



Towards a less unequal Latin America? Lessons from the recent drop in income inequality in Latin America

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1. Introduction

Inequality is a topic that has received a lot of attention in the international development debate lately. This is partly due to new books and studies such as

- **The Price of Inequality** by Joe Stiglitz
- **The Spirit Level** by Richard Wilkinson and Kate Pickett,
- **Capital in the Twenty-first century** by Thomas Piketty.

These studies and resulting debates have **highlighted the rise in inequality** around the world as well as **the negative effects such inequality** has on a range of issues such as economic growth, poverty reduction, and social cohesion.

Latin America is the region that has **historically had the highest levels of income** inequality in the world, and for many years, in spite of progress on many other development indicators such as life expectancy, child mortality, and literacy and to some extent poverty, the gap between rich and poor continued to widen. However, around 2003 that started to change. Income inequality measured by the Gini-coefficient began to decline significantly in the majority of Latin American countries. Since then, researchers have attempted to **explain why this has happened?** What are the major of explanations behind this reduction in income inequality? And of course: will this trend last and thus produce a real change to Latin American societies?

The **main message** I wish to convey here is that the current reduction in inequality is a result of four broad sets of factors: 1) innovation in social policy,

2) long term investments in education, 3) increased minimum wages and 4) the creation of employment for low-income groups due to labor-market dynamics. However, we do not yet know everything that is behind the recent inequality reduction, and thus it is still unclear whether there is ground for long term optimism or not.

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2. Methodological caveats

Before trying to answer the questions above, let me clarify a few issues:

First, there are many different forms of inequality: inequality in access to basic services, inequality in power and political influence, inequality in health, etc. etc. Here I will primarily limit myself to discuss **economic inequality**.

Second, there are many ways to measure economic inequality. For example, the much debated book by Thomas Piketty is concerned mainly with **inequality in wealth**, or the accumulation of property, money etc. over time. I will highlight **income inequality** rather than wealth mainly because there is no comparable data on wealth inequality over time in Latin America.

Third, the data that I will use come from **national household** surveys that over the last years have become much better and more comparable. These household surveys try to **measure income**, by asking people what they earn. This is in contrast to, for example in Africa, that mainly seeks to measure consumption as few have a formal income and the monetary economy is not dominant. Thus, although inequality levels in Latin America are often compared with those in Asia and Africa, such comparisons are often based on data that are not fully comparable.

Fourth, while the data from the household-surveys are considered to be of high quality, they do have some weaknesses. One of them is that they are often **unable to reach the very richest**. So, although the general income inequality has declined, it is still possible that the very rich of Latin America – the Carlos Slims and Eike Batistas – have become even richer compared to the general population.

Fifth, I will here concentrate only on **one indicator of inequality**: the Gini coefficient, which is a somewhat crude measure of income distribution: If a country has a distribution on the Gini coefficient of 0, then everyone has the

same share of income. If the Gini coefficient is 1, one person owns everything. Thus, the Gini coefficient does not provide adequate information about the distribution between different income groups.

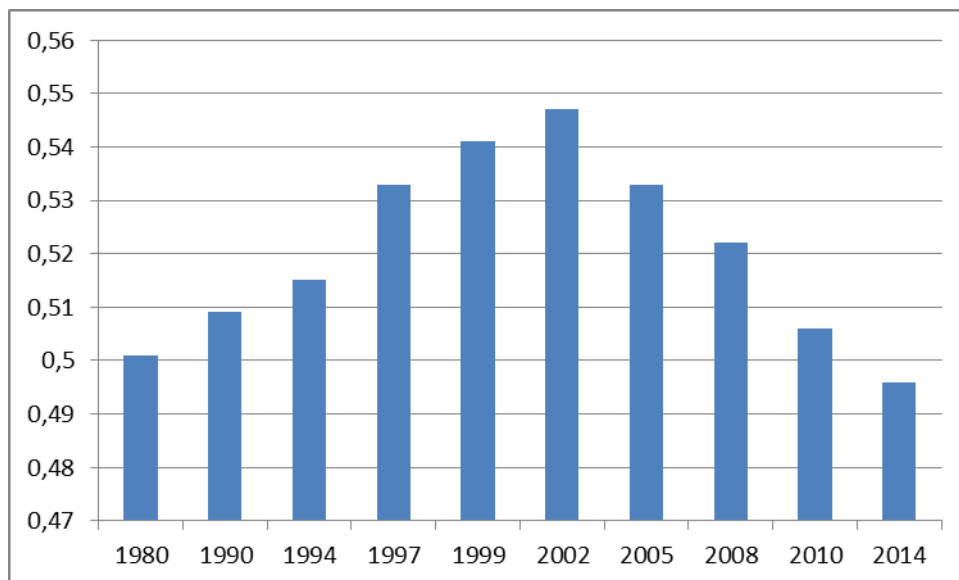
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3. Main developments

So, what happened in Latin America after 2003? A very rough graphical illustration is found here.

Gini coefficient Latin America, simple average 1980-2012 (Source: CEPALSTAT and Gasparini et al 2010).

(Slide 1)



Income inequality measured by the Gini coefficient increased steadily from 1980 to 2002. Then by 2010, it was almost back to 1980-levels. And by 2012, it had dropped below 1980-levels (to a simple average of 0.496). This is still very high. In comparison, the Nordic countries have Gini coefficients of around 25. Nevertheless, it is a significant improvement from the level in 2002.

4. Explanations

In theory, there are many different possible factors that can explain reduction in income inequality. The first is **demographical changes**. If for example, birth-rates are reduced among the poor, the number of family members that depend

on one or two incomes increases and thus average income will also increase. This has occurred in Latin America, but it explains a relatively small portion of the recent decline (approx. 12 percent according to one study).

4 A second factor is the impact of **taxes and transfers**, such as pensions and social security. Taxes are important for reducing inequality. Research has shown that the difference in income inequality in Latin America and Europe diminish substantially if we look at the distribution after taxes and transfers compared to the same distribution before. However, while the impact of taxation in reducing income inequality is significant in some countries, they turn out to **have changed very little in most**.

What has been more significant is changes in transfers, particularly the increase in transfers to the poor. Governmental transfers have traditionally gone disproportionately to the well-off, due to the pension systems that have favored those who have had high incomes. However, over the last 10 we have seen introduction of a number of different programs that transfer cash to poor families. These so called **cash-transfer programs** may be designed in many different ways – some make transfer conditional on the poor sending children to school or following health programs (so called Conditional Cash Transfer programs or CCTs), whereas others simply guarantee every poor a basic income. As a result of these programs, the share of transfers in total household income of the poorest 20 percent has almost tripled since 2000, increasing from an average of 7 percent of total household income in 2000 to 20 percent at the end of the decade. This change is especially stark in the case of Brazil, where the share of transfers in total household income of the bottom 20 percent has gone from 3 percent to 24 percent over the last decade. When the income of the poorest increases, inequality is reduced.

However, cash transfers still make up **a rather small portion of people's income**. Therefore, it does not explain a large share of the inequality reduction. In Brazil for example, it has been found that although governmental transfers (including pensions and cash transfers) have contributed to a reduction in income inequality, it only explains 17 percent of the observed reduction.

What **remains is labor income**. In a broad comparative study from 2013, by *Joao Pedro Azevedo* and colleagues, reduction in inequality in labor income is

found to account for 45 percent of the reduction of income inequality although there are significant differences between the countries (also because there are differences in the degree of inequality decline).

There has not been an increase in the average number of hours worked by those earning less, so that cannot account for the reduced income inequality. That means that there is an actual reduction in the inequality of hourly wages: what the well paid and less well paid make per hour. The question is then: what can account for that decline?

As a first step towards an explanation for that, researchers have looked at the distribution between groups with high and low levels of education and work experience. They have found that in most countries, there has been a reduction in the “skills premium”, that is the differences in wages between high and low-skill groups.

However, that only brings us one step closer to the answer. The question remains: Why did the skills premium decline? In a recent publication, Nora Lustig and her colleagues list four main possible reasons:

- 1) That the relative demand for skilled workers has declined;
- 2) That there has been an increase in the relative supply of skilled workers;
- 3) That there has been an increase in the minimum wages and unionization rates benefiting low-wage workers more than high-wage workers; or
- 4) That the quality of higher education has been reduced to the extent that the advantage of having it had been reduced.

It is obvious that whether we consider the recent inequality decline a real development success depends on which of these factors that are found to explain more of the inequality decline.

For example, a loss in the quality of higher education, or that it fails to provide the students with the skills they need to advance in the labor market, is obviously not a positive development. Or if we find that the **reduction in the relative demand for skilled workers**, is due to increased employment opportunities for non-skilled workers, that is good, but if it is found to result from reduced activities in high-productive sectors reducing demand for skilled workers, that is obviously not that good.

Although there are a number of studies of particular countries or aspects of this, it is difficult to conclude in a very certain way of which of these four explanations that explain most of the recent inequality decline.

Many studies indicate that the **investments in secondary and tertiary education** that took place in Latin America from the 1990s on has increased the relative supply of skilled workers, and thus made the relative gain for each person with higher education, less.

Other studies find, however, that the shift in demand has been more important. In the 1990s – before the reduction in income inequality begun – there was also a relative increase in the supply of skilled labor, but then it did not lead to reduced inequality since there was simultaneous increase in demand for skilled workers and not much increase in the demand for non-skilled workers.

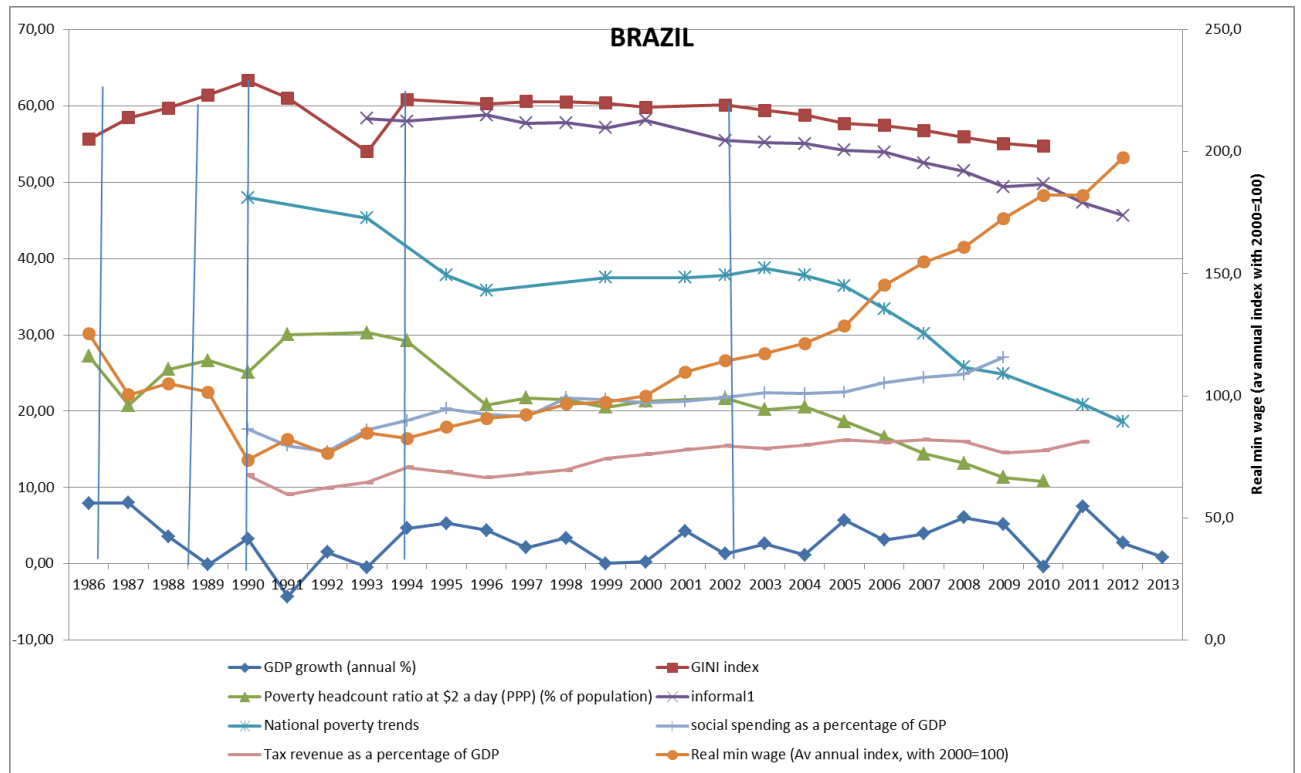
However, the increased number of educated people did lead to income inequality reduction in the 2000s. So we have to find out whether this was due to an increased demand for non-skilled workers or reduction of the demand for skilled workers.

Some argue, among them Gasparini and his colleagues, that the main reason is the combination of increased demand for unskilled workers due to the adoption of a more competitive exchange rate favoring the unskilled, labor-intensive tradable sector; and a decline in the supply of unskilled labor due to rising educational attainment, a fall in birth rates and an increase in the rate of emigration (Gasparini et al 2011).

However, in addition to this, it is important to look at labor policies. Although they have not been important across the region, the increase in the coverage, rate and of compliance with the minimum wage, has been important in some of the countries that have seen the most significant decline in income inequality being Brazil, Argentina and Ecuador. Let us take a closer look at these:

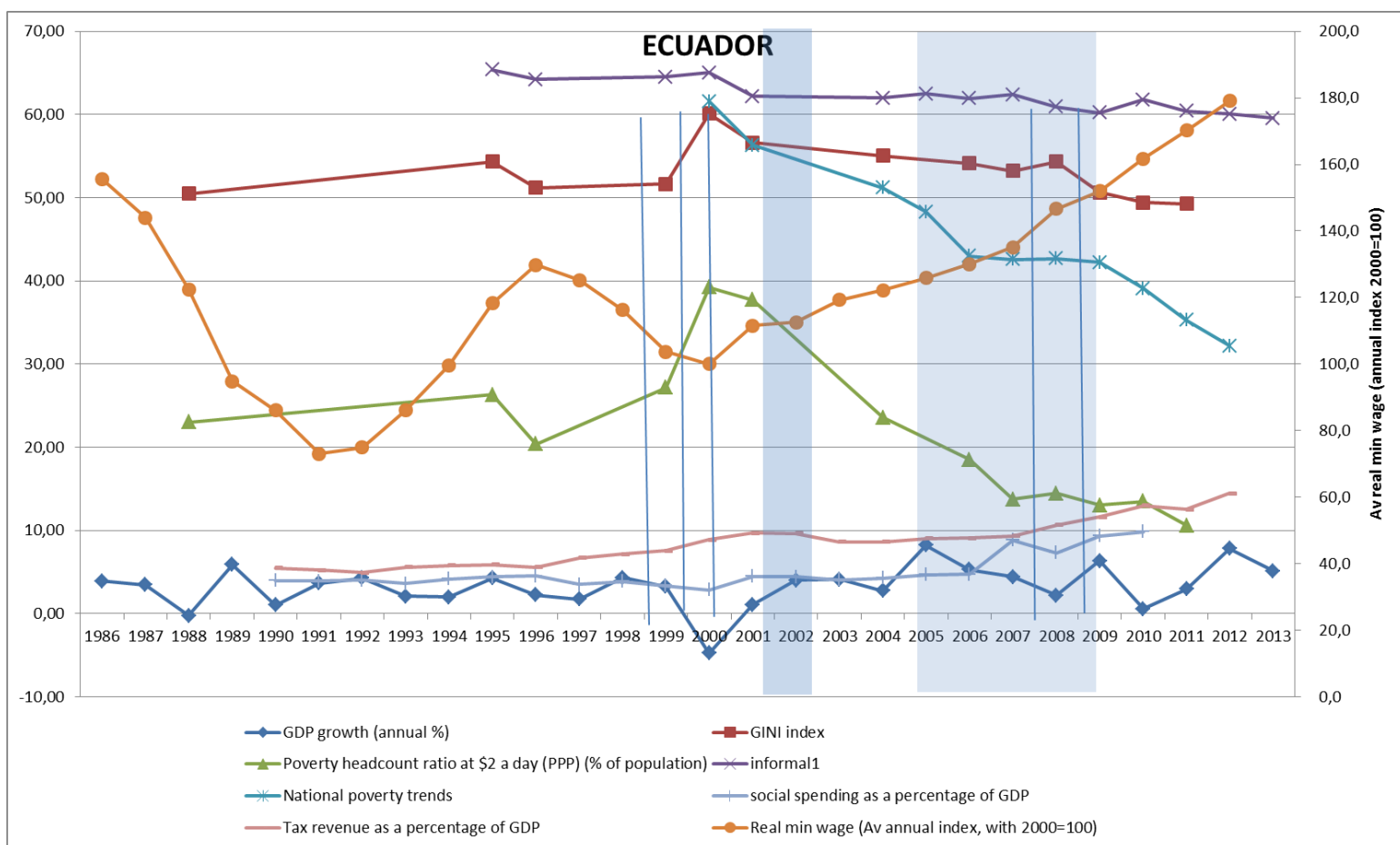
The following chart shows some selected indicators for Brazil. The slides I will show you here are made by my colleague Shabana Mitra.

(Slide 2)



We see here that the late 1980s and early 1990s were characterized by first a rise and then a decline in poverty; then there is a long period of little change until a sustained drop in poverty from 2002. This coincides with a less marked, but nevertheless significant drop in inequality (the red line). (I think the combination of trends that you see here is particularly interesting considering the stories that we heard about Brazil related to the soccer World Cup this summer: we often heard that Brazil had had very dynamic economic growth, but a simultaneous increase in inequality. Both assertions are actually incorrect: as you can see, Brazil has had a historically very high income inequality, but it has dropped lately in spite of very modest and uneven economic growth). Looking at this table, there are two possible explanations spring to mind: increase in minimum wage and decline in labor informality. However, let us move to a different country before drawing conclusions.

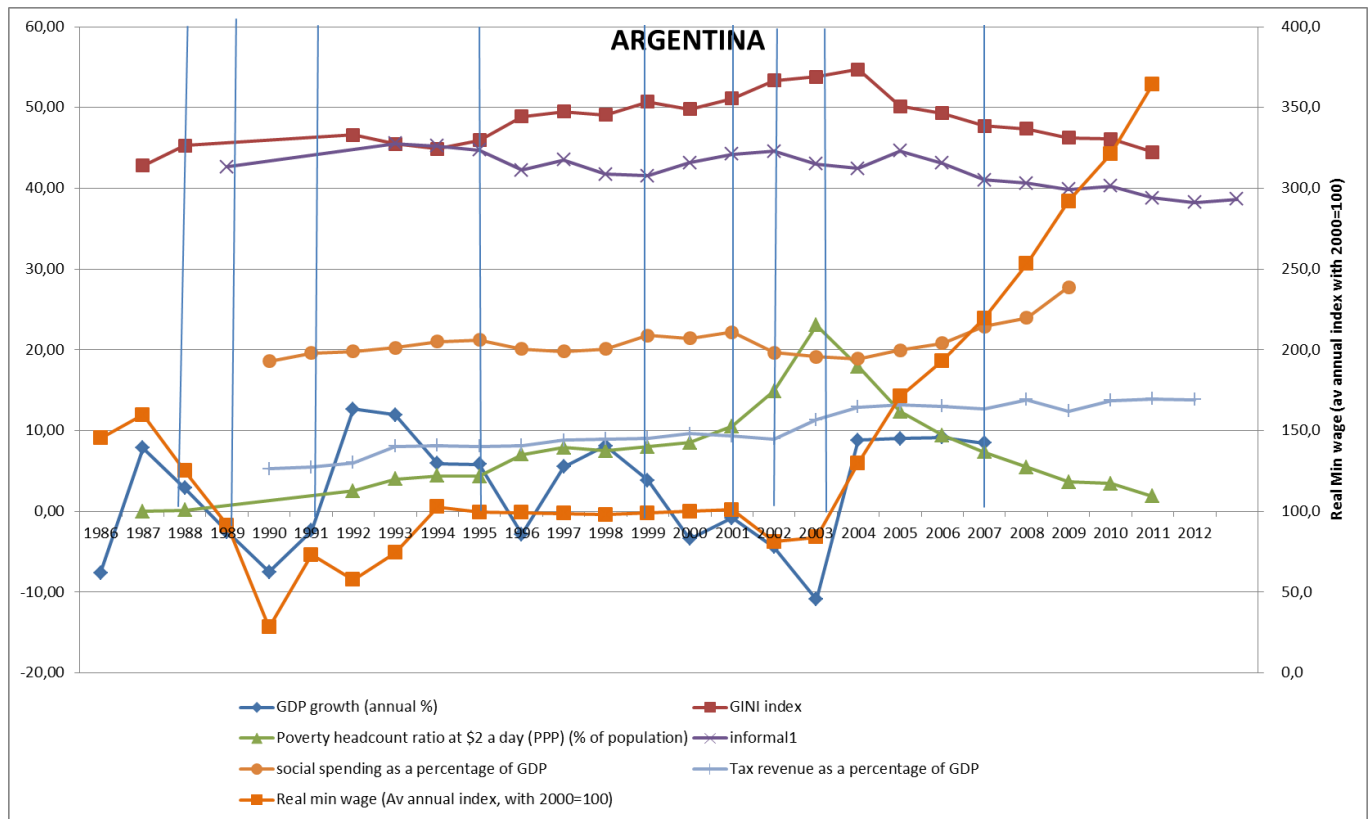
Slide 3



In Ecuador you see many of the same trends: steep poverty reduction, steep increase in minimum wages, and a significant drop in inequality from a high point in 2000, mainly bringing Ecuador back to where it was in 1989 in terms of Gini coefficient. Here we also see that this has been accompanied by a steep increase in real minimum wages.

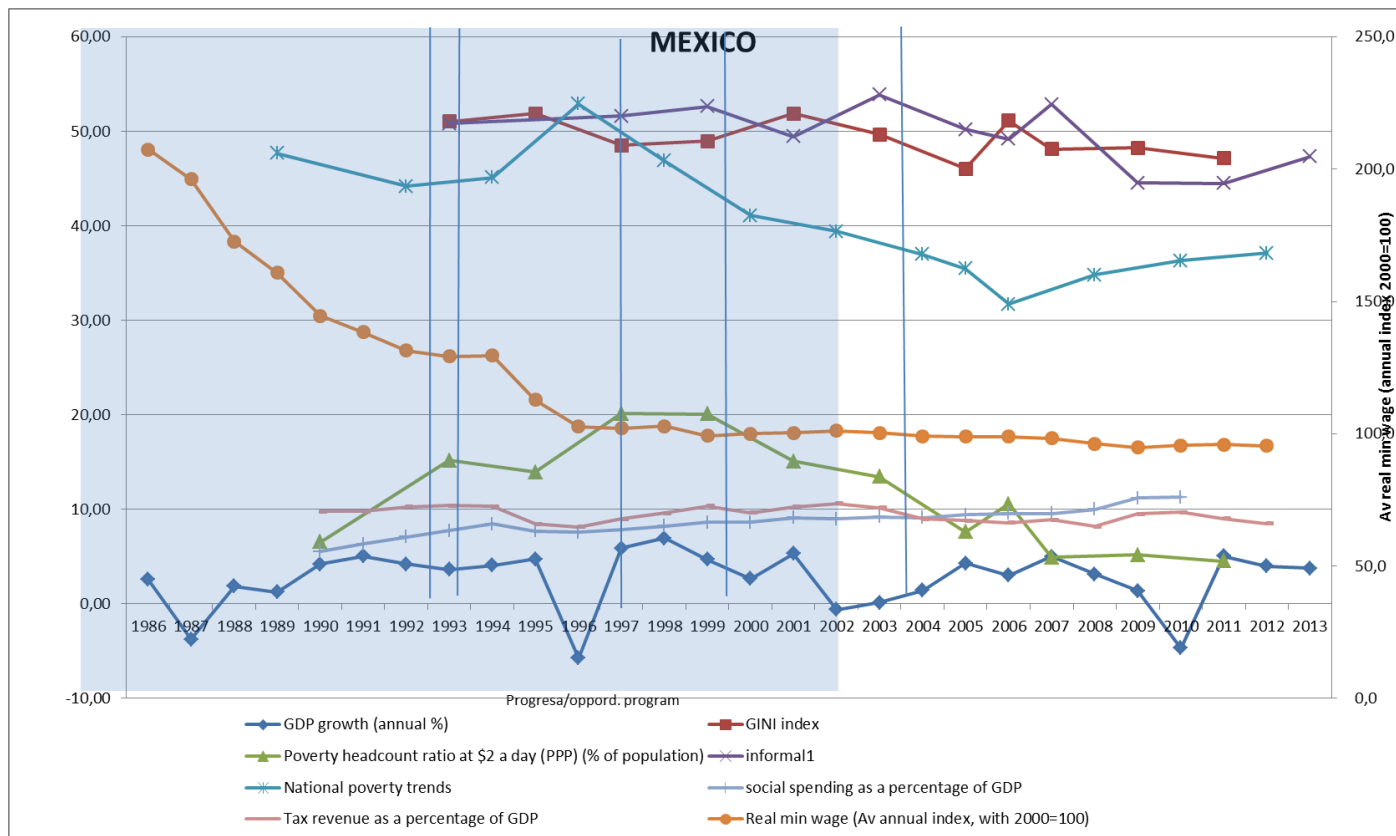
Argentina is a little bit more messy, and there are some quite important data problems here, due to disagreement about inflation rates. However, you do see the same development in minimum wages:

Slide 4:



After the crisis in 2003 we see that growth is resumed, social spending increases, the informal sector declines as does poverty and inequality. However, the steepest line is the real minimum wage.

This picture contrasts sharply with that of Mexico (Slide 5).



Here we can also observe a drop in poverty, but only a more modest drop in inequality. We see, moreover simultaneous drop in minimum wages.

So is increased minimum wages the answer? That depends on a lot of things: on the absolute level of minimum wages (are they so low that almost everyone earn more anyways), on whether employers actually observe them and whether they will be punished if not, etc.

Another major question is the long term effect of increased minimum wages. Some argue that that an increase in the wages in low-skill, low-productivity sectors will eventually lead to increased unemployment or informalization if productivity is not increased simultaneously.

However, research from my own country (by another colleague Kalle Moene) shows that here reduction in income inequality was to a significant degree a degree a result of wage-increases in low-productivity sectors. This had the effect of diverting investments towards high-productivity sectors where wages were relatively low, and profit thus comparably higher.

5. Conclusion

What development lessons can we draw from the recent experiences in Latin America? Since the experiences in Latin America are very recent, it is interesting to analyze the results in the context also of other international experiences.

First, that **investment in education pays off** in terms of inequality reduction in the long term. However, it will not have an effect on inequality unless it coincides with positive economic conjunctures, or is combined with other policy measures that help ensure that the low-skilled do not lag too much behind.

Second, **increased minimum wages** can be an effective means to improve income distribution, if combined with efforts to ensure a sectorial shift from low-skill, low-productivity and low-pay sectors towards more productive sectors. This would require investments in technology and again education, but raising the low-wages can be important incentives for employers do so.

Third, **governmental cash-transfers** can be an important means to raise the income of low-income groups. However, it will have a stronger effect inequality if recipients simultaneously qualify for work and are able to use it as a spring-board towards entering the labor market where most of the inequality reduction has taken place

In sum, what Latin America's experience shows is that the success in terms of reduction of inequality up to date can be explained by a **combination of education-policies, social transfers, labor-policies and labor market dynamic**. In order to ensure that it will be sustained, the current policies will have to be complemented with a stronger focus on increasing labor productivity.