that these measures of (low) intergenerational educational mobility imply similarly limited mobility in incomes between generations? Although we did not conduct original analysis on intergenerational income transitions for this report, the scholarly literature suggests that Latin America is also a region of low intergenerational mobility in terms of income, and that this goes hand in hand with the region’s (still) high levels of income inequality. This relationship is corroborated in figure 7—which reproduces a well-known positive association: the higher the inequality of income (as measured by the Gini coefficient), the higher the intergenerational immobility.

In sum, the region’s stubbornly low levels of intergenerational mobility stand in contrast to the recent sharp increase in intragenerational mobility. The overall picture of economic mobility in Latin America is therefore a mixed one. Mobility across generations—in the sense that personal outcomes are independent of family background and social origin—remains an elusive goal. In intergenerational terms, Latin America is not a mobile society, and the signs that it is becoming a little more mobile are tentative and so far limited to educational attainment. This picture is consistent with what is known about the high degree of inequality of opportunity that continues to characterize the region.

**A snapshot of the Latin American middle class**

What are the main characteristics of this emerging middle class? How similar is it across countries? Does it hold different views and opinions than other social groups? Our analysis suggests, perhaps surprisingly, that the rising Latin American middle class, while sharing some common objective features across the region, displays much less similarity in its subjective values and beliefs. Take first the common objective features: In all Latin American countries, the heads of middle-class households have substantially more years of schooling than those in the poor or vulnerable classes but fewer years than the rich (figure 8). Middle-class households are also more urbanized than poorer groups. In addition, formal employment appears to be a distinctive sign of the middle class in Latin America; the middle-class worker is typically a formal employee rather than being self-employed, unemployed, or an employer. In contrast, the poor and vulnerable rely on self-employment (or suffer from unemployment) more often, while the rich are more frequently employers and, in some countries, self-employed.

In terms of sector of economic activity, middle-class workers are frequently found in the services sector, including health, education, and public services, but manufacturing jobs are more frequent among the middle class (and the vulnerable) than they are among the poor or the rich. There is no evidence that the middle class is overly dependent on—or employed by—the public sector.
In most Latin American countries for which data exist, public sector employment was more frequent among the rich than among the middle class (although Mexico and Peru were exceptions). The public sector employed more than one-fourth of middle-class workers in only one country: Honduras. It would appear, therefore, that popular images of the middle class—as being made up of either intrepid entrepreneurs (who start their own small businesses and pull themselves up the ladder by their own shoestrings) or lazy bureaucrats (comfortably relying on a government paycheck)—are inaccurate. Typically, the Latin American middle-class worker is a reasonably educated service worker, formally employed by a private enterprise in an urban area.

Family dynamics and demographics provide, perhaps, the most interesting traits of the Latin American middle-class profile. Between 1992 and 2009, the average size of a middle-class household in Latin America fell from 3.3 to 2.9 individuals. This compares with populationwide averages of 4.1 and 3.4, respectively. Middle-class households typically have fewer children as well as women who join the labor force more frequently: 73 percent of middle-class women ages 25–65 across Latin America are either employed or looking for work compared with a region-wide population average of 62 percent. Their children are typically in school: virtually all 6- to 12-year-old middle-class children attend school, as do roughly three-quarters of those who are 13–18.

In summary, although there are evidently variations in the middle-class profile across countries, the similarities dominate: the middle class presents a set of distinctive demographic and socioeconomic patterns that are present in almost every Latin American country. Would this mean that the middle class also systematically shares opinions and beliefs about society that are different from other groups? Our research suggests this not to be the case.

An analysis of middle-class values and beliefs using opinion surveys shows that country characteristics account for a much larger share of the variance in people’s values than class membership. In particular, there is no strong evidence of any “middle-class exceptionalism” in terms of values and beliefs. To be sure, middle-class respondents are generally likelier than their poorer counterparts to trust their countries’ institutions (including the government, political parties, and the police) and to report greater faith in the meritocracy of their societies, and they are less likely to perceive political violence as legitimate. But most of these associations simply reflect positive correlations with income and education rather than something to do specifically with middle-class status. And, on the whole, income and class status account for only a small share of the overall variance in values.

This contrasting reality may be simply described as follows: when it comes to socioeconomic and demographic characteristics, a middle-class person in Peru has more in
common with a middle-class person in Mexico than with a poorer person in Peru; but when it comes to values and aspirations, the same middle-class person in Peru has more in common with a poor person in Peru than with a middle-class person in Mexico.

The middle class and the social contract

What, if any, are the implications of a rising middle class with these characteristics—urban, better educated, largely privately employed, and with beliefs and opinions broadly in line with those of their poorer and less-educated fellow citizens—for social and economic policy? In particular, is the growth of the Latin American middle class likely to spell any changes for the region’s fragmented social contract?

A “social contract” may be broadly understood as the combination of implicit and explicit arrangements that determine what each group contributes to and receives from the state. In stylized terms, Latin America’s social contract in the latter half of the 20th century was characterized by a small state, to which the elite (and the small middle class appended to it) contributed through low taxes, and from which they benefited largely through a “truncated” set of in-cash benefits such as retirement pensions, severance payments, and the like, for which only formal sector workers qualified. Little was left for providing high-quality public services in the areas of education, health, infrastructure, and security, for example. Public services in these areas were therefore generally of low quality; while the vast majority of the (poor and vulnerable) population had no choice, the rich and the small middle class opted out and chose privately provided alternatives. The essence of this (implicit) contract was simple: the upper and middle classes were not asked to pay much and did not expect to receive much from public services either. The poor also paid little and received correspondingly little in terms of public benefits.

One manifestation of this social contract was a state that was typically small as well as skewed toward the provision of formal sector social security payments to the better-off. To this day, with the exception of Argentina and Brazil, the region is characterized by relatively low tax revenues overall. The average total tax revenue in 2010 was 20.4 percent of GDP in Latin America, versus 33.7 percent in the Organisation for Economic Co-operation and Development (OECD) countries, for example. In addition, the composition of these tax revenues tended to be skewed toward indirect (sales) taxes and social security contributions, relative to income and property taxes, leading to a system that is not particularly progressive.

On the benefit side, the middle class (and the elite) participated disproportionately in the social security system (including old-age and disability pensions, unemployment protection, severance payments, and health insurance). But it tended to opt out of public education and health services, in particular. Instead, the upper and middle classes in Latin America often resorted to private alternatives to obtain these latter services. This tendency to opt out extended even to services where public provision should be the uncontested norm, such as electricity: in some Latin American countries, private ownership of electricity generators is still observed to rise with household income. The same applies for public security, with private security in closed condominiums not uncommon in a number of countries in the region.

This picture has not remained static, however. Over the past 10–20 years—and, in particular, following redemocratization processes in many Latin American countries—this political equilibrium has begun to shift, albeit gradually. The spread of noncontributory old-age pension and health insurance schemes and the growth of conditional cash transfers has meant that redistributive transfers from the state now reach the poor to an extent that was unheard of 20 years ago in most of the region. At the same time, in most countries in the region, the extension of cash benefits to the poor has not been matched by a return of the middle class to public health and education services. Latin
America’s “welfare state” may have become less “truncated,” but its social contract remains fragmented. It is natural to question whether Latin America will be able to continue its recent run of “growth with equity” (or at least with declining inequality) on the basis of such a fragmented contract, which inherently generates fewer opportunities for the bulk of the population. Whether in postwar Western Europe or postrevolutionary China, whether in the post-land-reform Republic of Korea or in the United States under the New Deal, socioeconomic progress has often required a combination of economic freedom and a sound foundation of public education, health, and infrastructure. It is almost certain that most countries in Latin America and the Caribbean will require additional reforms to their social contracts to enable their states to provide that foundation and sustain growth.

But can the rise of the middle class documented in this study facilitate these reforms? Or will it instead entrench the middle-class choice of private services and further reduce its willingness to contribute to the public purse to generate opportunities for those who remain poor? In a sense, as it evolves toward a more mature social structure, with a larger and more vocal middle class, Latin America stands at a crossroads: will it break (further) with the fragmented social contract it inherited from its colonial past and continue to pursue greater parity of opportunities, or will it embrace even more forcefully a perverse model where the middle class opts out and fends for itself?

This study does not answer those big questions. It merely poses them, because they follow naturally from the recent trends in economic mobility and the size of the middle class—trends that combine the good news of recent income growth and poverty reduction with the reality of limited mobility between generations and persistent inequality of opportunity. The study suggests, however, that the middle classes may not automatically become the much-hoped-for catalytic agent for reforms. Whether and how the new middle class will help strengthen the region’s social contract remains to be seen and will doubtless be the subject of much research in the future. Nevertheless, the report highlights three areas where reforms may help to gain the support of the middle class for a fairer and more legitimate social contract:

- **Incorporate the goal of equal opportunities more explicitly into public policy.** This is crucial for ensuring that the middle classes feel that they live in a society where effort pays and merit is rewarded instead of one that is rigged in favor of privileged groups. It is also crucial for broadening the access of those who remain poor or vulnerable to good jobs and stable sources of income. Although this effort will require reforms in a wide range of fields, this report emphasizes the need to improve the quality of public education, from the development of cognitive and social skills during early childhood all the way to better colleges and universities. Greater equality of opportunity would, in turn, enhance economic efficiency, thus helping address Latin America’s persistent low-growth problem and improving the conditions for the region’s private sector to generate better and more stable jobs for all classes.

- **Embark on a second generation of reforms to the social protection system, encompassing both social assistance and social insurance.** Although the aforementioned improvements in targeted social assistance during the past 10–15 years contributed much to the observed reductions in poverty and income inequality, their expansion has not been well integrated into the overall social protection system, and this has led to new challenges for both efficiency and fairness. Increasingly, the middle classes are asked to pay for services that are provided to others for free. A dual social protection system based on targeted assistance for the poor and (subsidized) insurance for the middle
classes may also be poorly tailored to a large vulnerable population that is neither poor nor middle class and whose vulnerability will rise if the external environment becomes less favorable than in the past. The time is ripe for embarking on a second generation of social protection reforms, in which fragmentation will be overcome in ways that enhance fairness, solidarity, and inclusion.

- **Break the vicious cycle of low taxation and low quality of public services that leads the middle and upper classes to opt out.** Although there is some margin to improve the quality of public services within the current budget envelopes, it will be challenging to do so without strengthening the revenue base, which remains low practically everywhere except in Argentina and Brazil. Improving the perception of fairness in taxation and the redistributive effectiveness of public spending will be key to any successful reform. The middle classes will not buy into and contribute to an improved social contract if the goods that they value highly (such as civil rights protection, education, police, and health services) are deficiently supplied by the state and if they do not perceive that the rich contribute fairly to the social contract.

During most of the 2000s, Latin America’s improved policy framework allowed many countries to take advantage of a benign external environment to begin an impressive transition toward a middle-class society. This has created enormous expectations, which risk turning into frustration if this transition stalls. But the region cannot count on the external environment remaining as friendly as in the recent past to achieve further social and economic gains. A much greater policy effort will thus be required to consolidate and deepen the process of upward mobility and to make it more resilient to potential adverse shocks. In the end, the onus will mainly rest on the shoulders of the political leaders and democratic institutions of the region: they face the challenge of overhauling its social contract.

**Notes**

1. This lower income threshold was independently validated by an alternative approach, based on self-perceptions of class membership, that was separately applied to five countries: Brazil, Chile, Colombia, Mexico, and Peru. Methodological details of both approaches are documented in chapter 2 of the main report and in references therein.

2. As is well known, the household surveys on which figure 1 is based commonly suffer from compliance and reporting problems that render them unrepresentative of the top tail of the distribution. We are therefore circumspect in our analysis of the “rich” in our sample.

3. As detailed in chapter 5, these decompositions are for the 1995–2010 period.

4. Because each household’s growth rate is given equal weight, the average of growth rates is not the same as the growth in the average income. The latter involves income weights, whereas the former uses population weights.

5. Our measure of directional mobility is applied to a set of “synthetic panels” constructed from the region’s repeated cross-section household surveys. A key caveat is that the statistical procedures used to construct these synthetic panels can only generate upper- and lower-bound estimates of mobility rather than exact figures. Most of the analysis in this report relies on the lower-bound estimates, which yield a conservative picture of mobility in either direction. In our results, therefore, upward and downward mobility are both likely to be underestimated.

6. The bottom row does not match the numbers used above for describing figure 1 because of sample differences in both countries and years. In addition, table 1 conflates the middle class and elite into a single class. Despite sampling differences, though, the overall picture is consistent with the cross-section analysis described earlier.

7. The concepts of equality and inequality of opportunity are increasingly important to the World Bank’s work in Latin America. See, for example, the *World Development Report 2006: Equity and Development* (World Bank 2006), the regional study on *Measuring*
Overview

Inequality of Opportunities in Latin America and the Caribbean (Barros et al. 2009), and references in those two volumes.

8. The OECD’s Program of International Student Assessment (PISA) produces a set of school-based surveys that administer identical cognitive achievement tests to samples of students across a number of countries, as well as collecting (reasonably) comparable information about the students’ families and the schools they attend.

9. The capture of Latin America’s social security systems by (largely better-off) formal sector workers, to the exclusion of most of the continent’s poor, was described as a “truncated welfare state” in a previous regional report in this series, Inequality in Latin America: Breaking with History? (de Ferranti et al. 2004).

10. In 2010, Brazil’s total tax revenues were 33.6 percent of GDP, whereas in Argentina the figure was 33.3 percent.

References


Corak, Miles. Forthcoming. “Inequality from Generation to Generation: The United States in Comparison.” In The Economics of Inequality, Poverty and Discrimination in the 21st Century, ed. Robert Rycroft. ABC-CLIO.


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