

Call for Research Proposals

Strengthening Mobility and Entrepreneurship: A Case for the Middle Classes

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1. Justification and Background

The middle class is an increasingly important engine of economic development. Middle classes foster savings and human capital accumulation, as they specialize in occupations that require skills and experience (Torche and López-Calva, 2010) and which also shape values such as patience, effort and a strong work ethic (Doepke and Zilibotti, 2007). Additionally, other sources of economic growth, such as political stability and social cohesion, are furthered by large middle classes (Torche and López-Calva, 2010). The reasoning is that an increase in the middle class share of income predicts a rise in political rights (Barro, 1999) and, in turn, stimulates long-term investments (Alesina and Perotti, 1996).

The importance of analyzing the middle class in Latin America lies in the potential positive effect of this social class on the region's economic and social performance. There is evidence of a strong association between solid middle classes and higher income, more education, better health outcomes and faster upward mobility, as shown by Easterly (2000). Therefore, understanding the middle class is crucial for designing and implementing policies to reduce income and social inequalities.

In Latin America, the idea that a large and prosperous middle class might be good for an economy's development has likewise been debated for decades. In 1958, political scientist John Johnson formulated an influential thesis to the effect that "middle sectors" had emerged in many Latin American countries, where they championed state-sponsored development, expansion of public education and social welfare programs and democracy itself.

But political progressivism and stabilization is not the only mechanism whereby a large middle class could promote economic development; there are economic links as well. Thus, for example, middle-class households may exhibit values conducive to economic development: namely, they save and invest more than their poor counterparts, and they may acquire more education. In this view, a large middle class favors economic growth by investing vigorously in capital accumulation, both physical (housing, buildings, plant and equipment) and human (education and training).

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A related hypothesis is that the middle class is the cradle of entrepreneurs, and that indeed a large middle class is a sign of a vigorous business class. In this case, the middle class drives innovation and business start-ups above and beyond its contribution to factor accumulation; indeed, this middle-class dynamism was the cornerstone of the "Protestant ethic" identified by Max Weber as the source of capitalist development. An important element to consider, besides the size of the middle class, is prospects for social mobility. If the middle class contributes to social welfare, social mobility becomes a policy objective to pursue and social mobility becomes intrinsic to income and the expansion of the middle class over time.

Many champions of the middle classes have stressed their importance as a cradle of entrepreneurship. Acemoglu and Zilibotti, (1997) indicate that new entrepreneurs armed with a capacity and a tolerance for delayed gratification emerge from the middle class and create employment and productivity growth for the rest of society. The middle class is primarily a source of vital inputs for the entrepreneurial class: it is their "middle class values"—their emphasis on the accumulation of human capital and savings—that makes them central to the process of capitalist accumulation (Doepke and Zilibotti, 2005, 2007). Moreover, middle-class demand for quality spurs investment in production and marketing, with positive effects on income generation (Murphy, Shleifer, and Vishny, 1989).

Critics, in contrast, have argued that the middle class is not more entrepreneurial than other groups. Banerjee and Duflo (2007), analyzing data on patterns of consumption and investment by the middle class, conclude that the middle class is not particularly entrepreneurial, as human capital accumulation is more relevant to them than business investment: "Nothing seems more middle class than the fact of having a steady well-paying job. While there are many petty entrepreneurs among the middle class, most of them do not seem to be capitalists in waiting. They run businesses, but for the most part only because they are still relatively poor and every little bit helps. If they could only find the right salaried job, they might be quite content to shut their business down. If the middle class matters for growth, it is probably not because of its entrepreneurial spirit."

Using Latinobarómetro survey data, OECD (2010) shows that, consistently across all countries in the sample, the highest concentration of entrepreneurs is found among the richest group of the population rather than the middle sector. The analysis of attitudes towards entrepreneurship and opportunity indicates no systematic differences in attitudes to entrepreneurship across social groups. For instance, all share a common view of the importance of entrepreneurship for development, and an overwhelming majority of respondents across all income groups believe that opportunities for the affluent are larger than for others in their country. However, the belief that a person born poor can become rich by working hard is held by a substantially higher share of the middle class than of the affluent.

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To explore the role of entrepreneurship Quadrini (1999) characterizes the different accumulation behavior of agents across the wealth distribution and finds that the existence of borrowing constraints has the effect of selecting entrepreneurs among richer workers. He concludes that, while entrepreneurship enhances upward social mobility across all classes, the presence of borrowing constraints and the higher cost of external financing make undertaking entrepreneurial activity less likely for those households located in the lower portion of the wealth distribution. Because undertaking entrepreneurial activity increases a household's probability of moving to higher wealth classes, those households with lower levels of wealth—due to financial constraints and/or to the higher cost of external finance—have fewer opportunities to move up the wealth ladder.

In a survey comparing emerging economies' entrepreneurs, Kantis et al. (2002) find that dynamic entrepreneurs in Latin America come from a narrower range of social classes—primarily from the highly educated and middle classes—than in the case of East Asia. Nearly half—48 percent—of the dynamic ventures in East Asia are founded by people from the lower and middle classes, while in Latin America only about one-quarter—28.6 percent—of entrepreneurs come from the lower and middle classes. This suggests that the contribution of entrepreneurship to social mobility, and to the creation of wealth, is lower in Latin America than in East Asia.

Erik Hurst and Annamaria Lusardi (2004) find that the propensity to become a business owner is a nonlinear function of wealth. The relationship between wealth and entry into entrepreneurship is essentially flat over the majority of the wealth distribution. It is only at the top of the wealth distribution—after the ninety-fifth percentile—that a positive relationship can be found. Segmenting businesses into industries with high and low starting capital requirements, they find no evidence that wealth matters more for businesses requiring higher initial capital. When using inheritances as an instrument for wealth, they find that both past and future inheritances predict current business entry, showing that inheritances capture more than simply liquidity.

2. Objectives

The main objectives of this study are the following:

- (i) characterize middle class entrepreneurship along dimensions pertaining to the individual and the firm; dimensions of interest include socio-economic background, education, skills, firm size and sector
- (ii) assess the role of entrepreneurship in social and economic mobility
- (iii) identify the main constraints facing middle-class entrepreneurs; constraints of interest include finance, insurance, labor market regulations, knowledge and access

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to government programs, business organizations and other means of influencing or benefiting from public policies

- (iv) identify the type of economic and social policies that middle-class entrepreneurs support as a means to improve the chances of survival and success of their firms.

All research proposals must cover objective (i) and at least one of the other objectives.

For the purpose of this study, the recommended definition of middle class will be that proposed in Castellani and Parent 2010, where middle class individuals are those with incomes between 50% and 150% of respective median income.¹ This measurement presents income distributions akin to those based on national poverty lines, with the advantage of providing a standardized lower bound with respect to nationally defined poverty lines. Moreover, 50% of median household income is widely used and generally accepted as a proxy for low-income thresholds.² However, as long as they use this basic definition, researchers are welcome to also consider alternative definitions.

With respect to firm size, this study will focus on small- and medium-sized enterprises (SMEs), defined as firms with between 10 and 50 employees, and 51 and 250 employees, respectively (or similar size ranges depending on data availability). This definition is adopted for practical purposes: although there is not an internationally agreed-upon definition of SMEs, employment size is the criterion commonly used in LAC (Angelelli et al., 2006). Firms with fewer than 10 employees, usually known as microenterprises, will not be considered in the analysis. The focus on small and medium enterprises (SMEs) is dictated by their increasing recognition in the literature as a core element in countries' strategy to foster economic growth, employment and poverty alleviation in emerging economies and especially in Latin America (Ibarrarán et al., 2009; Ayyagari et al., 2007).

Applying the proposed definitions of middle class and SMEs, under objective (i) above each country case study should analyze at least the following issues:

- What is the distribution of entrepreneurs across the wealth spectrum? Is the middle class more entrepreneurial than poor and rich strata?
- What is middle class entrepreneurs' profile? (education/age/sector of activity/age of enterprise/firm size)
- What is the formal/informal status of firms owned by these entrepreneurs?

¹ To calculate household income OECD methodology can be used. OECD weights for equivalized or household size-adjusted income are as follows: 1 for the first adult; 0.5 for every other adult or child above 14 years old; 0.3 for every child under 14 years old.

² A relative poverty line, related to some fraction of typical incomes. The OECD and the European Union use 50-60% of national median equivalized household income, while Eurostat uses the risk-of-poverty threshold (60% of the median income). In practice, it calculates and publishes rates according to various risk-of-poverty thresholds using various percentages (40, 50, 60, 70%) of the median and the mean. ECLAC has used 50% of the median as standard for its calculations, although for internal uses other percentages of median and average income have been used.

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Specific questions to address objectives (ii) through (iv) may include, inter alia,

- Do middle-class small entrepreneurs (MCSEs) operate in sectors that are less dependent on the factors constraining them? What are the implications for investment, productivity, innovation and growth?
- How do SMEs run by MCSEs compare with other SMEs in their ability to grow, generate employment, manage financial constraints and resist external shocks?
- Do MCSEs adopt different business strategies in order to circumvent the constraints facing them?
- How do the policies demanded by MCSEs differ from those demanded by other entrepreneurs or other social groups, including non-entrepreneurs from the middle classes?
- Are the channels of influence used by MCSE (for instance, participation in business associations, political organizations, direct contact with politicians or government officials, etc.) different from those used by other entrepreneurs? What are the implications for the policymaking process?

Research proposals should include their own lists of specific questions to address objective (i) and at least one of the other objectives above.

Proposals may consider other topics of research that may help enrich the analysis of the entrepreneurship of the middle classes and their values, attitudes and behaviors.

Based on the analysis of the above questions, the case studies should provide well-articulated and prioritized recommendations for policy and institutional reform, taking into account the country's historical legacies, legal framework and political economy context. The methods of analysis of such questions are likely to vary across the sample countries, reflecting in particular the availability of the relevant data.

3. Data

Research teams should make use of existing databases, including household and firm surveys regularly conducted by the National Statistical Offices. Ideally, panel data that permits following individuals with entrepreneurial activity should be used. Since this type of information is extremely scarce, constructing pseudo panels must be considered when feasible (see Ñopo et al., 2011).

Also, alternative sources should be considered. See, in particular, the surveys conducted by the IDB for these two reports:

- Developing Entrepreneurship: Experience in Latin America and Worldwide (2005): <http://www.iadb.org/document.cfm?id=834797>
- Entrepreneurship in Emerging Economies: The Creation and Development of New Firms,

in Latin America and East Asia. 2002:

<http://www.cietec.org/documentos/Libro%20BID%20Entrepreneurship.pdf>

Besides firm and households surveys, opinion surveys such as Latinobarómetro, LAPOP, or Global Entrepreneurship Monitor (GEM) may provide useful information on attitude and behaviors. Use of other sources is also encouraged.

Each research proposal should describe in detail the databases and econometric methodologies to be used in assessing the questions proposed. The soundness of the proposed econometric methods will be a very important criterion in the selection of the proposals for the project.

4. Selection Criteria

Either research institutions or individual researchers may present proposals for this project. The final number of proposals accepted will depend on the quality and the proposed budget of the proposals received. Each approved research proposal will receive financial support of **up to US\$25,000** from the IDB. Proposed budgets will be evaluated taking into account the scope of work proposed. Projects that seek extra funding to complement financing by other institutions are strongly encouraged.

4.1. Required Documentation

Proposals should include a detailed background section and literature review, data templates (in Excel format) to be used in the study, with a preliminary assessment of data availability, and a detailed description of the methodologies and empirical strategies to be used for each of the objectives to be covered. The bibliography of this call for proposals lists several references for the empirical strategies used in the literature.

Final papers will be considered for dissemination as IDB working papers and may be included in a book or a special journal issue on Strengthening Mobility and Entrepreneurship: A Case for the Middle Classes in Latin America. For studies with only IDB funding, other forms of dissemination or publication must be explicitly approved by the coordinators until the journal issue option has been fully defined. Proposals may include suggestions for further dissemination of the final version of the paper and its policy implications.

4.2. Proposal Registration

Research institutions and individual researchers interested in submitting a proposal should pre-register before **April 15, 2011** by [clicking here](#). If unable to pre-register before the due date for proposals, please send an email to red@iadb.org. Proposals are due **May 9, 2011**:

Proposals should be submitted using the [Web Submission Form](#). **Please note that there are two options within the submission form: one for institutions and another for individual researchers. Please make sure to choose appropriately.**

The following information will be required for submitting your proposal:

- The proposal with all the technical aspects and methodology proposed involved in the development of the study, based on the Terms of Reference outlined in this Call for Proposals.
- A budget indicating the time and resources that will be used within the context of the research work plan. **The proposal and corresponding budget must be sent in separate files.** The proposed budget should disaggregate items financed by the IDB contribution and those financed by the research institution or by individual researchers. The budget should distinguish among amounts assigned to professional honoraria, "overhead" in the case of institutions, and other major categories of research expenditures.
- The name and Curricula vitae (three pages maximum per researcher) of the researchers involved in the project, whether they participate on behalf of an institution or as individual consultants. Researchers should demonstrate ability to meet the objectives of the project, including relevant experience. Please note that for proposals submitted by institutions, changes in the research staff cannot be made without the prior approval of the IDB project coordinators; the research leader may not be changed and must lead the entire project until its full completion.
- Institutions must provide the name and contact information of its legal representative, with authority to sign contracts with the IDB, if selected to conduct the study.

Note: ALL proposals and research papers must be submitted in English.

5. Coordination and Schedule

The project will be administered by the Research Department (RES) and the Andean Country Department (CAN/CCO) of the IDB. Mr. Santiago Levy, Vice-President of Sectors and Knowledge, Inter-American Development Bank, and Luis López-Calva, World Bank, will act as members of the Advisory Council of the project. Professors Zoltan Acs, George Mason University, David Audtretsch, Indiana University, and Christopher Woodruff, University of California, San Diego, are being considered as external technical advisors. Eduardo Lora

(General Manager of RES and Chief Economist a.i.) and Francesca Castellani (Senior Economist at CAN/CCO), will serve as coordinators.

The tentative schedule of activities is as follows:

- **April 15, 2011:** Due date for **pre-registration** ([click here](#))
- **May 9, 2011:** Due date for **receiving proposals**. Institutions and researchers should ensure that complete documentation is submitted through the [Web Submission Form](#).
- **May 16, 2011:** Announcement of **selected research proposals**.
- **June 20-21, 2011:** **First Discussion Seminar** in Washington, DC.
- **September 15, 2011:** Due date for receiving a **first draft** of research papers.
- **September 29-30, 2011:** **Second Discussion Seminar** (location to be determined).
- **November 17, 2011:** Due date for receiving a **second draft** of research papers.
- **November 30, 2011:** Deadline for a **final version of the research papers**, including a summary that discusses policy lessons and delivery of the datasets utilized by the study to the IDB.
- **January 30, 2012:** Deadline for receiving an **edited version** of the research papers, following the guidelines of the Bank's Publications Protocol, for publication as a Working Paper.

6. Financial Contribution

The IDB will contribute up to **US\$25,000** for each study, depending on the scope of the work proposed.

The payment schedule is as follows:

- 35 percent within 30 days of signing the formal agreement between the IDB and the respective research center or researchers.
- 15 percent within 30 days of presenting and approving the first draft of the research paper.
- 25 percent within 30 days of presenting and approving the second draft of the research paper.
- 25 percent upon approval by the Bank of the final research paper and upon delivery of the datasets utilized by the study to the IDB.

7. Bibliography

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