

Why we should pay attention to the middle class

*Jose Ramon G. Albert, Raymond E. Gaspar,
and Martin Joseph M. Raymundo*

Empirical evidence suggests that income distribution would likely affect economic growth, particularly in the medium term. Dabla-Norris et al. (2015) posited that an increase in the income share of the poor and the middle class is associated with higher economic growth, *ceteris paribus*. In contrast, economic growth wanes when the income share of the rich increases.¹

Anchored on these findings, this *Policy Note* examines the changes in income distribution in the Philippines in recent years. It also describes the middle class and provides its contributions to economic growth. Moreover, policy recommendations to maximize the role of the middle class in the country's economic performance are forwarded.

Middle class as driver of growth

The middle class plays a critical role in the

development of a country. For instance, England's economic progress is attributed to the ascendancy of 'the great English middle class' (Landes 1998). In Africa, the middle-income group has also contributed to the growth of the private sector.

The middle class is not only expected to create employment as business start-ups but also to boost investment and production as consumers. They also have an impact on governance as they can demand for better

¹ An increase in one percentage point (ppt) in the income share of the poor (bottom 20%) and the middle class (second and third quintile) is associated with higher GDP growth, i.e., by 0.38 ppt, 0.33 ppt, and 0.27 ppt, respectively. Meanwhile, a one ppt increase in the income share of the rich (top 20%) is associated with a decline in economic performance by 0.08 ppt.

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The authors are senior research fellow, research specialist, and research analyst at PIDS, respectively. The views expressed are those of the authors and do not necessarily reflect those of PIDS or any of the study's sponsors.

public services and institutional improvements. Countries with a large middle class tend to grow faster (Easterly 2001). Moreover, according to Kharas (2011), the middle classes in emerging economies, particularly in Asia, will determine the future global demand growth.

The *2010 Key Indicators for Asia and the Pacific* of the Asian Development Bank (2010) reports a significant increase in the size of the middle class in developing Asia. However, this report also warns that a big chunk of the middle class is in the lower portion of income distribution. This group may easily fall into poverty, and will deserve policy attention.

Who are considered middle class?

There is hitherto no internationally accepted definition for the middle class. Some studies defined the middle class by setting thresholds in relation to the average (or median) income. The Pew Research Center, a United States (US) think tank, for example, refers to adults whose annual household income falls on two-thirds to double of the national median income as the middle class. Meanwhile, for Easterly (2001), the middle class is the population lying between the 20th and 80th percentile of the consumption distribution. Birdsall et al. (2000) define the middle class as households with income between 75 and 125 percent of the median per capita income.

Absolute poverty lines are also used to define the middle class. According to

Ravallion (2009), the middle class includes the population whose consumption per capita ranges from USD 2 per day (median value for 70 national poverty lines) to USD 13 per day (US poverty line). Likewise, the Asian Development Bank (2010) defines the middle class as those with daily consumption per capita of USD 2–USD 20 at 2005 purchasing power parity.

In the Philippines, Virola et al. (2013) used a cluster analysis on income distribution based on the 2012 Family Income and Expenditure Survey (FIES) of the Philippine Statistics Authority (PSA) to estimate the size of the middle class. Based on this methodology, the country's middle class consists of those with annual per capita incomes in 2012 ranging from about PHP 64,317 to PHP 787,572.

Market researchers in the Philippines also cluster households based on the quality of consumers (i.e., employment and educational characteristics of the household), household assets, amenities, and facilities (Bersales et al. 2013).

This *Policy Note* adopts an alternative definition of the middle class by dividing the income distribution based on official poverty lines. Table 1 lists the definition of the middle class together with six other income classes. Here, the definition of the various income classes is provided an indicative range of monthly family incomes for a household size of five based on

Table 1. Income classes in the income distribution, indicative income ranges of income classes, and sizes of income classes, 2012

Income Class	Definition	Indicative Range of Monthly Family Incomes (for a family size of 5 members)	Size of Class (i.e., number of households)
Poor	Per capita income less than official poverty threshold	Less than PHP 7,890 per month	4.2 million
Low income (but not poor)	Per capita incomes between the poverty line and twice the poverty line	Between PHP 7,890 to PHP 15,780 per month	7.1 million
Lower middle income	Per capita incomes between twice the poverty line and four times the poverty line	Between PHP 15,780 to PHP 31,560 per month	5.8 million
Middle-income class	Per capita incomes between four times the poverty line and ten times the poverty line	Between PHP 31,560 to PHP 78,900 per month	3.6 million
Upper middle income	Per capita incomes between ten times the poverty line and fifteen times the poverty line	Between PHP 78,900 to PHP 118,350 per month	470,000
Upper income (but not rich)	Per capita incomes between fifteen times the poverty line and twenty times the poverty line	Between PHP 118,350 to PHP 157,800	170,000
Rich	Per capita incomes at least equal to twenty times the poverty line	At least PHP 157,800	150,000

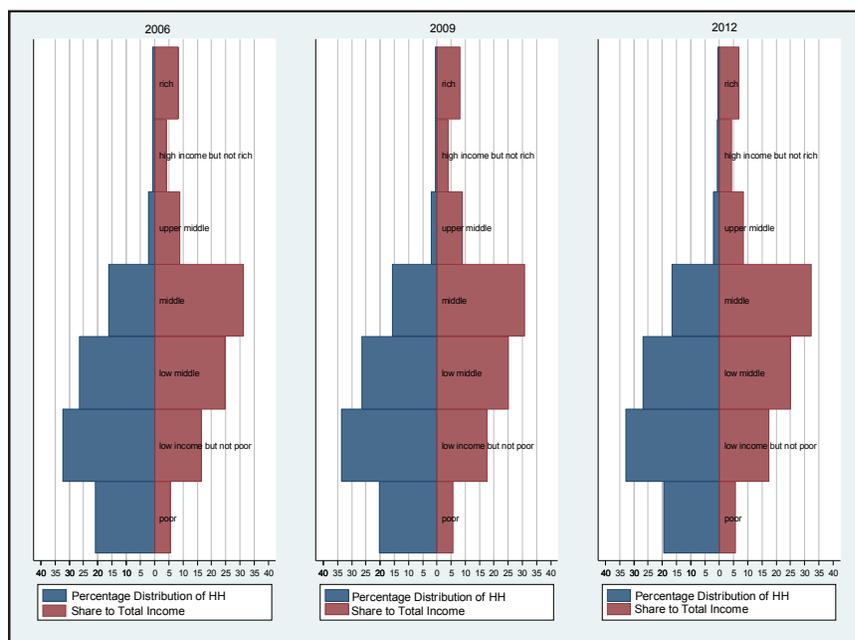
Note: Authors' calculations from the 2012 Family Income and Expenditure Survey (FIES), Philippine Statistics Authority (PSA)

average poverty lines in the country. Official poverty lines, however, vary across provincial urban/rural areas in the country.

Marginal changes in income distribution from 2006 to 2012

Between 2006 and 2012, the changes in income distribution in the country are marginal (Figure 1). The rich, who accounted for only 0.8 percent of the total number of households, had a 7.1-percent share of the total household income in 2012, from 8.4 percent in 2006. In contrast, the poor, during the same period, accounted for

Figure 1. Distribution of households and shares of total household income by income group: 2006, 2009, and 2012



Note: Authors' calculations from the 2006, 2009, and 2012 FIES, PSA

19.7 percent of the total number of households but only had a smaller share (5.6%) of total household income.

Income shares of the middle class slightly improved

In 2012, there are about 3.6 million households belonging to the middle class. The middle class accounted for 16.7 percent of the total number of households, which is slightly higher than the 16.2 percent and 15.8 percent registered in 2006 and 2009, respectively. While these changes are marginal (as in the case of other income classes), the change in the size of the middle class is notably accompanied by a similar change in its income share. The income share of the middle class in 2012 is estimated at 32.2 percent of the total household income in the country. This is also higher than the 31.4 percent and 30.7 percent estimated in 2006 and 2009, respectively.

The combined group of the middle class, the lower middle class (about 5.8 million

households), and the upper middle class (470,000 households) constituted 9 out of 20 households (45.8% of the total households) in 2012. Previous waves of the FIES showed almost the same result: 45.1 percent and 44.6 percent in 2006 and 2009, respectively. Note that the income share of these three income groups is about two-thirds of the country's total household income (65.1% in 2006, 64.7% in 2009, and 65.6% in 2012).

In comparison, the combined group of poor households (4.2 million) and low-income but not poor households (7.1 million) constituted more than half of the total households (52.7% or about 11.3 million households) in 2012. However, they contributed only a quarter to the total national household income (23.4%). Meanwhile, the combined group of rich households (160,000) and upper-income but not rich households (170,000) comprised only 1.5 percent of the total households but shared over a tenth of the total household income (11.4%) in 2012.

Table 2. Average per capita income by income group: 2006, 2009, and 2012

Income Group	At Current Prices			At Constant 2006 Prices		
	2006	2009	2012	2006	2009	2012
Poor	9,528	12,229	13,709	9,528	10,425	10,393
Low income (but not poor)	19,754	24,842	27,646	19,754	21,178	20,959
Lower middle	39,597	49,183	54,416	39,597	41,929	41,256
Middle class	83,989	104,112	115,879	83,989	88,757	87,853
Upper middle	171,669	212,670	236,173	171,669	181,305	179,055
High income (but not rich)	244,504	307,886	332,932	244,504	262,477	252,413
Rich	455,657	658,427	607,958	455,657	561,318	460,924

Note: Authors' calculations from the 2006, 2009, and 2012 FIES and Consumer Price Index, PSA

Average per capita income improved in nominal terms, but offset by rise in price

All income groups except the rich, on average, earned higher nominal incomes from 2006 to 2012 (Table 2). Accounting for inflation, there was hardly any change in incomes between 2009 and 2012 among income groups, with the rich having been reported to have lower incomes. However, it should be noted that wealthy households are likely not going to participate in the FIES should they be targeted for interview by the PSA. The average interview time for the FIES is five hours, and the PSA conducts its FIES survey operations twice: in July of the reference year to obtain first semester

data, and in January of the succeeding year to get the second semester data.

What are the characteristics of the middle class?

Aside from describing the incomes of the middle class (in relation to other income classes), it can be informative to describe their geographic concentration, family size, household head educational attainment, spending patterns, and major sources of income.

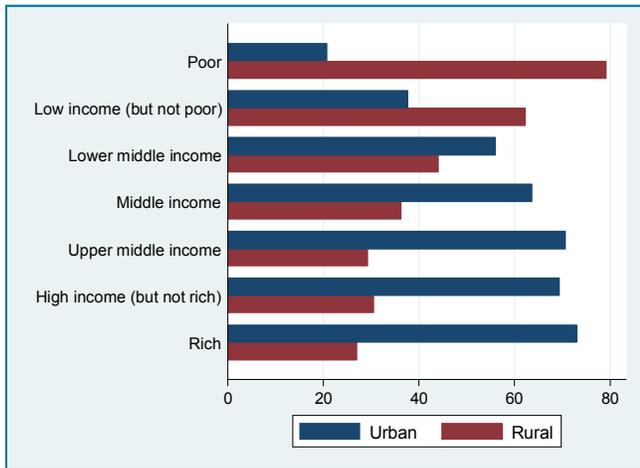
Geographically, a large number of the middle-class families can be found in the National Capital Region, CALABARZON, and Central Luzon (Table 3).

Table 3. Income distribution by income group and by region, 2012

Region/Group	Poor	Low Income (but not poor)	Lower Middle Income	Middle Income	Upper Middle Income	High Income (but not rich)	Rich
I - Ilocos Region	3.7	6.2	5.5	4.4	4.3	3.9	3.5
II - Cagayan Valley	3.1	4.5	3.4	2.8	3.1	2.3	2.1
III - Central Luzon	5.7	11.3	14.4	12.4	9.0	10.5	8.8
IVA - CALABARZON	6.1	13.2	18.8	18.8	17.1	17.6	15.4
IVB - MIMAROPA	3.6	3.3	2.7	2.4	2.0	1.7	3.5
V - Bicol Region	8.9	6.4	3.4	3.1	3.1	2.0	2.9
VI - Western Visayas	8.7	8.1	6.3	6.9	7.4	6.7	7.2
VII - Central Visayas	9.6	7.3	7.1	5.6	6.1	6.2	4.4
VIII - Eastern Visayas	8.0	4.2	2.6	2.5	2.8	4.0	3.4
IX - Western Mindanao	6.1	4.0	2.4	2.1	1.8	3.0	1.4
X - Northern Mindanao	7.6	4.8	3.2	3.0	3.1	3.4	4.4
XI - Southern Mindanao	6.4	5.6	4.5	3.6	3.0	4.4	1.8
XII - Central Mindanao	8.7	4.7	2.9	2.9	2.3	3.0	0.9
National Capital Region	1.8	8.7	18.4	25.6	31.5	27.1	36.6
Cordillera Administrative Region	1.6	1.6	1.8	2.1	2.2	1.6	2.3
Autonomous Region in Muslim Mindanao	6.4	3.1	1.0	0.2	0.1	0.4	0.0
Caraga	4.0	2.8	1.7	1.5	1.3	2.1	1.4

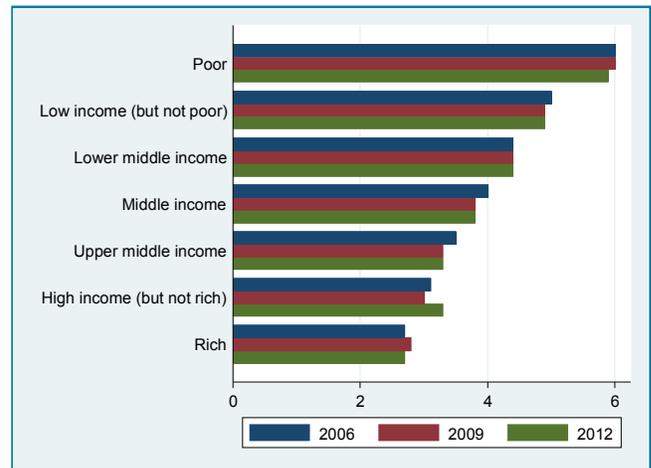
Note: Authors' calculations from the 2012 FIES, PSA

Figure 2. Income distribution by income group and by urban/rural classification, 2012



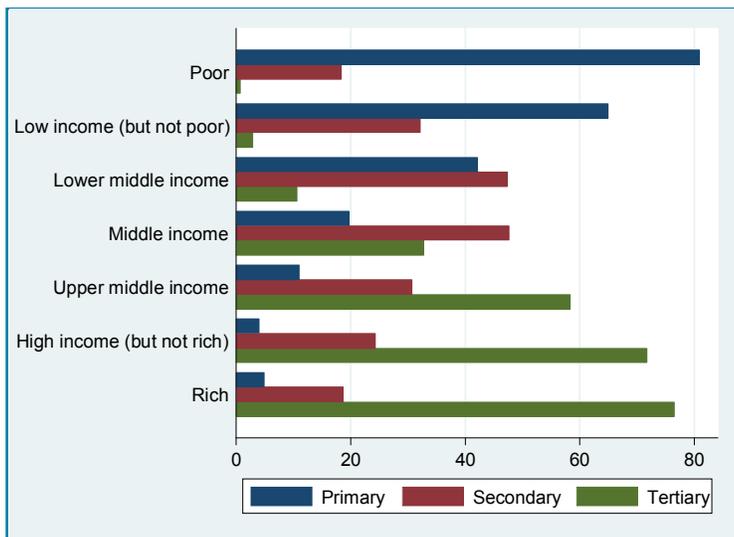
Note: Authors' calculations from the 2012 FIES, PSA

Figure 3. Average family size by income group: 2006, 2009, and 2012



Note: Authors' calculations from the 2006, 2009, and 2012 FIES, PSA

Figure 4. Educational level of household head by income group, 2012



Note: Authors' calculations from the 2012 FIES, PSA

Expectedly, the middle class is concentrated in urban areas (Figure 2), while the poor and low-income families are more concentrated in rural areas. Although they tend to be more concentrated in urban areas, the concentration of high-income and

rich households is difficult to determine given their small size.

Compared to the poor and low-income groups, the middle class tends to have a smaller family size (Figure 3). On average, a middle-class household is comprised of four members, which is lower than the average family size of six among poor households.

Another feature that separates the poor and the middle class is the educational attainment of the household head. Figure 4 shows that middle-class household heads have higher educational attainment. It is important to note that parents' education has long-term effects on their children's developmental outcome. Dubow et al. (2009), for instance, found that parents' educational level when the child is eight years old significantly predicts the child's

educational and occupational success 40 years later.

In terms of spending, household data show that the middle class is spending a higher percentage of their income in human capital investments, such as education and health, than the poor (Figure 5). Notably, the middle class also spends more on education than those in the high-income group.

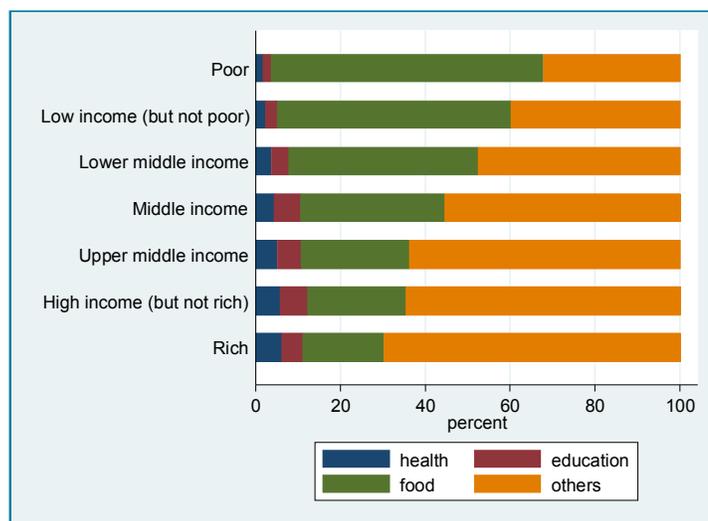
Data sourced from the FIES also show that the middle class tends to rely more on salaried jobs (Figure 6). In part, this explains why the middle class consistently accounts for the largest share not only in total income tax payments but also in total taxes (Figure 7).

Figure 8 shows that the majority of overseas Filipinos belongs to the middle class, particularly in the lower middle class.

Some caveats on analysis of income distribution

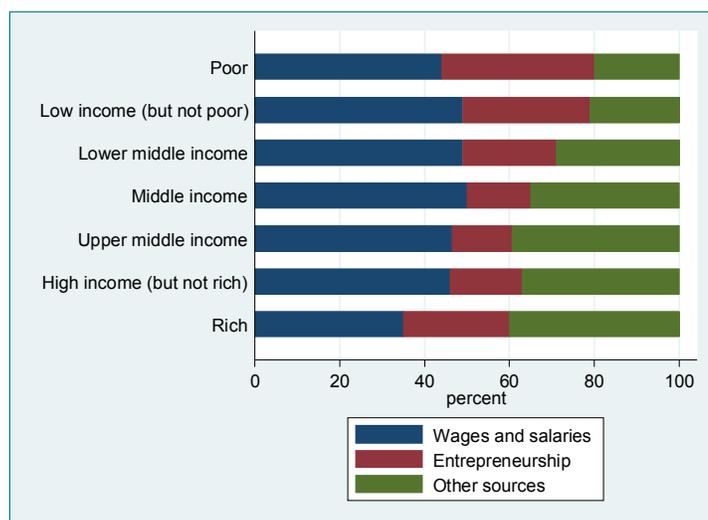
While the general picture of income distribution looks the same for various years examined (i.e., 2006, 2009, 2012), there are issues on the quality of data on income distribution in the country. As was pointed earlier, the share of the highest income group to total household income might be underestimated as households from wealthy families are likely not captured in the FIES data, given the interview time (of 5 hours per visit for each of the 2 visits) to conduct the FIES. Likewise, the challenge of recalling

Figure 5. Spending pattern (% to total expenditure) by income group, 2012



Note: Authors' calculations from the 2012 FIES, PSA

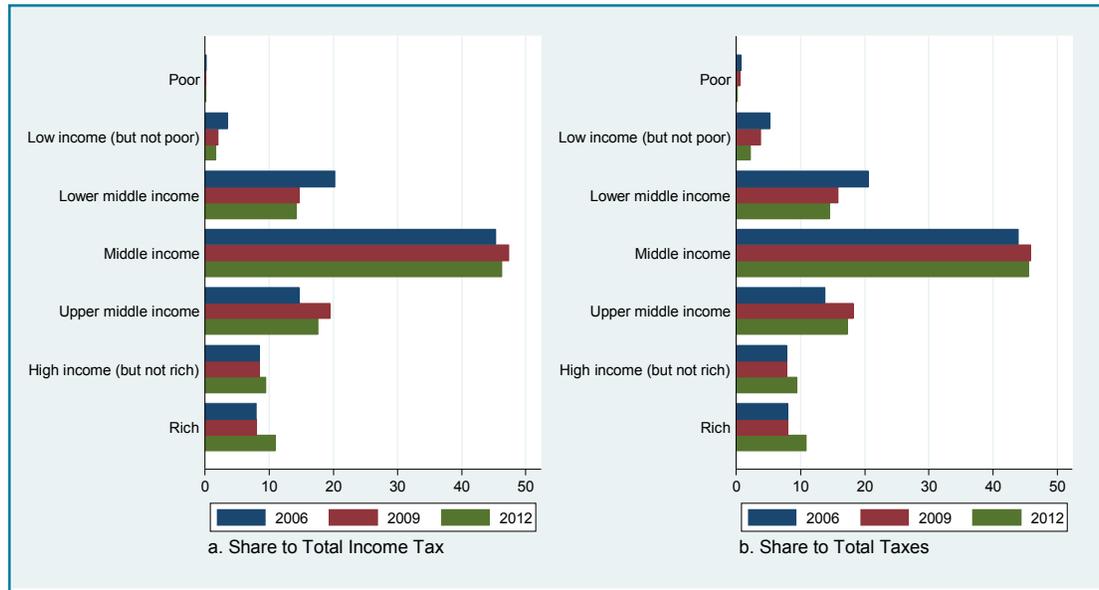
Figure 6. Major source of income by income group, 2012



Note: Authors' calculations from the 2012 FIES, PSA

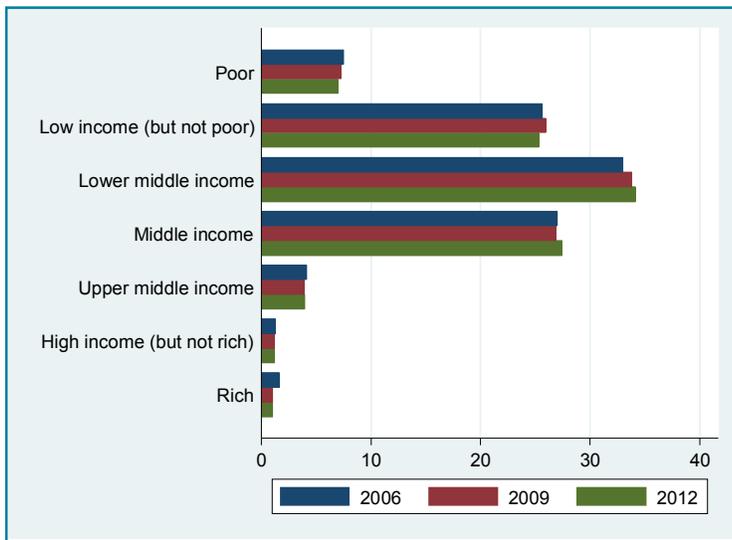
income and spending for the whole year might compromise the accuracy of income and expenditure data, especially income data. The available data though provide insights for policy discussions.

Figure 7. Share to total income tax and total tax by income group, 2012



Note: Authors' calculations from the 2012 FIES, PSA

Figure 8. Families of overseas Filipinos by income group: 2006, 2009, and 2012



Note: Authors' calculations from the 2006, 2009, and 2012 FIES, PSA

How to maximize the growth-enhancing role of the middle class?

Measuring and monitoring poverty have been the focus of many developing

countries, particularly the Philippines, especially on account of commitments to the Millennium Development Goals. Although they are not expected to change poverty rates in the short term, propoor programs, such as the government's conditional cash transfer, are means to help the poor attain better education and improve their quality of life in the long run.

While poverty reduction should be the main focus of development policy, there is a growing need for policy attention to boost the participation of the middle class in growth and development. It is important to make the middle class a stable force to sustain the growth of the Philippine economy. In doing so, the government should focus on improving human capital investments, such as education and health

care. Government programs that target the poor should be expanded to include the low-income households. The middle, lower middle, and lower-income classes, who are at risk of falling into poverty due to income shocks (i.e., illness, death of the provider, natural hazards), should also be provided targeted interventions.

Unemployment in the Philippines has been noted to be more of a ‘middle class concern’ (Albert 2014). Hence, the government should find more avenues to attract investments (foreign and local) that will create more and better-quality jobs. Better investment climates (including having better infrastructure, cheaper electricity, cheaper and faster Wi-Fi) are helpful in attracting new investments. Although the private sector is responsible for job creation and income-generating activities, the government sets the investment climate. The corporate social responsibilities of major companies, especially those owned and managed by taipans, could also be tapped to generate more and better-quality jobs, especially for the middle class.

The income tax reform being proposed in the legislative branch, once passed and implemented, will likely bolster the income share of the middle class. This income boost to the middle class will provide an opportunity to capitalize on domestic demand-led growth spurred by domestic consumption. It mirrors the recommendation of Dabla-Norris et al. (2015, p. 30) that a

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fiscal policy, particularly a fiscal redistribution, could be an “important tool to raise the income share of the poor and middle class and, in turn, support growth”. It will be important to examine the effects of removing income tax altogether, and instead only collecting consumption taxes (as the wealthy find too many income tax loopholes) with heavy consumption taxes on luxury items, and minimal consumption taxes on basic items (especially those consumed by the poor).

Unintended consequences (i.e., effects of increased urbanization) may likely occur when the middle class grows in number and their incomes increase. However, expanding the middle class will also provide opportunities for more inclusive development, shared prosperity, and sustained growth in the country. 📄

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For further information, please contact

The Research Information Staff
 Philippine Institute for Development Studies
 NEDA sa Makati Building, 106 Amorsolo Street, Legaspi Village, 1229 Makati City
 Telephone Nos: (63-2) 894-2584 and 893-5705
 Fax Nos: (63-2) 893-9589 and 816-1091
 E-mail: jalbert@mail.pids.gov.ph; publications@mail.pids.gov.ph

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