46. The decline and recent uptick of income inequality in Latin America, 2002–13

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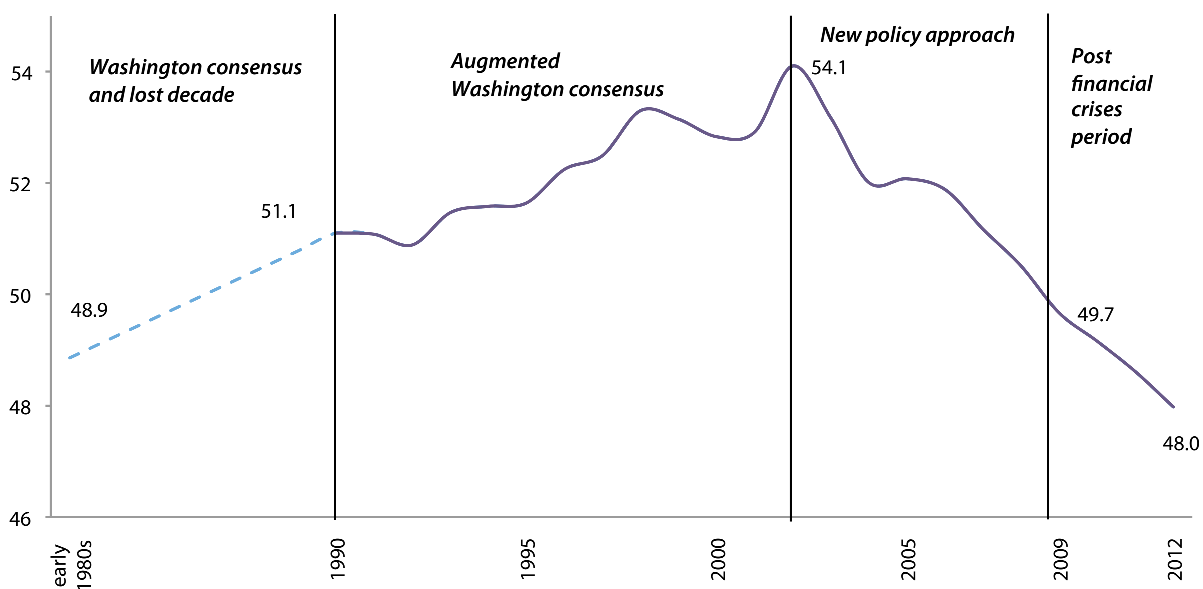
This contribution discusses the exogenous and policy factors behind the large decline in income inequality recorded in Latin America in the 2000s. In particular, it relates the adoption of progressive policies to the election of left-of-centre regimes in most of the region. Finally, it discusses whether such a policy model is sustainable in a world affected by sluggish growth, falling terms of trade, some domestic policy mistakes, and a possible vanishing of middle-class support for the policy model of the 2000s.

Inequality trends during the last thirty years

The colonial origins of the high income inequality that has afflicted Latin America for centuries have been well analysed by Engerman and Sokoloff (2005). These authors argue that the high land, assets and power concentration inherited from the colonial era led to the development of institutions which perpetuated well into the post-Second World War period the privileges of a small agrarian and commercial oligarchy. This path-dependent situation continued until the last quarter of the twentieth century, a period during which Latin America suffered from slow growth, frequent financial crises and a Gini rise from 48.9 in the early 1980s to 54.1 in 2002 (*Figure 46.1*).

Figure 46.1 **Trend in the average regional Gini index, early 1980s to 2012**



Note: The trend for 1990–06 covers eighteen countries. That for 2006–12 covers fifteen countries, as it excludes Venezuela, Guatemala and Nicaragua, for which there are no data. Source: author's elaboration on Cornia (2014) and Center for Distributional, Labor and Social Studies (CEDLAS) data.

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Things changed significantly in the 2000s. After the turn of the century, the region enhanced its growth performance, reduced inequality and improved macroeconomic stability. The most striking change was a 6.1 point Gini decline over 2003–12, which more than offset in only ten years its increase of the two prior decades (*Figure 46.1*). The largest falls (twelve points) were recorded in Argentina and Brazil, while smaller or no gains were registered in conflict-affected countries (Colombia and Mexico) and Central America. It is important to underscore that the Latin American inequality fall stands out. During the same period the OECD nations, China, South Asia and the mining economies of sub-Saharan Africa recorded sizeable Gini rises (Cornia and Martorano, 2012).

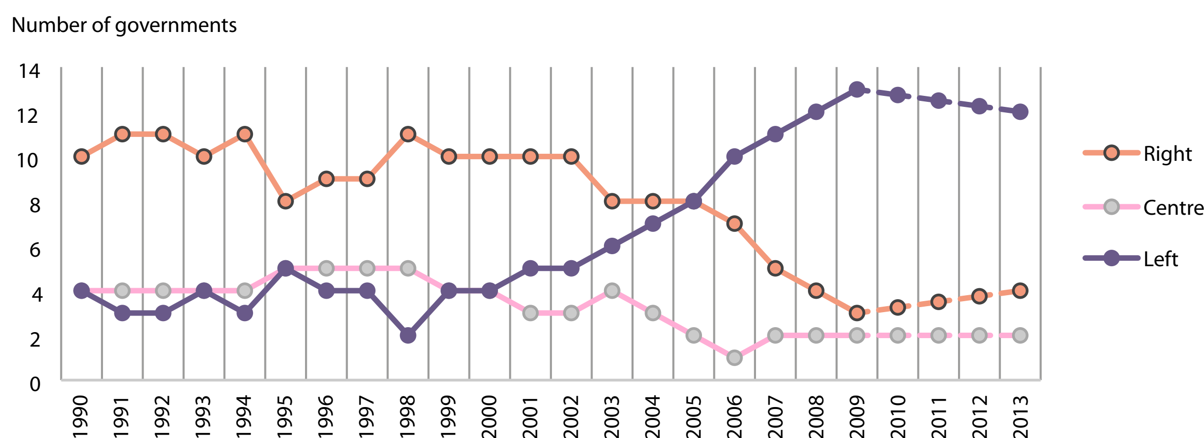
Drivers of the recent inequality decline

What explains the inequality decline observed between 2002 and 2012? A decomposition of the Gini fall over 2002–10 for Chile, Ecuador, El Salvador, Honduras, Mexico and Uruguay shows that it was due (in order of importance) to a drop in the skilled–unskilled wage ratio, an increase in social transfers, and a lower concentration of capital incomes. In other economies, a fall in the urban–rural wage gap and increasingly better distributed remittances were also important (Cornia, 2014). The underlying causes of such changes are discussed below.

Impact of global economic conditions

Some have argued that the inequality decline of the 2000s was due to 'luck', in the sense of an improvement in global economic conditions. For sure, better terms of trade and growing remittances produced beneficial effects on growth. Furthermore, between 2002 and 2008 the region experienced yearly portfolio inflows amounting to 2.4 per cent of its GDP. Yet given the high concentration of assets in the export sector and the selective access to finance prevailing in the region, these improvements in external conditions did not reduce inequality. Instead they generated, all other things being unchanged, an un-equalizing effect on the distribution of market income. Such shocks also generated a positive income effect and relaxed the balance of payments constraint to growth. However, faster growth in itself is no guarantee of falling inequality, as is shown by the recent experience of China and India. In fact, in Latin America a more favourable global environment would not have reduced inequality in the absence of the policy changes discussed below. Regression analysis shows that until 2002 improvements in terms of trade and export volumes did not reduce inequality, while since then they have, thanks – among other factors – to the introduction of redistributive institutions financed by export proceeds.

Figure 46.2 **Trends in ideological orientation of eighteen Latin American governments, 1990–2013**



Source: Cornia (2014), updated to 2013.

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New policy approaches

During the last twenty years the region experienced a return to and consolidation of democracy, and from the late 1990s a sudden shift in political orientation towards centre-left regimes,[1] whose number rose from two in 1998 to thirteen in 2009 (*Figure 46.2*). As suggested by the Latino Barometro, a major factor in this unprecedented turnaround was growing frustration with the sluggish growth, rising unemployment, and informalization of the economy brought about by the Washington consensus policies of the 1980s and 1990s.

The left turn of the 2000s was the result of retrospective economic voting and rising demand for a more active role of the state in the provision of public services and welfare, rather than marking an ideological realignment of the electorate. It was also the result of a reorganization of the left. As noted by Panizza (2005), the political coalitions supporting these new regimes included organizations of the urban and rural poor, unemployed, informal sector workers, indigenous groups and local communities that replaced the trade unions and traditional left parties at the forefront of social mobilization. The new coalitions also included parts of business and the middle class that had traditionally voted for conservative parties, but which switched allegiance after experiencing a decline in the level and share of their income.

As underscored by the recent debate, the middle class is seen as a source of equitable growth and political stability. To assess its incentives to back up the left regimes, we defined the middle class as the sixth to ninth income deciles. In this regard, the sluggish and unequal growth of 1990–2002 affected not only the low-income group (deciles 1 to 5) but also the middle class, which in six out of thirteen countries analysed in Cornia (2012) experienced the largest drop in income share. Symmetrically, the later gains of 2002–09 also benefited the middle class, if less markedly.

Policies adopted by the centre-left regimes

The new policy approach was inspired by the European social-democratic model, and is broadly consistent with the 'redistribution with growth' paradigm. In contrast, the radical-left policies are more in line with the 'redistribution before growth' paradigm that also emphasizes asset redistribution.

The main components of the social-democratic package are listed below, starting from those which had the greatest inequality impact.

First, a key role was played by an increase in public expenditure on education, which had already started in the 1990s, but which accelerated in the 2000s. The net effect was a massive increase in secondary enrolments, especially among the children of the poor. The resulting increase in the supply of skilled workers improved the distribution of human capital and reduced the skilled/unskilled wage ratio. The latter was also affected by a drop in the supply of unskilled workers (because of a prior slowdown of population growth), the educational upgrading of uneducated workers, a drop in the demand for skilled workers, a rise in that for unskilled workers, and changes in labour policies.

Next, during the 2000s, tax policy placed more emphasis on revenue collection, reduced exemptions, progressive taxation, reduced excise duties, and indirect taxes on luxuries. As a result, the regional tax/GDP ratio rose by 3.5 points over 2003–08. The surge in commodity prices contributed to its increase in six oil and metals exporters, but the revenue rise had begun before the commodity boom and also involved non-commodity exporters. These changes helped improve the progressivity of taxation, while higher revenues permitted the expansion of social assistance and education in a non-inflationary way.

Social assistance expenditure started to rise in the 1990s but accelerated its upward trend in the 2000s. All governments introduced measures to complement the uneven coverage of social insurance. These programmes absorbed less than 1 per cent of GDP, covered a large share of the target population, and benefited new political constituencies such as the urban and rural poor. Such programmes included cash transfers aimed at reducing child poverty and ensuring that children remain in school and have access to health services and proper nutrition (such as Brazil's famous Bolsa Familia). In addition, the centre-left regimes of Argentina, Bolivia, Brazil, Chile and Costa Rica introduced a progressive non-contributory social pension costing 0.18–1.3 per cent of GDP.

Labour policy explicitly addressed the problems inherited from the two previous decades: unemployment, job informalization, falling unskilled and minimum wages, and declining social security coverage. Most centre-left governments and a few conservative ones decreed hikes in minimum wages which further improved wage distribution.

These policies could not have been sustained in the absence of prudent and progressive macroeconomic policies that avoided the unequalizing effects of past crises. These included:

- Foreign macroeconomic policy aimed at reducing vulnerability to external shocks. Governments avoided the large balance of payments deficits and debt accumulation of the past by raising tax/GDP ratios and reducing dependence on foreign finance. With the exception of Brazil and Venezuela, they abandoned fixed pegs[2] in favour of more flexible exchange rate regimes, and encouraged central banks to accumulate reserves, which quadrupled between 2002 and 2010 for the region as a whole (ECLAC, 2014). Meanwhile, the region's gross foreign debt was cut in half.

- Domestic macroeconomic policy avoided the traditional procyclical fiscal and monetary biases of the past. Deficits were reduced below 1 per cent of GDP (ECLAC, 2014), and some governments created stabilization funds to draw upon when there were revenue shortfalls. There were also measures to control money supply, reduce interest rates, and expand lending by public banks in periods of crisis. The financial sector was re-regulated to avoid a repeat of the banking crises triggered by the deregulation of the 1980s. As a result, and unlike other regions, Latin America did not experience any financial crisis, even after the 2009 recession.

The 2013 break in the declining inequality trend

The US and EU financial crises, and the slowdown of East Asian growth, led to a fall in remittances, exports and commodity prices which caused a 2 per cent contraction of Latin American GDP in 2009, and a growth decline from 5 per cent over 2002–8 to 3 per cent over 2010–14 (ECLAC, 2014). Yet inequality continued to decline until 2012 (*Figure 46.1*). In 2013 inequality fell moderately in six countries but rose in nine, so that the regional Gini rose by 0.2 points (or by 0.55 if Honduras's exceptional 4.1 Gini drop is excluded). While the downward trend in inequality had not yet deviated substantially from its prior direction, a slow-growing world economy and domestic policy mistakes might have made it more difficult to continue lowering it. The possible decline of middle-class support for centre-left regimes might also threaten the continuation of redistributive policies.

Until 2013, the centre-left regimes continued to dominate the political scene (*Figure 46.2*), and until 2013–14 there were no signs that the centre-left policy package was going to be abandoned. However, policy mistakes, and the political choice to focus redistribution mainly on the poor (a key constituency of centre-left regimes) during the years of slow growth and stagnant revenue may have alienated the support of the middle class. This conjecture is supported by data showing that in countries affected by political tensions, the inequality decline of 2010–13 benefited only the low-income group. As discussed next in the case of Brazil, the lack of inequality gains by the middle class – which during these three years had borne a heavy tax burden to finance redistribution, without receiving in exchange adequate services and jobs – eroded its support for the centre-left regimes.

The 2013 Latino Barometro survey captures well the dissatisfaction emerging in several centre-left countries – in particular in Argentina, Brazil, Venezuela, Mexico, Paraguay and El Salvador – that experienced a drop of the income share of the middle class over 2010–13, a Gini rise in 2013, and in some cases an electoral reversal in 2015.

Brazil offers a good illustration of the relation between worsening economic conditions, policy mistakes, the weakening of distributive policies and the loss of middle-class support. As noted by Saad-Filho (2015), in 2015 hundreds of thousands of the middle class took to the streets to protest against their centre-left government. For a time, its policies had delivered growth, jobs, minimum wages and social transfers that reduced inequality. The commodity boom of 2003–08 sustained redistribution, a small expansion of infrastructure and the creation of 21 million low-wage jobs in services. The subsequent reduction in inequality was, however, hampered by global stagnation and a conservative macro policy that precluded fiscal expansion, industrial restructuring and devaluation of the reais. Because of its overvaluation, 4.5 million middle-class manufacturing jobs were lost in the 2000s, while urban infrastructure was neglected (Saad-Filho, 2015). The government did not drop its redistributive targets, but found it more difficult to finance them in a situation of falling commodity prices, zero growth and weakening middle-class support. Meanwhile, insufficient past investment in infrastructure led to a worsening of transport, water and health services which affected the middle class, who had paid substantial taxes during the golden years.

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Conclusions: limitations of the new policy approach

Despite recent improvements, Latin America remains the region with the highest inequality in the world, paralleled only by Southern Africa. The battle for a more egalitarian society needs therefore to continue. In much of the region – and particularly in Central America and the Andean countries – the distributive gains of 2002–12 can be furthered by intensifying recent educational, tax, public expenditure, labour and macroeconomic reforms. Across the region, additional, if politically difficult, reforms should be tried to tackle the region's inheritance of unequal access to land, credit and tertiary education, and its low level of domestic savings. Inability to deal with these problems, if only in part, may prevent future inequality declines once the social-democratic reforms have run their course.

Finally, the 2008 crisis brought to the fore the limitations of the region's foreign-financed, export-led growth strategy introduced by the liberalization of the 1980s and 1990s. These reforms were not overturned in the 2000s. In years of low world growth, such a strategy has once more underscored the dependent nature of the Latin American economy. Even during the years of rapid growth, the region experienced large-scale deindustrialization which sacrificed middle-class jobs, led to the 're-primarization' of exports and output (Ocampo, 2012), and exposed the region to the risk of unstable terms of trade and sudden stops in capital inflows. Reversing the deindustrialization of the past three decades is a key policy challenge with important implications in terms of middle-class support for progressive policies. Such a challenge may be tackled with open-economy industrial policies that support labour-intensive manufacturing and services by means of competitive exchange rates, production support measures, technological upgrading, public–private partnerships to enter new sectors, regional cooperation, and a rebalancing of trade asymmetries with China.

Acknowledgement

This work is an author's update of Cornia (2014) based on recent data.

Notes

1. Some of them are social-democratic, as in Chile, Uruguay and Brazil. In turn, Venezuela, Bolivia and Nicaragua followed a radical populist approach which also entailed a redistribution of assets. The largest yearly Gini drops were recorded by the social-democratic regimes (0.96 Gini points), followed by radical and centrist regimes (both around 0.50).

2. In pegged exchange rate systems a country will fix ('peg') its currency to a major currency such as the US dollar, or to a basket of currencies.

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