



Inequalities in Latin America: Trends and implications for Policy

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Abstract

A growing empirical literature has focused on the drivers of the remarkable reduction, albeit from comparatively high levels, in income disparities in the vast majority of Latin American countries since the 1990s. This is unlike most other parts of the world, including the OECD area, where income inequality has actually been rising. This improvement in the distribution of income has contributed to a reduction in the incidence of poverty in the region, although vulnerable groups face the risk of falling back into poverty if the economic environment deteriorates. Structural factors, such as a reduction in skill premia and labour income gains at the lower end of the income distribution, coupled with increased government spending on redistributive programmes, have been the main drivers of the reduction in inequality. Short-term, cyclical factors, including GDP growth and sizeable terms-of-trade gains in the resource-based economies, have played a relatively smaller role. Importantly, inequalities have also narrowed in non-income outcomes, such as educational attainment, the health status of the population and employment, which matter for people's wellbeing.

Key words: income distribution, poverty, Latin America.

JEL Classification: D30, D60, I30.

1. Introduction

Several countries in Latin America¹ are among the most unequal in the world on the basis of standards measures of income distribution. To illustrate, according to the World Bank's World Development Indicator database, for example, the Gini coefficient of the distribution of disposable income was about 0.50 on average in the region in 2012, as opposed to about 0.32 for the OECD countries on average. In terms of income ratios, which is another conventional gauge of income disparities, the OECD's Income Distribution database shows that the income of households in the top 20 percent of the distribution is about 5 times higher than that of households in the bottom 20 percent in the OECD area, against 12 times higher in Chile, 17 times in Brazil and 19 times in Colombia².

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Despite high levels of inequality, there has been a notable improvement in the distribution of income in most Latin American countries over the last two decades or so. This trend is at odds with the deterioration observed in OECD countries, including in those more egalitarian societies, such as the Nordic countries (OECD, 2015a). The Gini coefficient of disposable income in Latin America decreased from 0.54 in 1995 to 0.5 in 2012, thanks notably to improvements in Peru, Paraguay, Argentina and Brazil. Nevertheless, progress has stalled more recently, raising doubt about whether or not the past achievements can be maintained in the years to come without further pro-growth and distribution-friendly structural reforms and in an environment of slow global growth combined with what appears to be the end of a long commodity price boom that benefited the resource-based economies of the region.

While analysis of trends and drivers of income distribution in Latin America has suffered from a dearth of internationally comparable data, much progress has been made. Better quality information is now available from different sources, including the World Bank's World Development Indicators, the OECD's Income Distribution database and Luxembourg Income Study, which allows for a finer measurement of the distribution of income in the region on the basis of household surveys that distinguish between pre- and post-tax and benefits and accounts for cross-country variations in the coverage of the household income data. Recent methodologies have also been applied to a growing number of Latin American countries to complement survey data with information from tax returns as a means of gauging the income and wealth of the top segments of the distribution, which tend to be underestimated in household surveys.

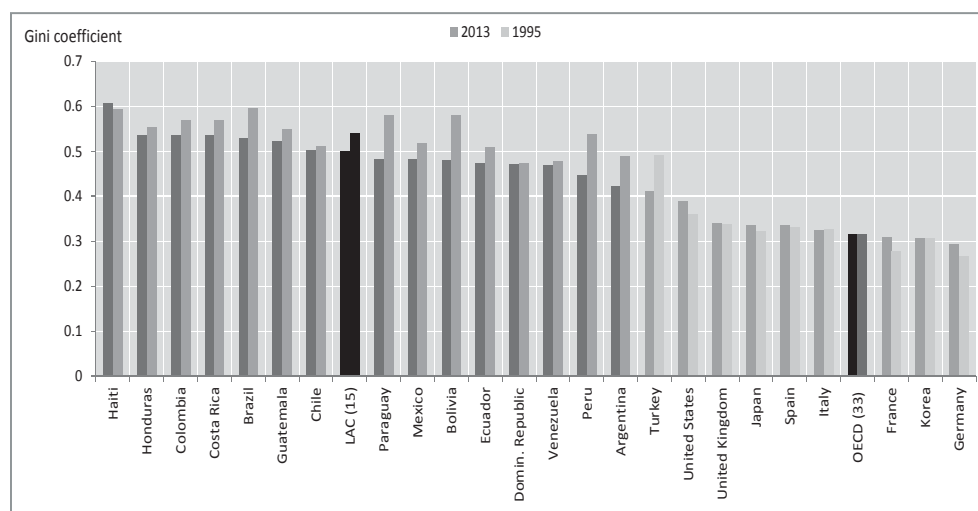
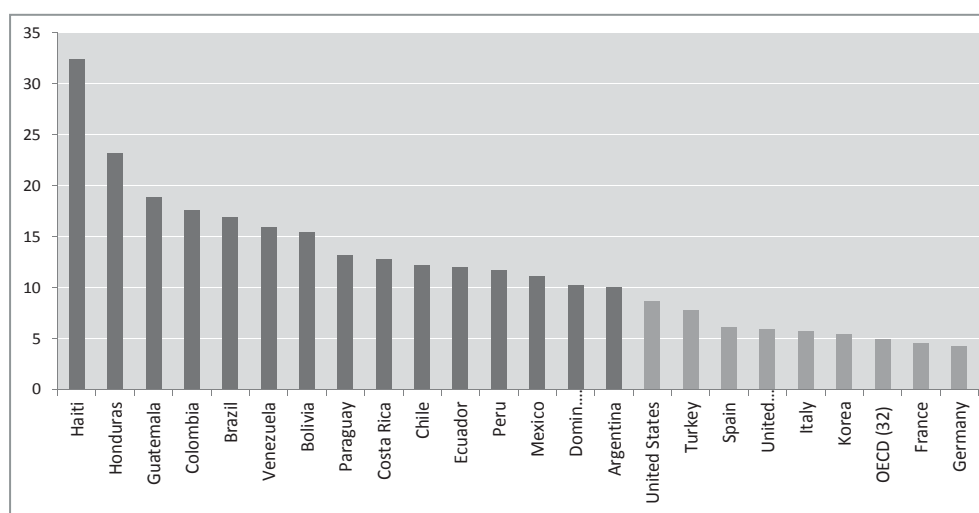
Against this background, this paper takes stock of the trends in the distribution of income and other outcomes that matter for people's wellbeing, such as labour market outcomes, educational attainment and the health status of the population. On the basis of a survey of the empirical literature, the paper also discusses the short-term (cyclical) and structural factors that have shaped the trends, as well as the policy actions that can be considered to build on, or at least maintain, the past achievements.

The paper is organised as follows. Section 2 reviews key indicators and trends in the distribution of income and other relevant outcomes in Latin America and OECD countries, as well as broader methodological issues related to the measurement of income distribution. Section 3 elaborates on the short-term and structural policy drivers of income distribution in the region, comparing and contrasting them to the extent possible with the situation in OECD countries. Section 4 concludes and discusses the policy reforms that would be needed for building on past achievements.

2. Trends in inequalities in Latin America

Trends in the distribution of income

The distribution of income is severely skewed in most Latin American countries on the basis of conventional indicators, such as the Gini coefficient of the interpersonal distribution of income and top-to-bottom income shares (Figure 1). Disparities are also high, although they tend to be somewhat narrower, when measured on the basis of consumption or expenditure. Moreover, income inequality is higher in Latin America than predicted on the basis of income and economic development, and it has traditionally been attributed to the region's unequal distribution of land and natural resources, which has its origins in the region's colonial history, as well as poor educational outcomes.

Figure 1. Income inequality indicators: Latin America and OECD**A. Gini coefficient, selected OECD and Latin America countries, 1995 and 2013****B. Ratio of disposable income held by top quintile to that held by the bottom quintile, 2012**

Note: Gini data refer to 1995 or earliest year available and 2013 or latest year available. For some Latin American countries data may refer to household consumption expenditure. Countries are ranked in descending order of the Gini coefficient in 2013. Disposable income shares refer to 2012 with the exception of Costa Rica and Argentina where the latest available year is 2006. Chile and Mexico are the only countries in Latin America that are members of the OECD.

Source: Authors' calculations based on data from the World Bank's World Development Indicators database (Latin American countries) and the OECD Income Distribution Database (OECD countries).

The distribution of income has nevertheless improved in the vast majority of Latin American countries since the 1990s. There is now a large body of empirical work on income distribution in the region, which shows a large, widespread narrowing of income discrepancies, despite differences in methodology and data. For example, Lustig *et al.* (2014) show that the Gini coefficient of household per capita income fell from a weighted average of 0.55 in the late 1990s to 0.49 in the late 2000s in a set of 17 Latin American countries for which comparable data are available in their dataset. This is the case of the largest economies, including notably Brazil and Mexico, but also Chile and Colombia, a trend that is also confirmed by household survey-based indicators available from the OECD for a larger set of countries (OECD, 2015a). In fact, this improvement in the distribution of income, albeit from high levels, is in sharp contrast with most OECD countries, where income inequality has actually worsened over the last three decades or so, at least as far as measured by income ratios.

While labour income accounts for the lion's share of household income, it is important to look at non-labour sources, which include returns to capital, such as rents, profit and interest, as well as remittances and government transfers. Capital income is notoriously difficult to measure in household surveys and tends to be underreported, as discussed below. However, there is some evidence that changes in returns to capital have been small and unequalising in Argentina, Brazil and Mexico (Lustig *et al.*, 2013a). As for remittances from migrant workers abroad, it appears that they have contributed to an improvement in the distribution of income in countries such as El Salvador and Mexico during the 2000s (Esquivel *et al.*, 2010; Cornia, 2013). To some extent, this is due to the effect that remittances have in narrowing the income gap between rural and urban households.

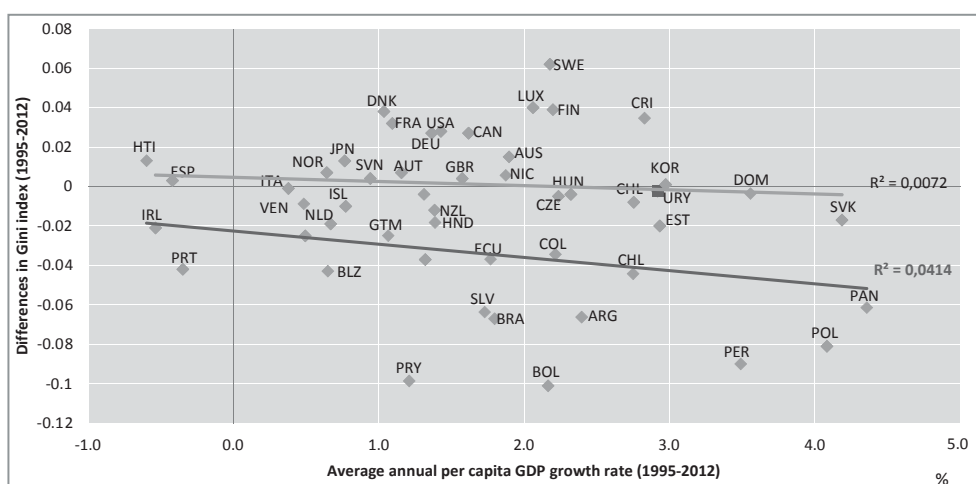
As for the effects of taxes and government transfers, estimates vary a great deal across countries and empirical studies. Overall, tax systems are typically less redistributive in Latin America than in OECD countries on account of greater reliance on indirect taxes and less progressive direct tax schedules. At the same time, contributory programmes, such as old-age pensions, account for a larger share of government social spending in Latin America than targeted transfers to individuals and households. As far as transfers are concerned, although equalising, their effect on the distribution of income has been lower than that of changes in labour income. For example, studies for Argentina, Brazil and Mexico (Souza and Medeiros, 2013; Lustig and Pessino, 2013; Barros *et al.*, 2010; and Esquivel *et al.*, 2010) show that transfers have accounted for less than half of the reduction in income disparities in these countries. An expansion of non-contributory pensions in Argentina and changes in the design and coverage of transfers in Brazil have been important factors, as discussed below. Incidence analysis also shows that the redistributive impact of tax-benefit systems varies considerably from country to country, and it tends to be stronger in Argentina, Brazil and Uruguay (Lustig *et al.*, 2013a; Goñi-Pacchioni *et al.*, 2011; Lustig, 2011).

Income inequality, growth and poverty

Several Latin American countries have managed to combine growth in GDP per capita with improvements in the distribution of income. There are many channels through which income inequality could harm growth, but empirical evidence remains mixed. In particular, there appears to be stronger evidence of a negative correlation between income inequality and growth within countries than across countries³. However, despite their high levels of income inequality, most Latin American countries have managed to grow without sacrificing equity. This is in sharp contrast with the experience of several OECD countries, where widening income gaps have been accompanied by sagging productivity and output growth (Figure 2).

Figure 2. Income inequality and economic growth: Latin America and OECD, 1995-2012

OECD (blue) and Latin American (red) countries



Note: Hungary, Israel, Mexico, Switzerland and Turkey are excluded due to a lack of data on comparable years. GDP is measured in constant prices (2005 USD).

Source: Authors' calculations based on data from the World Bank's World Development Indicators database (Gini index and GDP per capita in Latin American countries except for Mexico and Chile), the OECD Income Distribution Database (Gini index in OECD countries) and the OECD National Accounts database (GDP per capita in OECD countries).

The narrowing of income discrepancies has contributed to an overall reduction in poverty. On the basis of an international poverty line, the share of the Latin American population with daily incomes of at most USD 2.50 (measured in purchasing power parity terms) dropped from a quarter to about 12 percent during the 2000s, which corresponds to a reduction in the poverty headcount of about 50 million people. According to the World Bank, in 2011, for the first time, the Latin American countries had more people in the

middle class than in poverty (World Bank, 2013)⁴. Nevertheless, the incidence of extreme poverty varies considerably across countries: while in Argentina, Brazil, Chile, Paraguay and Uruguay extreme poverty rates are on average below 11 percent, in Mexico and Central America they are above 16 percent. All in all, empirical evidence suggests that the reduction in income inequality has been a driver of poverty reduction in Latin America: applying the Datt-Ravallion decomposition approach (Datt and Ravallion, 1992) on regional averages shows that 43 percent of the reduction in poverty is due to the decline in inequality (Lustig *et al.*, 2014). The poverty reduction effect of the fall in inequality has been particularly strong in Argentina, Bolivia and Mexico.

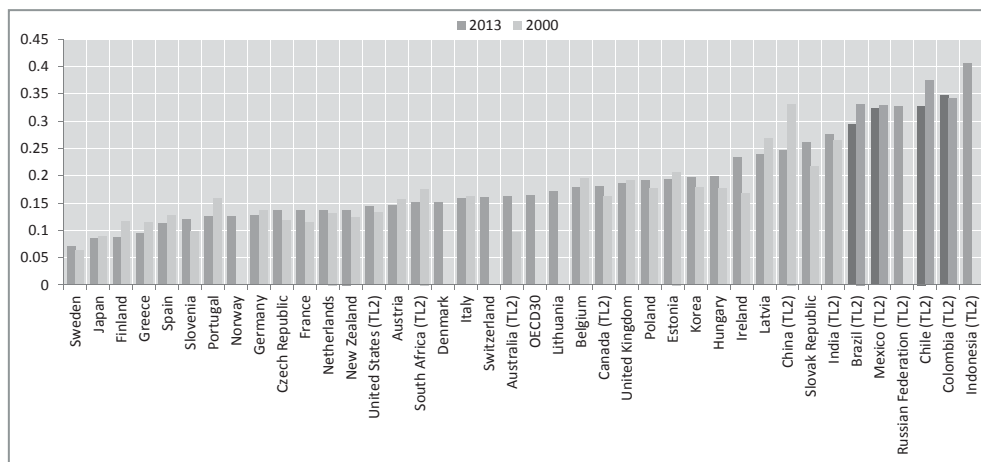
Despite these impressive gains, vulnerability remains, and poverty has become a pressing issue in urban areas. Extreme poverty rates are still higher in rural areas, where residents are more likely to work in the primary sector and have fewer years of education. However, in headcount terms, the majority of poor people live in urban areas in Latin America, raising the issue of ensuring quality jobs, services and infrastructure for the increasing urban population. Also, vulnerability remains a problem, and the World Bank estimates that about 40 percent of Latin Americans risk falling back into poverty if economic conditions deteriorate. Indeed, most citizens who escaped poverty did not actually enter the middle class but made it only into the vulnerable group living on USD 4-10 a day (World Bank, 2013)⁵. Therefore, the slowdown of the region's economy since 2010 poses a risk on the capacity to build on, or at least maintain, the past achievements in terms of poverty reduction and rising living standard.

Income inequality across regions

Income disparities are also large at both the interpersonal and interregional levels in Latin America. This is not surprising, given that economic activity tends to be geographically concentrated, especially in resource-based economies. To illustrate, the Gini coefficient of the distribution of GDP per capita among regions within Colombia, Chile, Mexico and Brazil is about twice as high as the average of OECD regions (Figure 3). In addition to the “between dimension”, income inequality also varies within regions: the difference in income inequality across the Mexican and Chilean regions is the highest among the OECD countries after the United States (Figure 4). For example, the Gini coefficient of household disposable income in the Mexican state of Puebla is 15 percentage points higher than the one in Tlaxcala, and comparable differences are found in Brazil and Colombia (OECD, 2013b and 2014a).

Figure 3. Income distribution between regions: Latin America and OECD countries, 2000 and 2013

Gini coefficient of GDP per capita (2010 USD PPP constant prices)

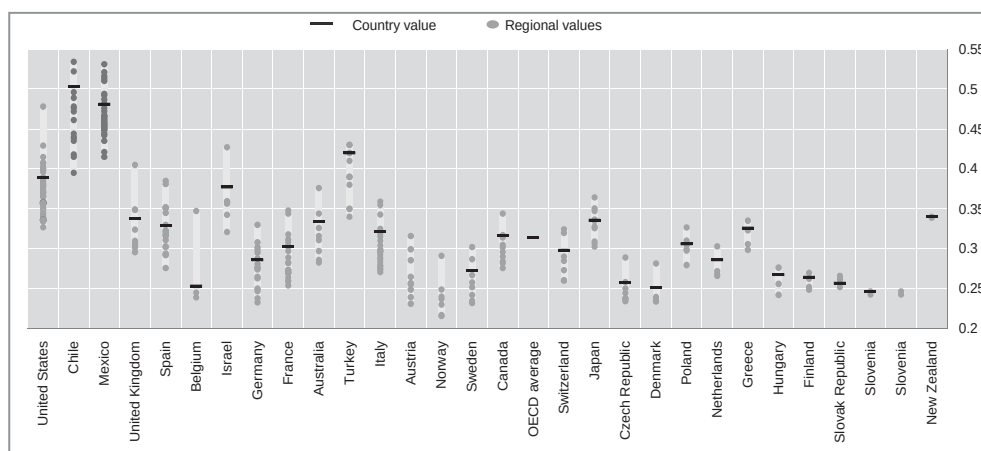


Note: Regions are defined as at the TL3 level for most countries, which corresponds to local governments, such as municipalities, or at the TL2 level, which corresponds to middle-tier jurisdictions, such as states. The Latin American countries are depicted in grey.

Source: Authors' calculations based on the OECD Regional Database.

Figure 4. Household disposable income: Latin America and OECD countries, 2010

Gini coefficient of household disposable income at the regional level (2010 USD PPP constant prices)



Note: Countries are ranked by the difference between the maximum and minimum values of the Gini coefficient of regional household disposable income. Each point in the graph represents a region within the respective country.

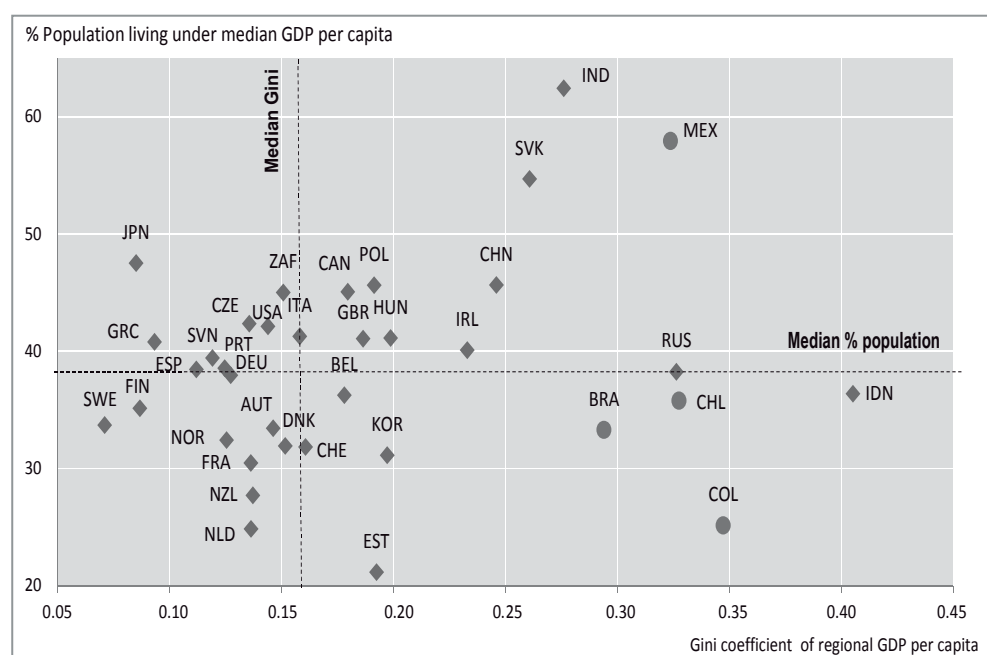
Source: Authors' calculation based on the OECD Regional Well-Being Database.

To some extent, income disparities among the regions are due to the limited scope for equalisation of spending capacity in intergovernmental fiscal transfers. This is in contrast with other decentralised countries of comparable income levels, such as South Africa, where inequality is high within regions but much less so between regions, as a result of intergovernmental equalization mechanisms. As a result, income differentials tend to be high both between and within regions in Latin America (Figure 5).

Trends in the distribution of wealth

Wealth is even more concentrated than income. According to recent estimates (Credit Suisse, 2015), at the global level households in the top decile of the income distribution owned 88 percent of the world's wealth in 2015, a share that has risen gradually since 2009. In Latin America, wealth is estimated to be very unequally distributed in Argentina, Brazil and Peru, where the top decile accounts for at least 70 percent of nation-wide wealth, followed by Chile, Colombia and Mexico, where the top decile accounts for at least 60 percent of wealth. Similarly to other developed and developing countries, wealth inequality began to rise after 2007 in Latin America, surpassing in 2014 its pre-2000 levels (Credit Suisse, 2015). International comparisons of wealth distribution, however, should be taken with caution as they are subject to high margin of errors, since in many countries direct wealth data are not available (see below).

Figure 5. Income inequality within and between regions, 2013



Source: OECD (2016).

Measurement challenges: underestimation of top incomes and wealth

Data on household income obtained from household surveys vary in quality, due to the sampling and non-sampling problems. Key non-sampling errors include a low response rate among top-income households and the underreporting of financial assets in general, which make it difficult to obtain an accurate picture of the upper tail of the income and wealth distributions. Indeed, research pioneered by Piketty and Saez (2003) and Atkinson *et al.* (2011) has triggered renewed interest in the use of information available from tax returns to complement household survey-based data on top incomes. At the same time, recent research has sought to compute data series on wealth on the basis of inheritance tax multipliers and different income tax capitalization techniques (Saez and Zucman, 2014). These different strands of work suggest that the underestimation of top incomes, and indeed wealth, are likely to have worsened since the crisis due to the changing nature of income among top earners (Piketty and Saez, 2013; Kopczuk, 2014).

Although the use of tax returns to complement household survey data on the distribution of income is becoming common practice, a few challenges need to be addressed, especially in the context of developing countries and emerging-market economies. First, exemption thresholds for the personal income tax tend to be higher as a percent of average incomes than in developed countries, which restricts the pool of individuals and households covered in tax returns to a much smaller share of the population than in developed countries. Information on income at the lower and middle segments of the distribution is therefore much more limited. Second, tax avoidance and evasion are likely to be higher in developing countries and emerging-market economies than in developed countries, reducing somewhat the scope for using tax returns as a means of addressing the underestimation of top incomes. Finally, while household surveys have certain fairly standard features across countries, data from tax and other registers cover the entire population only in the Nordic countries; differences in the definition of key variables used for income and wealth estimates from tax records can therefore hamper international comparability.

Whereas recent computations have made information on the distribution of income (including top incomes) available for all OECD countries, this is not the case of most Latin American countries. On the basis of recent computations, the top 1 percent of the distribution accounted for about 9 percent of income on average among OECD countries in 2010, a share that rises to close to 25 percent in Chile and Mexico (Ruiz and Woloszko, 2016). Complementing household survey-based information on income with data from tax returns indeed raises the Gini coefficient from 0.31 to 0.37 and the share to income from the top to the bottom decile from 10 to 15 on average for OECD countries.

A few studies have looked at tax returns to gauge the extent of underestimation of top incomes in the distribution of income in Latin America. For example, Alvaredo and Londoño (2013) show that the share of income accruing to the top 1 percent was about 20 percent in Colombia in 2010, a share that is somewhat lower than the 25 percent computed by Ruiz and Woloszko (2016) for Chile and Mexico, and by Medeiros *et al.* (2015) for Brazil. In addition, the reduction in inequality experienced by these countries has been less pronounced than estimated on the basis of household surveys, suggesting that the share of top incomes has been relatively stable over the time. This is also the case of more egalitarian societies, such

as Uruguay, whose share of top incomes is much lower, at 14 percent in 2011, according to the computations reported by Burdín *et al.* (2014). Unlike OECD countries, where the increase in top incomes has been due to rising labour compensation, most top income earners in Latin America are rentiers and capital owners.

Trends in the distribution of non-income outcomes

Inequality goes beyond income and affects other outcomes that matter for people's well-being. A growing literature on wellbeing makes a compelling case for looking at the distribution of outcomes from a multidimensional vantage point that includes not only material conditions, such as income, but also education, jobs and health, among others. In particular, recent literature shows that opportunities, measured through intergenerational income mobility, appear to be shaped by factors, such as quality of education, safety of neighbourhoods, college attendance or teenage birth rates, which affect children's job prospects and income later in life even before they enter the labour market (Chetty *et al.*, 2014; Rothwell and Massey, 2015). Assessing simultaneously the effects of policies on growth, income and other outcomes helps to leverage cross-over benefits and manage possible trade-offs (OECD, 2015c). Beyond income, other outcomes such as being employed and in good health are powerful predictors of subjective wellbeing⁶. Indeed, in OECD countries employment rates and self-reported health status are highly correlated to life satisfaction (Figure 6).

Improvements in educational attainment correlate strongly with falling inequality in income and non-income outcomes. In Brazil, for example, household data for 2009 show that almost half of the differences in labour income can be explained by years of schooling, even after controlling for other determinants (Ferreira de Souza *et al.*, 2012). Educational attainment also affects the quality of jobs and labour market outcomes, which is important in a region where informality in labour relations is often widespread. Indeed, evidence for Mexico shows that an increase of 10 percentage points in the share of workers in the labour force with at least secondary education is associated with a reduction in informal employment by 14 percentage points across the states, a relation that has been stable over the past decade (OECD, 2015b).

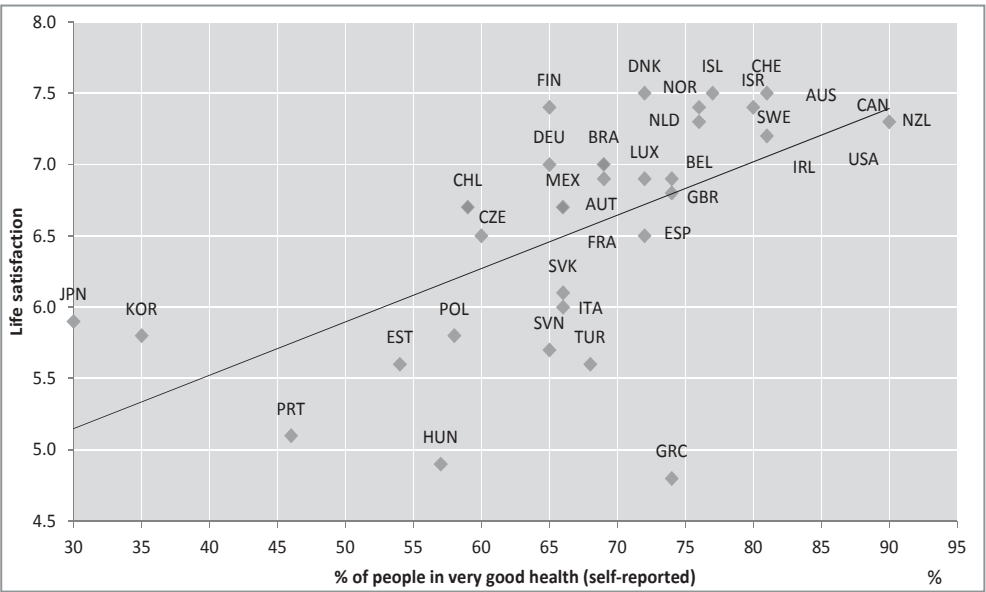
Beyond income, regional disparities in access to, and quality of, services can lock in opportunities for current and future generations. In addition to the historical rural-urban divide observed in many Latin American countries and the need for modernisation of the economy in rural areas, recent literature provides evidence on how individual circumstances, such as place of residence, affect people's access to quality services and have an impact on their opportunities to achieve better outcomes later in life (Chetty *et al.*, 2014; Molinas *et al.*, 2012). This is important, because the socio-economic background of students has a marked influence on access to education, performance and completion in Latin America. To illustrate, only 56 percent of individuals in the lowest income quintile attend secondary school and only 9 percent continue into tertiary education, compared with 87 percent and 46 percent, respectively, for those in the highest income quintile (OECD/CAF, 2014).

Figure 6. Life satisfaction, employment and health: Latin America and OECD, 2014

A. Employment and life satisfaction



B. Health and life satisfaction

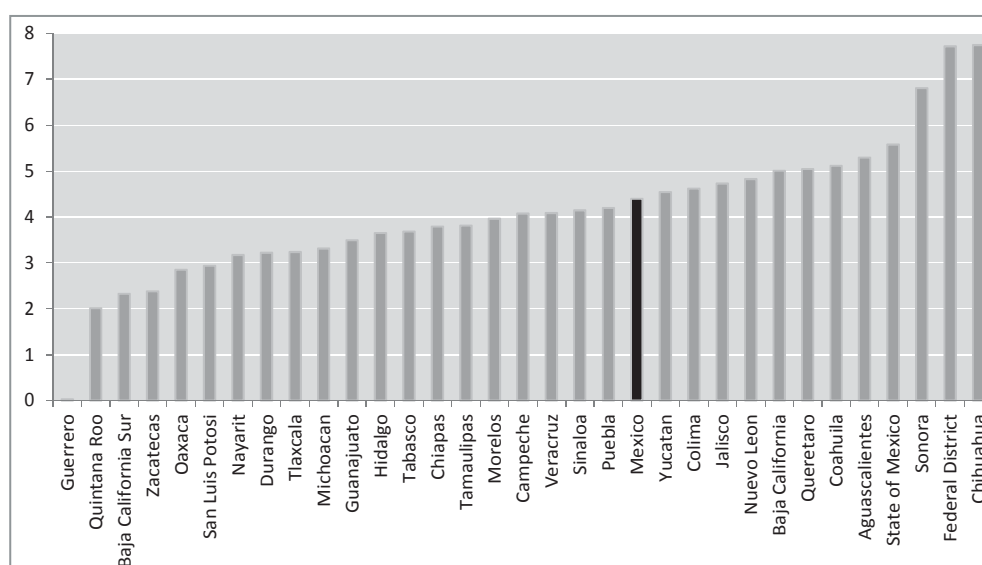


Source: Authors' calculation based on the OECD Better Life Database.

Of course, inequality is often highly correlated across the several dimensions that matter for wellbeing. For example, better educated individuals are better paid than their less educated counterparts. According to OECD calculations, workers with tertiary education or equivalent advanced research qualifications earn about 250 percent more than those with secondary education in Brazil (over 300 percent in Chile), against the OECD average of about 175 percent (OECD, 2014), suggesting that skill premia remain comparatively high in Latin America. The employment rate and probability of working full-time also increase considerably with educational attainment. In addition, evidence for OECD countries shows a strong correlation between educational attainment and the population's health status, both as gauged by surveys of individuals' perceptions about their health and by objective health outcomes, such as life expectancy. In Mexico, for example, individuals with at least a secondary school degree live on average four years longer than those with only basic education, and the gap in life expectancy is even larger among the states: secondary-school degree holders live on average seven years more than their peers with only basic education in Chihuahua, the Federal District and Sonora (Figure 7).

Figure 7. Life expectancy and educational attainment: Mexican states, 2014

Difference between life expectancy (in years) at age 25 between those with secondary or higher education and those with lower than secondary education



Note: “Lower-than-secondary education” corresponds to no education, pre-primary, primary and lower-secondary education, while “secondary or higher education” combines upper, postsecondary non-tertiary, and first and second stage of tertiary education.

Source: OECD (2015b).

To the extent that the educational attainment of children is affected by their socio-economic backgrounds, a vicious circle of inequality of opportunity and outcomes is created. However, the situation varies a great deal among the Latin American countries. For example, the OECD calculates that among its member countries, 21 percent of the variation in student performance in mathematics is attributed to differences in students' socio-economic status (OECD, 2013a). The percentage is much lower in Mexico (10 percent), close to the OECD average in Argentina, Brazil and Colombia, but higher in Chile, Costa Rica, Peru and Uruguay, where more than 25 percent of the difference in student performance can be attributed to students' socio-economic background. In countries where this proportion is large, students from disadvantaged families are less likely to achieve high levels of performance, which poses a considerable challenge for the design of public policies.

3. Drivers of income distribution in Latin America

There seems to be general agreement among scholars about the main drivers of the reduction in income inequality in Latin America since the 1990s. Two main reasons are prominent in the empirical literature: a reduction in hourly labour income inequality driven by a reduction in skill premia, and more robust and progressive government transfers. Indeed, empirical studies based on decomposition exercises, such as those conducted by Barros *et al.* (2006) and Azevedo *et al.* (2012), show that the most important factor has been relatively strong growth in labour income for workers at the bottom of the income distribution and, in particular, an increase in hourly earnings, coupled with an increase in non-labour income, mainly government transfers and pensions. The reduction in returns to schooling is due to a combination of a rise in the supply of more educated workers that has outpaced the increase in demand for these workers (de Mello *et al.*, 2006; Azevedo *et al.* 2013). At the same time, increased dynamism in sectors, such as services, which require relatively low skilled workers, has created demand for unskilled labour.

Interestingly, economic growth per se, measured in terms of growth in GDP per capita, is not among the key drivers of the decline in income inequity in the region. Inequality fell in high-growth countries, such as Chile and Peru, as well as in low-growth countries, such as Brazil and Mexico. This suggests that structural, longer-lasting factors have been at the heart of the improvement in the distribution of income in Latin America. However, other short-term, cyclical factors, such as terms-of-trade gains in the resource-based economies, have played a role.

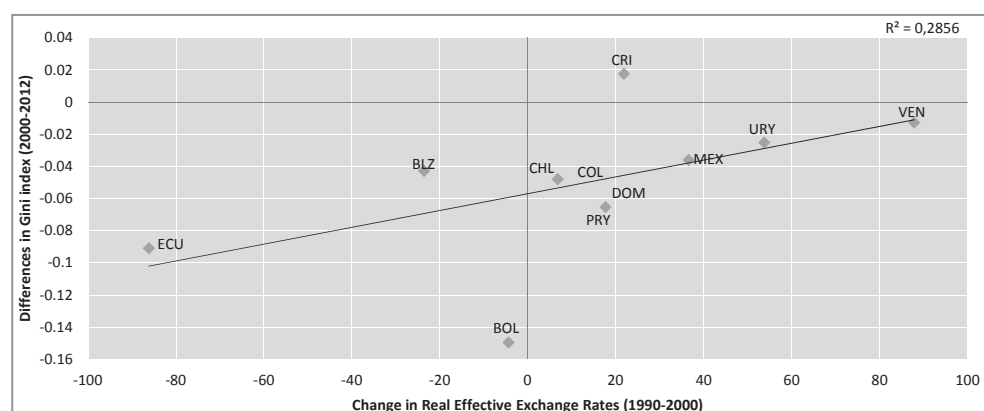
Cyclical factors: macroeconomic stabilisation and terms-of-trade gains

Macroeconomic stabilisation has been an important driver of income redistribution in Latin America. During the 1980s, the larger economies, including Argentina, Brazil and Mexico, were coping with erratic growth, high inflation, distressed public finances and a lack

of access to international capital markets as a result of the foreign debt crisis. Chile went through a severe banking crisis in the early 1980s. Stabilisation followed in the 1990s in most countries on the back of foreign debt restructuring, market-friendly structural reforms (see below) and a gradual implementation of institutional reforms that restored fiscal and monetary discipline. All these developments resulted in lower inflation, stronger output growth and lower macroeconomic volatility, which benefited those social groups who are less equipped to insure themselves against adverse income shocks. Indeed, adverse economic shocks, accompanied by erratic growth and high inflation, hurt the poor and disadvantaged population harder than the better-off, who have access to financial instruments that can protect them against these shocks.

Increased flexibility in exchange rate regimes is likely to have contributed to income redistribution. Macroeconomic stabilisation in the higher-inflation countries was supported by the adoption of fixed or managed exchange rate regimes that could provide a nominal anchor to stabilise the price-wage dynamics in the aftermath of reform. Argentina adopted a currency board, whereas Brazil and other countries opted for more flexible, yet managed, mechanisms⁷. Towards the end of the 1990s, exchange rate regimes became increasingly flexible in most countries, allowing countries to weather adverse external shocks more effectively, especially where macroeconomic fundamentals were strong (de Mello and Mocero, 2009 and 2010)⁸. The attendant depreciation of real effective exchange rates led to a shift of income towards the higher-productivity tradable sectors, which benefited those individuals working in these sectors, and spurred output growth, which also benefitted workers in the non-tradable sectors, who tend to have lower productivity and wages. The balance of all these effects varies across countries, and the transmission mechanisms need to be assessed empirically in more depth. Nevertheless, stronger growth and the income shift between the tradable and non-tradable sectors appear to have benefitted the worse-off more than the better-off, leading to an improvement in the distribution of income (Figure 8).

Figure 8. Income inequality and exchange rates: Latin America, 1990-2012



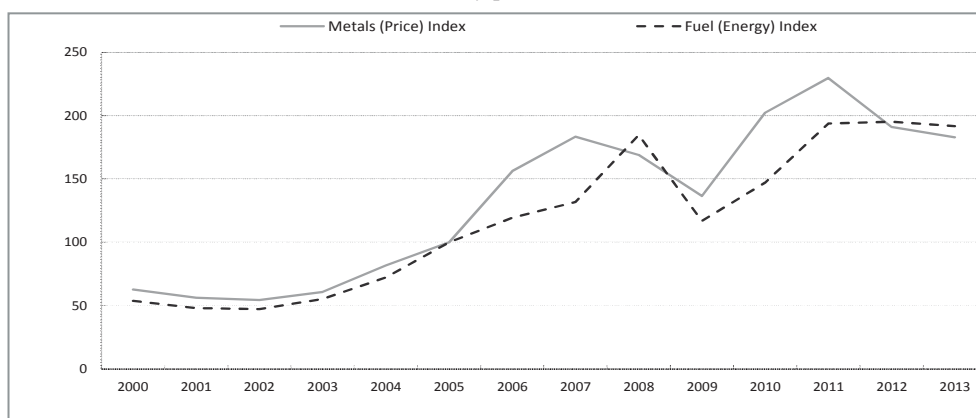
Note: Real effective exchange rate indices (GDP deflator based) were used to compute the change in the real effective exchange rate between 1998 and 2014.

Source: Authors' calculations based on data from UNCTAD (real effective exchange rate) and the World Bank's World Development Indicators database (Gini index).

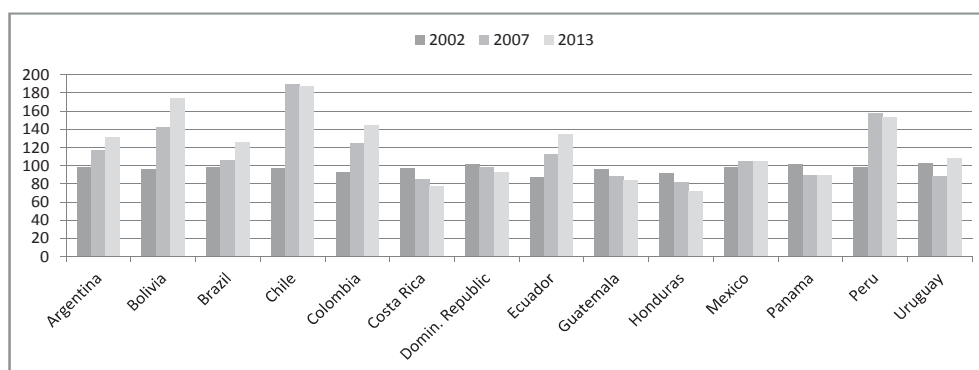
Of particular interest is the long commodity price cycle that generated sizeable terms-of-trade gains for the resource-based economies in Latin America (Figure 9). These gains typically benefited workers in the lower segments of the income distribution through income effects. Of course, the commodity-importing countries of the Caribbean, for example, faced an opposite phenomenon, due to income losses associated with higher import prices. However, empirical evidence suggests that, while sizeable in many countries, these gains in the terms of trade have not played a dominant role in explaining the reduction in income inequality in the region (Gasparini *et al.*, 2011; de la Torre *et al.*, 2012; Cornia, 2013). An important question is whether or not the resource-based economies will be able to avoid a corresponding bust in activity as the commodity cycle ends, leading to a deterioration in the terms-of-trade, as well as a reversal of the gains in income distribution of the previous years. Those countries that have put in place appropriate mechanisms for insulating the domestic economy from the vagaries of commodity prices, such as wealth or stabilisation funds, are in principle better equipped to deal with the downturn than those whose policy setting exacerbated, as opposed to, mitigating the effects of the commodity price cycle on activity.

Figure 9. Commodity prices, terms of trade and government revenue, Latin America

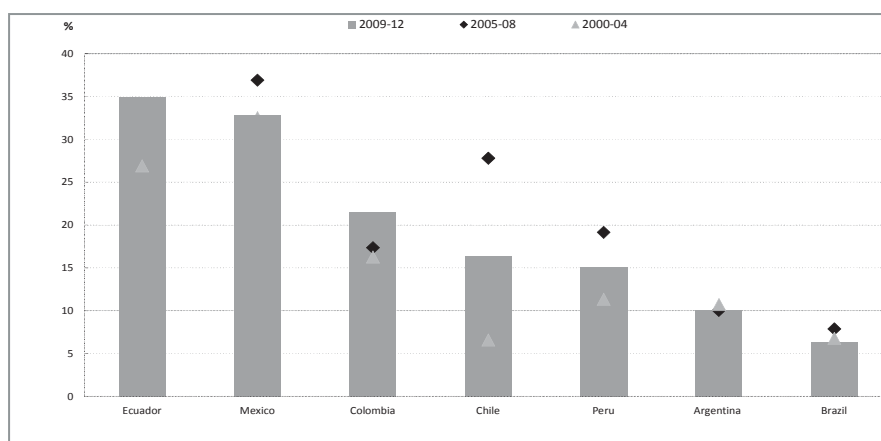
A. Commodity prices (2005=100)



B. Net barter terms-of-trade index (2000=100)



C. Revenue from non-renewable natural resources (in percent of revenue)



Note: Commodity prices include metals (copper, aluminium, iron ore, tin, nickel, zinc, lead and uranium) and fuels (crude oil (petroleum), natural gas, and coal price indices). Data refer to the non-financial national public sector in Argentina, the general government in Brazil and Peru, the central government in Chile and Colombia, the non-financial public sector in Ecuador, and the public sector in Mexico. In the case of Chile, taxing of private mining is included since 1994. The net barter terms-of-trade index is calculated as the percentage ratio of the export unit value indexes to the import unit value indexes, measured relative to the base year 2000.

Source: Authors' calculations based on data from the OECD Government at a Glance database, and the World Bank Development Indicators.

Structural factors: from education and skills to budgetary and market-friendly reforms

Education and skills: enhancing access to services and improving outcomes

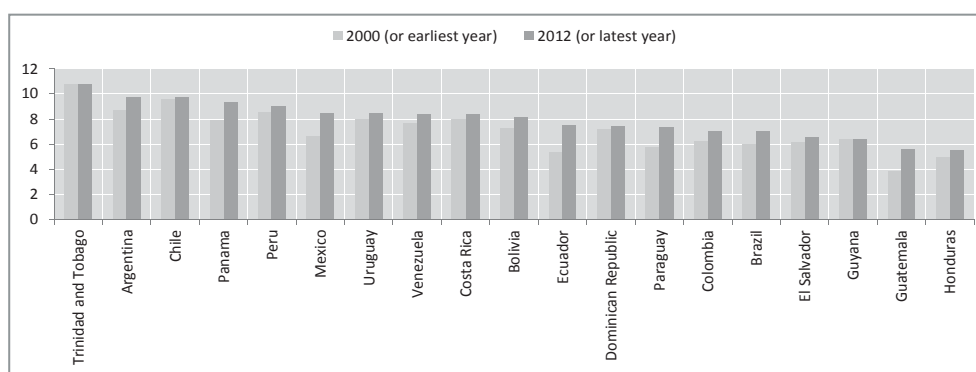
Several structural factors have contributed to the improvement in the distribution of income in Latin America. First and foremost is a marked improvement in educational attainment in most countries, which has led to an increase in the supply of skilled labour relative to unskilled labour. This supply-side effect was coupled with a change in the composition of demand for skills, which favoured unskilled labour in many countries and compressed the wage distribution. For example, Gasparini *et al.* (2011) show that the wage premium fell on average in a set of 16 Latin American countries by close to 3 percent per year during the 2000s on the back of an increase in the relative supply of skilled labour (relative to unskilled labour) by close to 3.5 percent per year and a fall in the relative demand for skilled labour by over 5 percent per year.

Policies to improve access to education by the hitherto underserved population have led to rising school enrolment and subsequently educational attainment at the primary and secondary levels (Figure 10)⁹. Brazil is a case in point: a programme was put in place in the 1990s to introduce a nation-wide per-student spending floor with federal top-up grants for

local governments that cannot afford the national floor. The programme focused initially on primary education and was subsequently expanded to secondary and pre-school education, resulting in a significant increase in enrolment and attainment (de Mello and Hoppe, 2005). The quality of education has also improved, contributing to a gradual improvement in outcomes, as measured by international standardised tests, such as PISA (OECD, 2013a)¹⁰. Evidence for other countries is mixed, and improved access to education, especially as result of the expansion of cash transfer programmes that are conditional on school enrolment, may actually have occurred at the expense of quality of services¹¹. This underscores the need to complement policies aimed at expanding supply with initiatives to improve, or at least maintain, the quality of services.

Figure 10. Schooling in Latin America, 2000 and 2012

Average years of schooling



Note: Average number of completed years of education of a country's population aged 25 years and older, excluding years spent repeating individual grades. *Budgetary policy:* increasing spending, strengthening tax-benefit systems and improving targeting

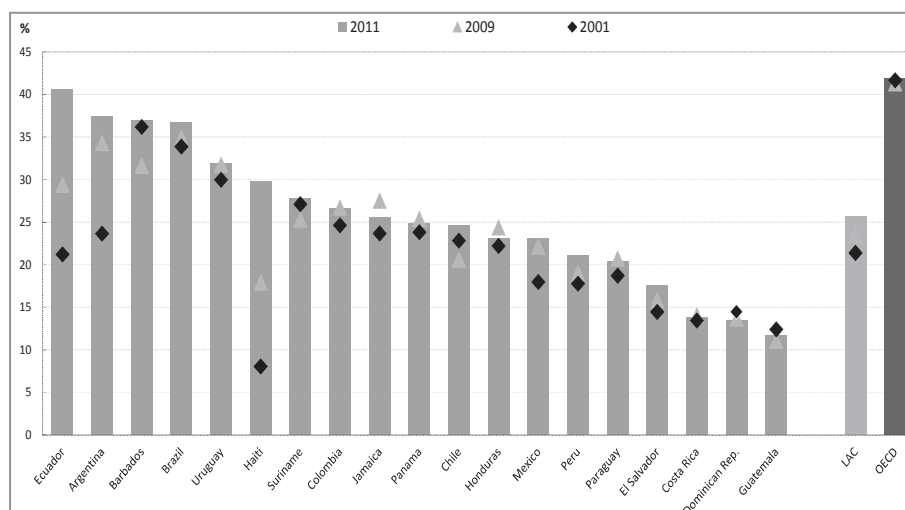
Source: Data available from the UNESCO Institute for Statistics.

Although tax-benefit systems are the most potent redistributive policy levers, they are not used effectively in most Latin American countries. With few exceptions, such as Argentina, Brazil and Uruguay, tax collection is low in relation to GDP in most countries. Indeed, on average the region's government revenue-to-GDP ratio is just above half the average of OECD countries (Figure 11). Tax systems are also overly reliant on natural resources: for example, taxes on activities and income associated with oil and gas account for at least one-half of government revenue in Bolivia, Mexico and Venezuela. Moreover, the composition of tax revenue is tilted towards indirect taxes in the region, which tend to be regressive. By contrast, direct taxes on income and property account the lion's share of government revenue in the OECD area. Furthermore, in some cases the tax system imposes a comparatively heavy burden on labour income, which encourages informality in labour relations, particularly for lower skilled workers. For all these reasons the potential for redistribution through the tax system is rather

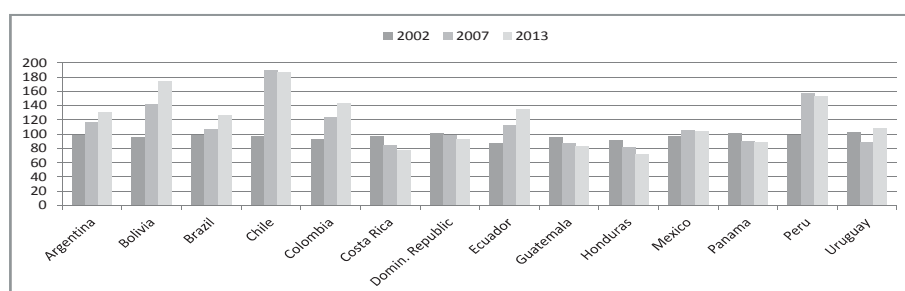
limited in Latin America. Indeed, incidence analysis shows that direct taxes are progressive where available but their redistributive effect is low because collection is low in comparison with indirect taxes (Lustig *et al.*, 2013a).

Figure 11. Government revenue and expenditure, Latin America countries and OECD area

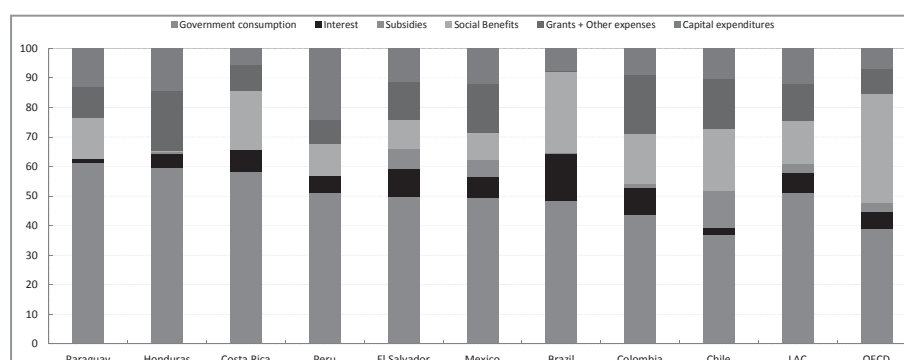
A. Revenue (in percent of GDP), 2001, 2009 and 2011



B. Composition of revenue, 2001 and 2011



C. Composition of expenditure (economic classification), 2011



Note: Revenue and expenditure statistics refer to the general government. Government consumption is the sum of expenditures on compensation of government employees plus purchases of goods and services. Interest on public debt is measured as consolidated interest payable by the general government. Subsidies are current unrequited payments that governments make to enterprises on the basis of the levels of their production activities or the quantities or values of the goods or services which they produce, sell or import. Social benefits refer to the two main categories of social benefits other than social transfers in kind (e.g., pensions and unemployment benefits) and social transfers in kind are related to expenditures on products supplied to households via market producers. Grants and other expenses include other current transfers, capital transfers and other remaining expenses (e.g., property income other than interest). Capital expenditures encompass gross capital formation plus acquisitions less disposals of non-produced nonfinancial assets.

Source: Data available from the OECD (2016) *Government at a Glance* database.

The use of the indirect tax system to achieve redistributive goals is not clear-cut. For example, the value added tax (VAT) is not necessarily regressive, especially when its incidence is measured in relation to expenditure, which is a more reliable measure of the lifetime distributional effects of consumption taxes, rather than income¹². In any case, most countries in Latin America, with the exception of Chile, where the VAT is collected at a uniform rate, exempt or apply reduced rates on several goods that account for a larger share of the consumption basket of lower-income groups, such as food and basic necessities. However, these measures in pursuit of distributional objectives may benefit the better-off more than the poor in aggregate terms and in relation to expenditure, which runs counter to their intended objectives.

Redistributive goals are also often pursued in Latin America through the earmarking of tax revenue to finance specific programmes, especially in the social area, in addition to transfers to other levels of administration. Revenue earmarking is particularly prevalent in Argentina, Brazil, Colombia and Costa Rica, and to a lesser extent Mexico, according to a recent OECD Survey of budgetary practices (OECD, 2014b). The main problem with revenue earmarking, at least as far as redistributive policies are concerned, is that it most often affects broad categories of social spending regardless of their cost-effectiveness, and it prevents the reallocation of budgetary resource to more meritorious programmes. Revenue earmarking provisions, especially those enshrined in constitutions, are also hardly ever assessed against their intended objectives, which undermines efforts to enhance the effectiveness of tax-benefit systems.

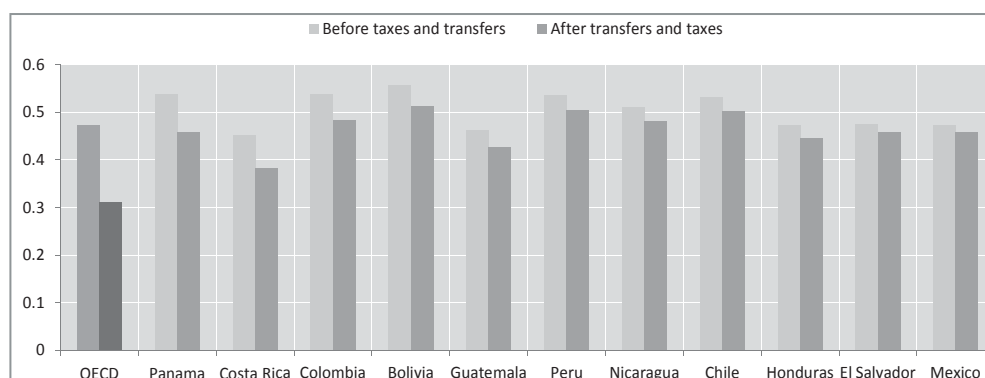
Consistent with low tax collection on average, the region spends a comparatively low share of GDP on redistributive programmes. Government spending is on average low in relation to GDP in Latin America on account of the region's low revenue mobilisation capacity, and the bulk of expenditure is on programmes that are by and large untargeted, such as education and health care. When these in-kind transfers are imputed in household income, they are shown to be more redistributive than direct transfers to households, which account for a much lower share of government spending in the region (Lustig, 2013a). In some cases, such as Brazil, spending on pensions and other transfers is comparable to the OECD average in relation to GDP and total government spending, but most of these programmes are contributory (*i.e.*, benefits are calculated on the basis of contributions and are not means-tested) and therefore have limited redistributive potential. In addition, in some countries eligibility to programmes such as unemployment insurance, where available, and in some cases health care, is conditional on labour market status, which due to widespread informality in most countries leaves workers without a formal labour contract vulnerable to adverse income shocks as a result of job losses.

Evidence of the redistributive effect of conditional cash transfers is mixed. Many countries have put in place since the 1990s income support programmes that condition assistance to poor households on school enrolment for children and participation in preventive health care programmes. Brazil, Chile and Mexico have been pioneers in this area and have improved the coverage, design and administration of their programmes so as to ensure access to the targeted population, improve means-testing and prevent abuse. Support for the elderly and disabled has increased in some cases, notably Brazil, on the back of general efforts to strengthen social safety nets. Where these programmes are reasonably well targeted and disincentives for labour force participation can be avoided, they have indeed contributed to redistribute income towards the needy while at the same time helping them to pull themselves out of poverty. Incidence analysis shows that cash transfers have reduced extreme poverty by more than 60 percent in Uruguay and Argentina but only by 7 percent in Peru, essentially due to low spending on these programmes, and even less in Bolivia, because spending is not targeted to the poor (Lustig *et al.*, 2013a).

On the tax front, however, most reforms over the last two decades or so have focused on raising revenue, rather than on making tax systems more redistributive. Reforms have aimed at raising revenue from domestic sources, not least by improving the effectiveness of tax administration and curbing evasion. Much less progress has been made to make income tax schedules more progressive and reduce exemption thresholds, as well as collecting property taxes, which are notoriously low in the region by comparison with OECD standards¹³. Despite the progress that has been made, tax-benefit systems remain by and large much less distributive in Latin America and the Caribbean than among OECD countries (Figure 12).

Figure 12. Distributional effect of tax-benefit systems, Latin America and OECD

Difference in Gini coefficient



Note: Countries are ranked by the difference in Gini coefficient before and after taxes and transfers. The dates differ across countries: Chile (2011), Mexico (2012), Costa Rica, Bolivia, Peru and El Salvador (2000), Guatemala and Honduras (2004), Nicaragua and Colombia (2003).

Source: Authors' calculations based on data from the OECD Income Distribution Database for Chile, Mexico and OECD average, and a compilation of previous studies for the other countries published in Cubero and Hollar (2010).

Minimum wage policy

Minimum wage policy has also played a role in income distribution, albeit a comparatively weaker one. Brazil is a case in point: there has been a sharp increase in the real value of the minimum wage since the mid-1990s, which has contributed to an increase in the purchasing power of lower-income individuals and households. Nevertheless, increases in the minimum wage have also put additional pressure on the public finances, because the minimum pension is indexed to the minimum wage, which reduces the fiscal space required for financing additional redistributive spending. Minimum wage policy is therefore a comparatively poor redistributive tool when the undesired consequences of minimum wage hikes on incentives to work and the sustainability of the public finances are taken into account (Barros *et al.*, 2010).

Market-friendly reform

Throughout the 1990s, several Latin American countries implemented reforms to liberalise their domestic product markets, as well as their trade and investment regimes¹⁴. These reforms encouraged foreign investment and productivity gains that enhanced economic performance following years of stagnation during the “lost decade” of the 1980s, where macro-economic mismanagement and protectionism led to slow growth and high, often chronically high, inflation in many countries. Both the efficiency and equity consequences of these pro-growth, market-friendly reforms vary from country to country, and they need to be assessed

against a broader background of improvements in the design and coverage of social programmes as well as the extension of targeted social protection and safety nets.

In most Latin American countries, trade liberalisation seems to have had an unequalising effect on the distribution of income. Evidence indeed shows that the reduction of import tariffs that took place in many countries during the 1990s as part of broader economic liberalisation programmes affected sectors that were relatively intensive in unskilled labour. As a result, trade liberalisation led to an increase in the demand for skills that could not be met by a concomitant expansion of supply, resulting in a deterioration in the distribution of labour income (Gasparini and Lustig, 2011). Skill-saving technological progress often follows trade liberalisation and the opening of hitherto protected domestic markets to external competition and is expected to have compounded this unequalising effect. While this is indeed the case in most Latin American countries, Brazil seems to have been an exception in that trade liberalisation led to a change in relative prices in the first half of the 1990s that benefited unskilled workers, leading to an attendant fall in the skill premium (Ferreira *et al.*, 2007).

Regional development policies

Regional development policies have yielded mixed results. Many countries in Latin America have put in place policies to encourage the development of lagging regions. These policies have included the earmarking of taxes, especially from natural resource-based activities, to finance investment and other development programmes in lagging regions (*i.e.*, Ecuador, Peru), as well as the establishment of regional development banks/agencies and special economic zones (*i.e.*, Brazil, Chile, Mexico). Explicit equalisation has seldom been pursued in intergovernmental transfer systems, as noted above, and tax competition among the sub-national jurisdictions has often been predatory (*i.e.*, Brazil), leading to an erosion of tax bases that undermines efforts to mobilise financing for cost-effective social and redistributive programmes¹⁵. Most importantly, these regional development initiatives have rarely been assessed against their intended objectives, which would permit a reallocation of scarce budgetary resources to more meritorious programmes.

4. Conclusions and options for reform

Latin America has made much progress over the last two decades or so to lay the policy foundations for more egalitarian societies. There has been a significant, widespread improvement in the distribution of income in the region since the turn of the century, although it remains among most unequal in the world. These efforts have been buttressed by a comparatively favourable external environment characterised by strong global growth, especially in the run-up to the global crisis, which sustained strong demand for the region's exports, and a long phase of terms-of-trade gains on the back of rising commodity prices, which benefited the region's resource-based economies. But, ultimately, it has been the policy reforms that

have been implemented in many countries since the 1990s to consolidate macroeconomic adjustment, improve educational attainment and skills, and strengthen social safety nets that, if maintained, will allow the countries in the region to build on their past achievements.

The greatest additional gains in income redistribution will most likely come from policies aimed at improving education and skills. Progress in this area has led to rising labour income, especially among the poor, as well as a reduction in skill premia, which account for the bulk of the improvement in the distribution of income during the 2000s. Because Latin America still fares poorly from an international perspective in these areas, despite the progress that has been made over the last two decades or so, there remains much room for further improvements in outcomes that can lead to an additional flattening of the distribution of market income. Of course, many other factors are at play, and it is difficult to be sure about the exact effects of additional progress in raising educational attainment and performance on labour market income and the distribution of income, once changes in tax-benefit systems and their attendant influence on labour supply have been taken into account.

More can be also done to enhance the redistributive potential of tax-benefit systems, although care needs to be taken when assessing the costs and benefits of alternative measures. As far as the tax system is concerned, in those countries where tax collection is low in relation to GDP and tilted towards the taxation of natural resources, much can be gained from enhancing tax administration and diversifying collection. Reducing reliance on indirect taxes would also be desirable from a redistributive point of view, but efforts in this area would need to be weighed against the distorting effects of direct taxes on labour force participation, the incentives those taxes create for informality in the labour market, and against a background of increasing international tax competition in mobile tax bases. As for government spending, there is much to gain from improving the incidence of targeted programme through effective means-testing (or alternative mechanisms, such as self-selection, where means-testing is not possible), enforcement and evaluation. Better incidence can also be achieved by designing untargeted programmes in a manner that ensures that the benefits of spending are spread more evenly among the different social groups. Equally important is the need to consider the tax-benefit system as a whole, so that the creation of entitlements and the associated increase in spending can be assessed against the costs arising from increasing reliance on distorting tax instruments.

There is room for narrowing income gaps between regions within countries by improving regional development policies. Income distribution is skewed not only within but also between regions in Latin America, leaving ample room for policy action to narrow income gaps between a country's more developed and lagging regions. Reform to intergovernmental grants and transfer systems towards greater equalisation of spending capacity would contribute to this end. Efforts could also be made to tailor programmes better to the specific conditions and opportunities that arise in different places. For example, since the creation of the two publicly-backed housing agencies in the 1970s, Mexico has made significant progress in facilitating access to housing for low-income families. However, policies focusing on housing without being consistent with either urban development plans or the economic and de-

mographic profile of cities have resulted in poor quality housing, away from schools, health care or public transportation, imposing costly travel to metropolitan areas. Regular evaluation of existing programmes would also be desirable, to the extent that it leads to a reallocation of fund to those programmes that are deemed more cost-effective.

Notes

1. The term Latin America will be used for simplicity throughout the paper to include the Caribbean region as well. When a distinction is needed between the two regions, it will be made explicit in the text.
2. The values refer to the average of 15 Latin American countries and 33 OECD countries, respectively.
3. See Washington Centre for Equitable Growth (2015) and OECD (2015a) for reviews of the empirical literature.
4. According to the World Bank's definition, a household with per capita income between USD 10 and USD 50 a day (in 2005 purchasing power parity) is considered to be in the middle class. Such a threshold is computed through country surveys on the probability of falling back into poverty over a five year interval.
5. A household is considered economically vulnerable if it faces a likelihood of falling back into poverty of more than 10 percent.
6. See de Mello and Tiongson (2009) for more information and empirical evidence.
7. To varying degrees, exchange rate rigidity led to a real appreciation of domestic currencies, a loss of export competitiveness and mounting balance-of-payments imbalances that left countries ill-equipped to deal with adverse external shocks and exposed them to speculative attacks. Slow growth, currency and, in most cases, banking crises ensued.
8. Interestingly, the currency crises of the 1990s hurt the well-off more than proportionally, leading to an improvement in the distribution of income. This is the case of Mexico, for example, following the exchange rate collapse of end-1994. Needless to say, the sharp exchange rate depreciation affected adversely all social groups as a result of job and income losses, but the well-off were also affected by the loss of value of financial assets. See Baldacci, de Mello and Inchauste (2006) for more information and empirical evidence.
9. Several scholars have highlighted the "paradox of progress" associated with the links between the distribution of income and educational attainment. Accordingly, due to the convexity of returns to education, a reduction in the skill wage premium tends to aggravate income inequality initially before it acts to improve it. See, for example, Gasparini *et al.* (2011) for further discussion.
10. In Brazil, for example, the average score in mathematics at the PISA test has increased by 35 points between 2003 and 2012, against a reduction of 3 points on average in the OECD countries.
11. See, for example, Filmer and Shady (2014) for empirical evidence for Cambodia.
12. Recent OECD analysis indeed shows that VAT systems tend to be regressive when measured as a percentage of income, but they are generally either proportional or slightly progressive when measured as a percentage of expenditure. By contrast, excise tax burdens (on alcohol, tobacco and transport fuels) are almost always regressive when measured as a percentage of income, and in most cases to be either regressive or roughly proportional when measured as a percentage of expenditure (OECD/Korean Institute of Public Finance, 2014).
13. The case of property taxation is important. Informal housing is an important culprit, but so are deficiencies in property tax administration that make it difficult for local governments, which are responsible for collecting property taxes, to maintain comprehensive property registries and update reference property values. Political economy reasons also matter, with make mayors unwilling to collect property taxes, especially where local governments can rely on intergovernmental grants and transfers to finance the provision of local services (de Mello, 2000).

14. See de Mello (2013) for further discussion with emphasis on the experience of Brazil.
15. See de Mello (2008) for a discussion and empirical evidence on tax competition in the VAT in Brazil.

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Resumen

Una creciente literatura empírica ha concentrado su atención en la determinación de los factores que han reducido notablemente las desigualdades en renta en la mayoría de los países de América Latina desde los años noventa –la región partía de altos niveles relativos de desigualdad–. Este hecho se separa de lo acontecido en otras partes del planeta, incluyendo los países OCDE, donde la desigualdad se ha incrementado. Esta mejora en la distribución de la renta ha contribuido a la reducción de la pobreza en Latinoamérica, aunque los grupos de riesgo pueden volver a una situación de pobreza si la coyuntura económica se deteriorase. Factores estructurales como la reducción de la prima por habilidades y un incremento en las rentas del trabajo de los trabajadores con menos ingresos, junto con un incremento del gasto público redistributivo, han sido los factores que más han impulsado la reducción de la desigualdad. En el corto plazo, factores cíclicos, incluyendo el crecimiento económico y notables ganancias en las relaciones de intercambio en economías basadas en la exportación de materias primas, han desempeñado un papel menor para la reducción de la desigualdad. Resulta reseñable que las desigualdades también se han reducido en áreas no-monetarias, pero decisivamente ligadas al bienestar de la población, como Educación, Salud y Empleo.

Palabras clave: distribución de la renta, pobreza, Latinoamérica.

Clasificación JEL: D30, D60, I30.