

DEBATES

# The Decline in Inequality in Latin America: The Role of Markets and the State

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Inequality is a distinctive feature of Latin America and the Caribbean, due both to its high level and its persistence<sup>1</sup>. However, after a period of rising inequality in the 1990s, income inequality in the region has been falling. For the region as a whole, the Gini coefficient declined from an average of 0.529 in 2000 to 0.509 in 2009. The decline has been widespread, its order of magnitude is non-trivial and, in the majority of cases, it is statistically significant. Based on the SEDLAC-World Bank data, the inequality fell in thirteen out of seventeen countries for which comparable data are available (see Figure 1). The average decline for the 13 countries is -0.94 percent a year. Interestingly, this trend occurred when inequality was growing in other parts of the world.<sup>2</sup>

Why has inequality declined? An in-depth analysis for Argentina, Brazil, Mexico and Peru, a representative sample of the region's

diversity in terms of initial inequality, political regimes, international trade patterns and economic growth, suggests that both a decline in earnings inequality and non-labor income inequality contributed to the fall in overall inequality. In both cases—as we shall see below—state action, through educational policies and more progressive transfers, has played an important role.

Before we turn to the next section, a caveat is in order. A well-known fact is that household surveys do not capture incomes accurately at the top of the income distribution. This can be due to limitations in the representativeness of the sample or non-sampling errors such as under-reporting of incomes on the part of rich households, particularly non-wage income. However, these limitations do not mean that what we learn from the rest of the distribution is irrelevant. As we shall see,

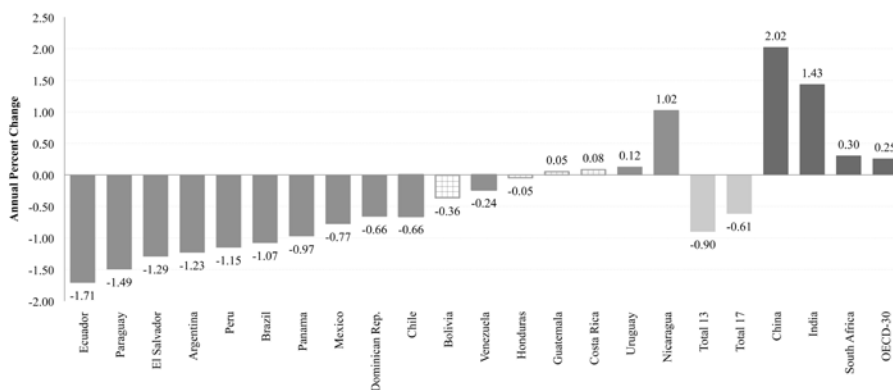
in the last decade new trends have emerged that are worth documenting and analyzing.

## Declining Earnings Inequality

What accounts for the decline in earnings inequality? The evidence suggests that the driving force was a reduction in the hourly wage gap for workers with more years of education (or skills) vis-à-vis less educated (or low-skilled) workers. In the 2000s—and in contrast to the previous decade—the skill premium fell and this factor was present in all four countries. So, then, what was behind the decline in the wage gap?

In economics we like to distinguish between the role of market forces (demand and supply of labor by skill) and institutional factors (especially minimum wages and the unionization rate). In the 2000s, the relative supply of workers with tertiary education increased, and the returns to tertiary education declined in all four countries. Conversely, the relative supply of workers with incomplete primary or no education declined and their wages rose over the same period. It is tempting to conclude, therefore, that we are seeing a simple case in which the growth in supply outpaced the growth in demand for skilled labor. However, even if both demand and supply had grown at the same rate (or even if demand outpaced supply), institutional factors could have changed to favor wages of low-skilled workers to such an extent that the wage scale compressed. Campos, Esquivel and Lustig (2012) show that in Mexico neither the minimum wage nor the unionization rate changed during the period of declining wage inequality. Thus, in Mexico market forces appear to have been predominant. The same might be said for Peru. In contrast, in Argentina and Brazil, both market forces and institutional factors contributed to the decline in wage

FIGURE 1  
**Declining Inequality in Latin America by Country: 2000-2009**  
*Annual Percentage Change in Gini*



Source: Lustig, N., Lopez-Calva, L.F. and Ortiz-Juarez, E. (2011), "The Decline in Inequality in Latin America: How Much, Since When and Why," Working Paper 1118, Tulane University.

inequality. In both countries the minimum wage rose significantly and the government took a more pro-union stance in the 2000s. In the case of Argentina, this translated into mandated increases in wages, which might have benefited workers at the lower end of the income scale relatively more. However, in the two countries changes in growth patterns must have resulted in a rise in demand for low-skilled workers. (It is interesting to note that this happened in spite of slow GDP growth both in Brazil and in Mexico).

The observed changes in the composition of labor supply are the result of a significant increase in the coverage of basic education (and in some countries beyond that), a “push” that gained momentum in the 1990s, especially in Brazil and Mexico. Hence, public policy was an underlying force in shaping the dynamics that materialized in the labor market as an interaction between demand and supply.

In addition, demographic changes were an underlying determinant of the overall decline in inequality. The direct effect of lower birth rates appeared in the form of lower dependency ratios (number of children or elderly per adult), especially for poorer households. A sharp increase in the participation of women in the labor force raised the ratio of working adults to total adults, especially for poorer households. Lower population growth among poorer households implied a slower increase in the supply of low-skilled workers than in the past. And lower population growth made it easier for the government to expand the coverage of education. Thus, behind the labor market dynamics are some deeper structural processes that have to do with changing values and behavior and, in particular, with the role of women and their ability to exercise more choice in terms of the number of children, their

education and their participation in the labor force as remunerated workers.

### **Declining Inequality in Non-labor Income**

The reduction in the inequality of non-labor income was also an important factor behind the fall in overall inequality. Non-labor income includes quite disparate income sources: (1) returns to physical and financial capital (interests, profits and rents), (2) private transfers (for example, remittances) and (3) public transfers (monetary, and in the case of Peru, some transfers in kind). As mentioned above, household surveys are not particularly good at capturing income from capital. Nevertheless, the evidence shows that the contribution of changes in returns to physical and financial capital tended to be small and regressive. In terms of private transfers, remittances were particularly relevant in the case of Mexico. They proved to be equalizing and became even more so in the 2000s, because they closed the gap between rural and urban household per capita incomes.

The new phenomenon in Latin America was the significant rise in importance of the equalizing contribution of public transfers in the 2000s. A trend that was present in the four countries analyzed here is that government spending on transfers (monetary and non-monetary) became more progressive in the 2000s. This trend went beyond targeted cash transfers. Spending on health, education, nutrition and basic infrastructure (electricity and water and sanitation, for example) became more progressive—that is, more pro-poor. The analysis of the contribution of cash transfers in Brazil and Mexico shows its remarkable power in reducing inequality. In Brazil, the *Benefício de Prestação Continuada* and *Bolsa Família* explain

more than 20 percent of the decline in household income inequality. In Mexico, *Oportunidades* accounts for 18 percent of the change in the pre/post-transfers difference in the Gini coefficient. Government spending on transfers became more progressive in the 2000s, but this trend went beyond targeted cash transfers: spending on health, education, nutrition and basic infrastructure also became more pro-poor. In Argentina, the *Moratoria Previsional* and *Asignación Universal por Hijo* reduce inequality and poverty by leaps and bounds. In Peru, *Juntos*—though a much more modest cash transfer program than those in the other three countries—together with transfers in kind has become more progressive and accounts for a significant portion of the decline in inequality in Peru.<sup>3</sup>

### **The Future**

Will the equalizing momentum in labor markets continue in the future? If it depends on the pace of educational upgrading, there are reasons to be less optimistic. First, it is still hard for many young people in Latin America to be able to afford to go on to post-secondary schooling, especially because of the opportunity cost of giving up earnings in order to study. Perhaps more importantly, because the quality of education in Latin America is low (especially for low-income groups), many high school graduates are not “college ready” and will not be admitted to good quality universities (public or private). If the state wants to continue to strengthen its current method of equalizing the distribution of income—equalizing opportunities through education—addressing the inequality in the quality of basic education and finding ways to compensate for the high opportunity cost of attending tertiary education for

poor children must take priority in the public policy agenda.

The results suggest that the region has been moving, for the most part, in the right redistributive direction. In particular, governments have been making a greater effort to correct for inequality in the distribution of opportunities. Moreover, governments have actively reduced poverty through direct transfers to the poor, making distributive outcomes, and not just opportunities, more equal. At the same time, however, the detailed analyses of government spending and revenue collection reveal that a large share of public spending is still neutral or not progressive enough from the distributive point of view. It also reveals that taxes, in particular personal income taxes, are severely underutilized as an instrument of redistribution in a region characterized by the presence of a substantial number of ultra-high net worth (i.e. super rich) individuals. A lot of work is still pending in the redistributive agenda of the state.

#### Endnotes

<sup>1</sup> This article is based on Lopez-Calva, Luis F. and Nora Lustig (2010) *Declining Inequality in Latin America: a Decade of Progress?* (Brookings Institution and UNDP) and Lustig, Nora, Luis F. Lopez-Calva and Eduardo Ortiz-Juarez (2011), “The Decline in Inequality in Latin America: How Much, Since When and Why”, Working Paper 1118, Tulane University. The authors are grateful to Emily Travis for her editorial suggestions.

<sup>2</sup> These results are robust even if we use the data presented by the United Nations Economic Commission for Latin America and the Caribbean (ECLAC or CEPAL). The ranking of the countries may vary but not the overall conclusion.

<sup>3</sup> For more details on the specific programs and the incidence of government spending see Lustig (2012), coordinator, “Taxes, Transfers and Redistribution in Argentina, Bolivia, Brazil, Mexico and Peru” (Team: *Argentina* (Carola Pessino); *Bolivia* (George Gray-Molina, Wilson Jimenez, Veronica Paz and Ernesto Yañez); *Brazil* (Claudiney Pereira and Sean Higgins); *Mexico* (John Scott); and *Peru* (Miguel Jaramillo), background paper for Corporación Andina de Fomento (CAF) *Fiscal Policy for Development: Improving the Nexus between Revenues and Spending/Política Fiscal para el Desarrollo: Mejorando la Conexión entre Ingresos y Gastos*. 2012. ■