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# FALLING INEQUALITY IN LATIN AMERICA

## POLICY CHANGES AND LESSONS

*Edited by*

*Giovanni Andrea Cornia*

UNU-WIDER STUDIES IN DEVELOPMENT ECONOMICS

# Falling Inequality in Latin America

UNU World Institute for Development Economics Research (UNU-WIDER) was established by the United Nations University as its first research and training centre and started work in Helsinki, Finland, in 1985. The purpose of the institute is to undertake applied research and policy analysis on structural changes affecting developing and transitional economies, to provide a forum for the advocacy of policies leading to robust, equitable, and environmentally sustainable growth, and to promote capacity strengthening and training in the field of economic and social policy making. Its work is carried out by staff researchers and visiting scholars in Helsinki and via networks of collaborating scholars and institutions around the world.

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# Foreword

This volume addresses a major issue in regional economic development with profound implications for many developing regions and possibly also for the beleaguered OECD countries mired in a long-lasting financial crisis and economic stagnation. For at least the last quarter of the twentieth century, Latin America suffered from very low rates of growth, high and rising inequality, and frequent financial and currency crises. However, since the turn of the century, the region's growth rates have improved, income inequality declined to the level of the early 1980s, poverty fallen, and macroeconomic stability improved, all this in parallel with the spread of centre-left political regimes in three-quarters of the countries of the region.

This decline in inequality has taken many by surprise. Indeed, the region has for long been a symbol of a deeply entrenched unequal distribution of assets, incomes, and opportunities, limited or no state redistribution, and a deeply embedded authoritarianism enforcing an unjust status quo. The recent Latin American experience is also particularly valuable as the inequality was reduced under open-economy conditions and in a period of intensifying global integration, which has often been considered by many as a cause of rising inequality.

In this sense, however imperfect, the Latin American experience in the aftermath of its redemocratization may be of interest to other developing countries completing their transition to the market and liberal democracy (such as some of the former socialist countries of Europe), facing a political transition (such as those affected by the Arab Spring, Myanmar, and some countries in sub-Saharan Africa), or recording rises in income inequality and social tensions in spite of rapid economic growth.

The causes of the recent higher economic growth in the region are clear enough and include the rebound from the severe regional crisis of 2001–2, improvement in the international environment (in terms of commodity prices, capital inflows, and migrant remittances), but also better domestic policies in the field of macroeconomic stability, exchange rates, taxation, financial regulation, minimum wages, human capital formation, social assistance, and deeper intra-regional trade integration.

Until recently there was not much agreement on the drivers of the decline in inequality, which was alternatively attributed to changes in the supply/demand of skilled workers, improvements in terms of trade (though no decline in inequality was observed on the occasion of prior commodity bonanzas), the spread of social assistance schemes, or 'luck'. In this respect, the volume offers the first scholarly and systematic exploration of this unexpected change on the basis of three pairs of comparative case studies and eight policy chapters that point to the slow emergence of a 'new policy model' in the aftermath of the social-democratization of many countries of the region. In view of the fact that income inequality has been rising and is currently rising in many parts of the world, a good understanding of the Latin American experience and policies over the 2000s, including the different approaches followed within the region, is a topic that will attract a lot of attention. As such this volume is of interest not only to scholars and students of development economics but also to policy makers and people interested in the understanding of inequality dynamics in developing nations. I thus strongly recommend this volume to all of them as well as to the general reader interested in development issues. I would also like to take this opportunity to convey my sincere thanks to the authors of this volume, including the many distinguished scholars working in the field of development economics.

*Finn Tarp*
*UNU-WIDER Director*
*Helsinki, October 2013*

# Acknowledgements

This volume would not have seen the light of the day without the collective effort of a large array of people working together in many ways, and without the inputs of many scholars. To start with, I would like to thank Juan Carlos Moreno Brid who as early as the mid-late 2000s drew my attention to the deep economic and political changes which were emerging in Latin America. My most sincere thanks go to all contributors to this volume for the time they dedicated with scholarly application to this undertaking, for their ground-breaking analyses, and for the patience shown in revising their chapters over and over again. Many thanks also to those participants at the UNU-WIDER 25th anniversary held in Helsinki in May 2010—including Tony Addison, Roberto Frenkel, Nora Lustig, José Antonio Ocampo, Andres Solimano, and Finn Tarp—who took part in the discussion on the framing of the main research hypotheses which have inspired this volume.

Heartfelt thanks also to all the participants of the two project research workshops held in New York (December 2010) and Buenos Aires (September 2011). These workshops offered the opportunity to provide comments and frank criticism on the preliminary drafts of the various chapters, and on the articulation of the project as a whole. The New York workshop strongly benefited from logistical support from the UNU office in New York and UNDESA. The Buenos Aires workshop also offered the opportunity to organize a well-attended UNU-WIDER-initiated roundtable held at the University of Buenos Aires with the co-sponsoring of CEDLAS (University of La Plata) and CEDES (Buenos Aires). Saúl Keifman and Cecilia Arena from the University of Buenos Aires and Annett Victorero of UNU-WIDER are especially to be thanked for the smooth organization of that event. Tony Addison also provided important inputs to the organization of the roundtable and helped substantially with the management of the Buenos Aires scientific workshop. Several colleagues from CEPAL, UNDP, the World Bank, and the New School University need to be thanked for sharing some of their research material with me, in particular Luis Beccaria, Luis Felipe López-Calva, Michael Cohen, Francisco Ferreira, Martin Hopenheim, and Ricardo Martner. The formulation of the working hypotheses of the project benefited also from very useful comments received from scholars and policy makers attending the conference organized in Pocantico by the New School University and the Rockefeller Foundation in November 2010. I would also like to acknowledge the hospitality of Nuffield College of the Oxford University during the 2010 Michaelmas term. During this period, I was able to set the project under way, formalize in detail the research hypotheses on which this study is based, and present and discuss them in various seminars held at the college itself, at the Latin American Centre of the University of Oxford, and at Queen Elizabeth House. In this regard, I would like to acknowledge the help of Diego-Sanchez Ancochea, Nancy Bermeo, Edmund Valpy Fitzgerald, Gwendolyn Sasse, and Frances Stewart for organizing and hosting such presentations which helped me revise some of my initial research ideas. While at Nuffield College I also had useful discussions on some of the topics of this volume with Tony Atkinson and Susan Stokes, who kindly shared with me some of their research ideas on top incomes and the politics of inequality.

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*Giovanni Andrea Cornia*
*University of Florence*
*October 2013*

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# Acronyms and Abbreviations

| | |
|---|---|
| 3SLS | 3-stages least squares |
| ACFTU | All China Federation of Trade Unions |
| AD | *Acción Democrática* (Venezuela) |
| AFAM | *Asignaciones Familiares Plan de Equidad* (system of family allowances, Uruguay) |
| AFPs | private pension fund management companies |
| BDH | *Bono de Desarrollo Humano* (conditional cash transfer programme, Ecuador) |
| CAFTA | Central American Free Trade Agreement |
| CCTs | conditional cash transfers |
| CEDLAS | Centre for Distributive Labour and Social Studies at the Universidad Nacional de La Plata (Argentina) |
| CIT | corporate income tax |
| EAP | economically active population |
| ECH | *Encuestas Continuas de Hogares* (household surveys, Uruguay) |
| EHPM | *Encuestas de Hogares de Propósitos Múltiples* (Multiple Purpose Household Surveys of El Salvador) |
| EIS | employment in the informal sector |
| EMCs | emerging-market countries |
| ENIGH | *Encuesta Nacional de Ingresos y Gastos de los Hogares* (National Survey of Household Incomes and Expenditures, Mexico) |
| ENOE | National Survey of Labour and Employment (Mexico) |
| EPFs | household budget surveys |
| FDI | foreign direct investments |
| FEES | social and economic stabilization fund (Chile) |
| FMLN | *Frente Farabundo Martí para Liberación Nacional* (El Salvador) |
| FONASA | Chile's national health fund |
| GATT | General Agreement on Tariffs and Trade |
| GCR | Global Competitiveness Report by the World Economic Forum |
| GDP | gross domestic product |
| GICs | growth incidence curves |

| | |
|---|---|
| IASS | *Impuesto de Asistencia a la Seguridad Social* (social security assistance tax, Uruguay) |
| ID | *Izquierda Democrática* (Ecuador) |
| IE | informal employment |
| ILO | International Labour Organization |
| INE | Chile's National Bureau of Statistics |
| INEC | *Instituto Nacional de Estadística y Censos* (Ecuador's National Statistical Office that collects the National Employment, Unemployment, and Underemployment Survey data (ENEMDU)) |
| IRPF | *Impuesto a la Renta de las Personas Físicas* (dual personal income tax system, Uruguay) |
| IS | informal sector |
| ISI | import substitution industrialization |
| LAC | Latin America and the Caribbean |
| LCSPP | LAC Poverty Reduction and Gender Sector of the World Bank |
| LSDV | least square dummy variable |
| MNR | *Movimiento Nacionalista Revolucionario* (Bolivia) |
| MST | Brazil's Landless Workers Movement |
| NAFTA | North American Free Trade Agreement |
| NER | nominal exchange rate |
| OB | Oaxaca-Blinder type of decomposition |
| PAN | *Partido Acción Nacional* (Mexico) |
| PANES | *Plan Nacional de Atención a la Emergencia Social* (Uruguay) |
| PCHI | per capita household income |
| PEM | minimum employment programme (Chile) |
| PIT | personal income tax |
| PLN | *Partido de Liberación Nacional* (Costa Rica) |
| POHJ | employment programme for household heads (Chile) |
| PRAF | conditional cash transfer programme (Honduras) |
| PRI | *Partido Revolucionario Institucional* (Mexico) |
| PT | *Partido dos Trabalhadores* (Brazil) |
| RER | real exchange rate |
| RIF | re-centred influence function |
| SBTC | skill-biased technical change |
| SCRER | stable and competitive real exchange rate |
| SEDLAC | Socioeconomic Database for Latin America and the Caribbean |
| SMEs | small and medium-sized enterprises |
| ToT | terms of trade |
| VAT | value added tax |

# Notes on Contributors

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Part I

# Inequality Changes and the Surfacing of New Policy Approaches

# 1

# Recent Distributive Changes in Latin America: An Overview

*Giovanni Andrea Cornia*

## 1.1 The Decline of Income Inequality During the 2000s

This volume aims to document and explain the sizeable decline of income inequality that has taken place in the majority of Latin American countries[1] during the last decade. It does so through a systematic exploration of inequality changes in six countries characterized by different economic structures, political regimes, and inequality trends. Structured comparisons between three pairs of these countries broadly similar in most respects except for their policy approaches or the external shocks endured can help to disentangle the region's recent inequality dynamics. The three country comparisons concern: (i) Ecuador (which was run by a centre-left government for most of the decade and which experienced a large decrease in inequality) versus Chile (also run by a centre-left regime, but which recorded only a moderate fall in inequality); (ii) Uruguay (centre-right till 2005 and featuring a large increase in inequality until 2007 followed thereafter by a moderate decline) versus Mexico (also centre-right, but exhibiting a sizeable fall in inequality during the 2000s); and (iii) Honduras (centre-right, characterized by a large rise in inequality) versus El Salvador (also centre-right, but registering a large decrease in inequality). These comparisons are integrated by analyses of policy changes in the field of macroeconomics, foreign trade, labour markets, education, taxation, and social assistance. In addition, Chapter 3

[1] The volume focuses on 18 countries, i.e. all the South American countries (except for the Guyanas) and all the Central American countries. Caribbean countries are excluded except for the Dominican Republic.

(by Kenneth M. Roberts, a political scientist) explores the factors explaining the re-politicization of inequality following the return to democracy in the late 1990s and the subsequent election in the 2000s of centre-left regimes in many countries. In this sense, however imperfect, the Latin American policy experience in the aftermath of its redemocratization may be of interest to other developing countries facing a political transition or recording rises in income inequality and social tensions in spite of rapid economic growth. The recent Latin American experience is particularly valuable as it shows that inequality can be reduced under open economy conditions and in a period of intensifying global integration if a new policy model (called for convenience 'open-economy growth with equity') is adopted.

The recent decline of inequality in Latin America has taken many by surprise. Indeed, the region has for long been a symbol of a deeply entrenched unequal distribution of assets, incomes, and opportunities, limited or no redistribution by the state, and authoritarian regimes enforcing an unjust *status quo*. The root causes of such a situation were to be found in the high concentration of land, human capital, credit, production opportunities, and political power in the hands of a tiny oligarchy. This high asset concentration was perpetuated well into the post-Second World War period by the creation of institutions which facilitated the diversification of the elites' agricultural, mining, and commercial assets into industrial and financial assets. As a result, with rare exceptions, the Gini coefficient of the distribution of income per capita in the 1950s and 1960s ranged between 0.47 and 0.65 (Chapter 2: Table 2.1), the highest in the world and matched only by a few countries in Southern and Eastern Africa.

As argued by Giovanni Andrea Cornia in Chapter 2, such high structural inequality rose on average by 0.32 Gini points a year during the 1980s, the decade that witnessed a prolonged recession and the dominance of Washington Consensus-type adjustment policies. Inequality continued rising on average by 0.16 Gini points a year during the 1990s, a decade of sluggish growth and the prevalence of the augmented Washington Consensus (Figure 1.1).

The inequality trend of the 1980s and 1990s came to a halt in the first decade of the twenty-first century, a period of major reversals of prior political, economic, and distributive trends. Indeed, as noted in Chapter 2, inequality fell between 2002 and 2010—albeit to different extents and with different timing—in all 18 countries of the region. Exceptions were Nicaragua, where it rose, and Costa Rica, where it stagnated. The average regional decline in the Gini coefficient over 2002–10 was a sizeable 5.5 points (Figure 1.1), but the fall was much more pronounced in Argentina, Paraguay, Peru, and Venezuela. Overall, inequality improved more in South America than in Central America (Chapter 2: Table 2.1).

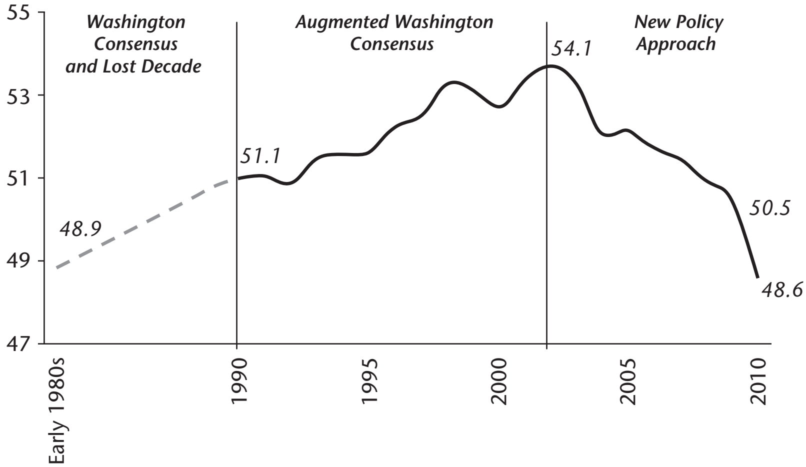


**Figure 1.1.** Trend in the average regional Gini index of the distribution of household income per capita, early 1980s–2010

*Source*: Author's elaboration based on the IDLA dataset (Martorano and Cornia 2011), which is based on SEDLAC data and on other sources for years with missing SEDLAC data.

The average drop in inequality was particularly marked during the 2003–4 recovery, particularly in countries that had experienced a sharp rise in income polarization during the 2001–2 crisis, and then slowed somewhat over 2004–8. Inequality, however, did not rise during the 2009 crisis, and fell sharply during the recovery of 2010 in half of the 13 countries with available data (Chapter 2: Table 2.1). Overall, over 2003–10 the region offset the inequality rises of the prior twenty years, thus returning to its average level of the early 1980s.

It has been argued that such a startling decline was facilitated by the high international prices of commodities exported by the region. This factor certainly played a role in reducing inequality in eight countries, and particularly in four (see Chapter 14 and Chapter 4 on Ecuador) heavily dependent on commodity exports (thanks to a rise in public expenditure and aggregate demand leading to a rise in the demand for unskilled labour). Yet, the evidence in Chapter 2 and the country studies in Chapters 4 to 9 indicate that such a decline was as pronounced in the semi-industrialized economies of the region, in remittance-dependent countries such as El Salvador (see Chapter 7), and in economies with a mixed production structure. The uniqueness of the recent inequality decrease in Latin America is underscored also by the fact that no other region experienced comparable distributive gains despite similar improvements in terms of trade, migrant remittances, financial flows, and economic growth. Neither can the recent inequality decline be closely associated with growth, as the fast-growing Asian countries experienced steep inequality rises during this period. It is thus unlikely that the recent distributive gains of Latin America were only due to a favourable external environment, world growth, or 'luck'. Other factors, including changes in public policies, must help to explain this encouraging trend.

## 1.2 Determinants of the Decline in Inequality in the Case Studies Analyzed

What, then, explains the recent decline in inequality? To answer this question, the country studies of this volume follow a two-step approach. Changes over time in the Gini coefficient of household income per capita are first decomposed[2] into changes in their 'proximate determinants', i.e. changes in the shares of different types of income and in their concentration coefficients, corrected when possible for changes in activity and participation rates. Next, changes in the shares and concentration coefficients of labour, transfer, capital, and remittance income are analysed in relation to their 'underlying determinants', i.e. exogenous shocks to the national economy, changes in domestic policies and institutions, and shifts in political regimes.

### *1.2.1 Proximate Causes of the Inequality Changes During 1990–2010 Emerging from the Country Case Studies*

There are several similarities among the factors which explain the inequality changes of the last two decades in the six countries analysed in this volume (Table 1.1) or in the related literature (López-Calva and Lustig 2010). These conclusions, however, are biased by the grossly incomplete accounting in household surveys of capital incomes and the labour income of the 'working rich'. As the analyses of income distribution changes based on tax-return data by Atkinson and Piketty (2010) and Alvaredo (2010) show, it is possible (but not necessary) that a decline in the survey-based Gini coefficient G* goes hand in hand with an increase in G, the survey-based G* corrected with the percentage income share S of the top income earners (1 or 0.1 per cent).[3]

[2] The most common decompositions used are those proposed by Lerman and Yitzhaki (1985), Milanovic (1998), and Bourguignon, Ferreira, and Lustig (2005). These works are respectively referenced in chapters 4, 2, and 7.

[3] When commenting on the differences between the household-survey-based Gini and that corrected on the basis of the following formula $G = G^* (1–S)+S$, Alvaredo (2010: 7) notes on Argentinean data that '. . . not only can [Gini] levels be different, but also the trends of G and G* can diverge. According to the survey's results, G* displays virtually no change when 2001 and 2003 are compared, going from 51.1 to 50.9. However, G 'corrected' with the top 1 per cent income share . . . was 57.4 in 2001 and 59.2 in 2003 (an increase of almost two percentage points). Finally, the discrepancy between the two formulas is larger, the larger the top group considered.' In contrast, in the case of the United States, both G* and G rose between 1976 and 2006, though the latter displayed a faster rate of increase.

Given the scarcity of information on capital incomes and the income of the 'working rich' in household surveys, this volume is thus unable to establish formally whether the distributive changes discussed in the various chapters concern also the top percentiles of the income distribution. Given all this, analyses of the country studies suggest that much of the shifts in overall survey-based inequality over the period 1990–2010 was explained by variations in the Gini coefficient of labour incomes (Table 1.1). The upward (during the 1990s) or downward (during the 2000s) changes in the latter were accompanied in all cases but one by parallel shifts in the skill premium (the ratio of the wage of secondary- or tertiary-educated workers to that of workers with less than secondary education). In turn, the drivers of the surge and subsequent decline in the skill premium (analysed in detail in the country studies according to a similar methodology) depended on several factors such as: a stagnation in the demand for skilled labour during the 2000s (after its rapid increase during the prior decade); an increase in the supply of skilled workers following a surge in educational investments by governments during the 1990s and 2000s and the subsequent decline of educational inequality, which favoured the low-income groups; the increase in the demand of unskilled workers following the adoption of a more competitive exchange rate, which favoured the unskilled labour-intensive traded sector; and the decline in the supply of unskilled labour due to rising education, a fall in birth rates, and an increase in the rate of emigration.

Third, with the exception of Chile and Uruguay, where the number of agricultural workers is comparatively low, the decline in labour-income inequality was accompanied by a drop in the urban–rural wage gap driven by the adoption of competitive exchange rates or increases in world prices of agricultural commodities. In practically all countries, part of the decline in inequality was also explained by a rise from low levels in the share of social assistance transfers in total household income due to improved revenue collection (as discussed in Chapter 6 on Uruguay), and by the better targeting of social assistance transfers. While these inequality changes were not as large as those resulting from the enhancement in the distribution of labour income, they nevertheless made a significant contribution to the recent decline of income inequality. Finally, contrary to expectations in the literature, the increase in migrant remittances in total household income appears to have had an equalizing effect in El Salvador and Mexico but an unequalizing one in Honduras.

### *1.2.2 Underlying Causes of Inequality Changes During 1990–2010 in the Country Studies*

Hereafter are summarized the underlying factors responsible for the changes in the proximate determinants of inequality in the six case studies included in this volume. They are discussed for pairs of similar countries which were affected by different macroeconomic shocks or followed dissimilar policy approaches.

ECUADOR VERSUS CHILE

During the 2000s, both countries were run by centre-left governments and both recorded a fall in inequality, although the drop recorded by Ecuador far exceeded that of Chile (Table 1.1). A possible explanation, as Juan Ponce and Rob Vos argue in Chapter 4, is that only Ecuador in the 2000s fully offset the large inequality rise experienced during the earlier liberalization of trade and finance, which strengthened the traditional capital-intensive sector (oil and traditional agriculture). This appreciated the exchange rate and raised modern sector wages but did not create new formal sector jobs, leaving the task of absorbing the surplus labour to the informal sector. Later, floods caused by El Niño and falling oil prices pushed the economy into a tailspin while the 1999 banking crisis triggered a further surge in inequality and a large outflow of migrants, as public transfers did not adequately compensate for the loss of wages due to the crisis. The recovery of the 2000s raised real wages, including those of unskilled and rural workers, and reduced the Gini of labour income. This decline was helped by an expansion in the supply of educated workers, a fall in the skill premium, and more proactive income-transfer policies. As a result, by the end of the 2000s the economy-wide Gini coefficient had returned to the pre-liberalization level of the early 1990s.

In contrast, as noted by Dante Contreras and Ricardo Ffrench Davis in Chapter 5, inequality in Chile rose sharply between 1973 and 1987 when the military regime liberalized foreign trade (a measure which raised the skill premium and reduced employment in the traded sector), introduced labour reforms biased against workers and unions, and lowered taxes on wealth, capital gains, profits, and VAT on luxuries. Those years were also characterized by a sweeping educational reform that favoured private schools and increased educational inequality. Despite the return to democracy in 1990, income inequality stagnated during the entire decade (Table 1.1) but fell moderately over 2000–10 (i.e. 4.3 points as opposed to ten in Ecuador) despite the initial introduction of a competitive real exchange rate, capital controls, a prudent macro policy, an increase in average and minimum wages, a rise in expenditure on social assistance, and expanding social security coverage. During the 1990s, however, inequality in secondary education stagnated and access to tertiary education became more skewed. In brief, while Ecuador offset most of the initial increase in inequality recorded during the liberal era, in the 2000s Chile offset only part of the 1973–87 inequality surge, mainly because of only limited equalization of educational opportunities. In addition, at the end of the 1990s, the previous prudent macroeconomic approach was replaced by

**Table 1.1.** Changes in the proximate determinants of income inequality in the six country case studies of the volume, 1990s and 2000s

| Country | Political regime | Period considered | Absolute changes in Gini index of overall income | Absolute changes in Gini index of all labour income[b] | % change in skill premium | % change in rural–urban wage gap | Absolute change in the Gini of: | | | Absolute change in the share of: | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | Capital income | Public transfers | Remittances | Labour income | Capital income | Transfer income | Remittance income |
| Chile | CL | 1990–2000 | +0.7 | +2.4[b] | +34.2[g] | not relevant | — | stable | not relevant | +2.0 | — | rising | not relevant |
| | CL | 2000–10 | –4.3 | –3.8[b] | –35.1[g] | not relevant | — | equalizing | not relevant | +5.0 | — | rising | not relevant |
| Ecuador | R | 1990–2001 | +14.0[a] | +14.0[a] | +25.4[h] | — | +15.0[a] | negligible | negligible | negligible | declining | rising | rising |
| | CL, L | 2001–10 | –10.0[a] | –11.0[a] | –21.5[h] | –10.0[l] | –18.0[a] | equalizing | equalizing | declining | rising | declining | declining |
| El Salvador | R | 1994–9 | +4.0 | +2.5[b] | 0.0[g] | rising | — | — | –3.7 | –0.5[c] | — | negligible | +0.5 |
| | R | 2000–9 | –7.0 | –3.2[b] | –16.0[g] | –21.0 | –9.0 | –8.0 | –3.2[e] | –1.0[d] | –0.1 | +2.0 | +2.0 |
| Honduras | R | 1991–2005 | +6.9 | +6.2 | +32.1 | +12.4 | — | negligible | +5.0 | –15.9 | — | negligible | up to 10.3 |
| | CL | 2005–7 | –5.2 | –2.0 | –33.7 | –4.3 | –9.6 | –2.7 | +2.6 | –0.8 | +0.3[k] | +0.9 | +1.2 |
| Mexico | CR | 1989–94 | +1.3 | +13.4 | +50.5[g] | +42.6 | — | –4.3 | +0.2 | –3.0 | — | +1.4 | –0.3 |
| | CR | 1995–2010 | –8.2 | –8.0 | –10.9[g] | –36.9 | — | –9.0 | –0 4 | +7.0 | — | +3.6 | +0.2 |
| Uruguay | CR | 1990–2007 | +3.3 | +6.7 | +42.2 | not relevant | +2.0 | + 0.6 | not relevant | -5.0 | –0.9 | 7.0 | not relevant |
| | CL | 2007–11 | –4.0 | –4.4 | –14.2 | not relevant | +3.0 | –1.59 | not relevant | 0.8 | 1.6 | 2.3 | not relevant |

*Notes:* C, L, R, CL, CR, respectively, refer to centre, left, right, centre-left, and centre-right political regimes; —means not available; [a] = urban sector; [b] = based on SEDLAC data on all types of labour income; [c] = labour and non-labour income; [d] = skilled labour only; [e] = the years 2001–9; [f] = data based on the CASEN survey; [g] = based on SEDLAC data on the ratio between the salaries of workers with tertiary versus primary education; [h] = urban male workers; [i] = the country was run during the years 1990–2005 by right or centre-right regimes, and by a centre-left regime during 2005–11. The different periodization chosen in the table better permits the highlighting of the turnaround in income inequality in the latter period; [k] = calculated as a residual, which includes other private transfers; [l] = refers to the period 2003–10.

*Source:* Author's compilation on the basis of chapters 4 to 9, unpublished background data supplied by the chapters' authors, and SEDLAC data where indicated.

a totally open capital account and a free-floating exchange rate which may have hampered employment creation in the labour-intensive traded sector. Inequality started to decline with the recovery in 2004 and the strengthening of targeted social programmes financed with progressive taxes, a further rise in the minimum wage and the wages of different types of workers, the effect of increased public expenditure on education, and greater formalization of employment and coverage of social security.

### URUGUAY VERSUS MEXICO

Both of these middle-income countries were run for most of the last twenty years by conservative governments. Yet, while income inequality in Mexico rose in the first decade and declined during the second, in Uruguay inequality started declining only in 2007 after the election in 2005 of a centre-left regime and the adoption in 2006 of redistributive policies. As noted in Chapter 6 by Verónica Amarante, Marco Colafranceschi, and Andrea Vigorito, the rise of inequality in Uruguay since the early 1990s was driven by the current and lagged effects of rapid trade liberalization, suppression of centralized wage-setting and reduction in minimum wages (which contributed to raise the skill premium and wage inequality), as well as by the suppression of personal income tax and lack of social protection for the poor. In contrast, between 2007 and 2011 inequality fell by four Gini points (Table 1.1) due to a drop in returns to education (a phenomenon also observed in Mexico) and a decline in earnings inequality. The decline in returns to education, however, can be ascribed only partially to the lagged effects of educational policies (which, unlike in Mexico, raised educational inequality in tertiary education and did not reduce it in secondary education), to the fall of spatial inequality, or to shifts in personal characteristics of workers, as a considerable portion of the returns-to-education variation remained unexplained. Hence, the authors attribute much of this unexplained decline in inequality to institutional and policy changes such as increased minimum wages, restoration of centralized wage-setting, and inception of a progressive personal income tax that reduced net returns to education. In turn, an expansion of well-targeted non-contributory benefits improved the distribution of public transfers.

As shown by Raymundo Campos-Vazques, Gerardo Esquivel, and Nora Lustig in Chapter 7, Mexico experienced a modest rise of the overall Gini coefficient between 1989 and the mid-1990s, a period characterized—as in Uruguay—by widespread trade liberalization and privatization, the dismantling of price supports and generalized subsidies, and reductions in minimum wages and unionization rates. In contrast, between the mid-1990s and 2010, overall inequality declined markedly following an improvement in the distribution of labour income and, to a lesser extent, non-labour income. During this period, the policy regime was characterized by limited structural reforms, rising global integration (as signalled by the signing of the North American Free Trade Agreement, NAFTA), and the introduction of large-scale cash transfer programmes. During both periods, the main driver of the total inequality change was a shift in earnings inequality explained by the swings in returns to education. In particular, over 1995–2010 both the supply of skilled workers and the distribution of years of schooling among workers improved markedly following past and current rises in secondary and tertiary enrolments, including rises among the poor. As a result, between 1994 and 2006 the supply of highly skilled workers outpaced its demand, while the demand of unskilled workers (driven by an expansion of assembly-line activities or *maquiladoras*) exceeded its supply. In turn, the decline in non-labour income inequality benefited from the launch of large transfer programmes such as *Progresa* and *Oportunidades* which transformed a neutral distribution of public subsidies into a highly progressive one. In contrast to the case of Uruguay, minimum wages became non-binding and the unionization rate remained low and did not affect the trend in relative wages over 1996–2010.

### EL SALVADOR VERSUS HONDURAS

These two fairly similar lower-middle-income countries were run for most of the last two decades by right-wing governments. Yet, the first experienced a major inequality decline while the second recorded a major increase until 2005. As argued in Chapter 8 by Carlos Acevedo and Maynor Cabrera, despite extensive liberalization and rapid growth driven by high post-war capital inflows, growing remittances, and urban growth, overall inequality stagnated during the 1990s as the impact of growing participation rates, falling unemployment, and rising urban wages was offset by the fall of agriculture's relative wages and employment. In contrast, the overall Gini coefficient fell sharply between 2000 and 2009 (Table 1.1). Yet, unlike in most Latin American countries, this decline coincided with a decade-long economic stagnation and dominance of an extreme right government. The inequality reduction was mainly due to a fall in the concentration coefficient of skilled and unskilled labour income mainly caused by the massive outmigration of both types of workers (and the ensuing slowdown in the rate of increase in their domestic supply), the slow rise in the urban demand for skilled labour due to a lengthy economic stagnation, and the slow but steady increase in the supply of skilled workers. These factors drove up the reservation wage of unskilled workers, reduced the skill premium and the urban–rural wage ratio, and triggered a rise in equalizing remittances since the mid-2000s. In contrast, the inequality-reducing effect of public transfers was relatively modest.

In contrast to El Salvador, in the highly dualistic economy of Honduras, income inequality rose between 1991 and 2005 and then fell between 2005 and 2007. As argued by Stephan Klasen, Thomas Otter, and Carlos Villalobos Barría in Chapter 9, the steep increase in inequality during the first 15 years was mainly the result of the surge in rural earnings inequality (while urban inequality remained unchanged) due to a fall in the demand for agricultural goods. The latter was caused by the persistent neglect of rural areas and large inflow of remittances and aid funds for reconstruction after hurricane Mitch which appreciated the real exchange rate. In addition, labour mobility between an increasingly less dynamic agricultural tradable sector and the more dynamic non-tradable service sector remained low because of high moving costs and stagnant educational achievements of rural workers over 1991–2007. The inequality trend has changed in part (Tables 1.1 and 2.1) since the mid-2000s, thanks to an increase in commodity prices that helped to raise wages in the tradable sector, while the rise in remittances also played an equalizing role. The increase in public transfers by the Zelaya government played an additional, if small, equalizing role.

## 1.3 Underlying Causes of the Inequality Decline of the 2000s: A Regional Perspective

The lessons emerging from the six case studies and the literature on the underlying factors explaining the recent inequality trends are discussed next for the region as a whole.

### *1.3.1 An Improvement in International Economic Conditions*

As noted above, it has been argued at times that the recent inequality gains were due to the improvement of global economic conditions over 2002–8. Indeed, the region as a whole benefited from a significant rise in export receipts for primary commodities. Likewise, the region experienced an inflow of foreign capitals at declining interest rates amounting to 2.4 per cent of the region's GDP (Ocampo 2008), which exerted downward pressure on domestic rates and triggered a boom in regional stock markets. Finally, official remittances grew substantially in some countries from the late 1990s and have come to represent at least 17 per cent of GDP in El Salvador, 10–12 per cent in Nicaragua and Costa Rica, and a major item in the Mexican current account balance.

What was the direct impact of these changes on income inequality? A partial equilibrium analysis suggests that, given the high concentration of ownership of land and mines and in access to finance prevailing in the region, the above improvements had, *ceteris paribus*, a unequalizing effect on the pre-tax distribution of income. In addition, production in the primary commodity sectors is land-, skilled labour-, and capital-intensive, and the absorption of unskilled labour is limited. At the same time, the increased availability of finance did not ease the access of small, labour-intensive enterprises to credit. In addition, the surge in capital inflows appreciated the real exchange rate in most countries, with the effect of slowing growth and employment creation in the labour-intensive non-commodity traded sector. As for the effect of remittances, the literature suggests that their short-term impact tends to be unequalizing, as only middle-class people are able to finance the high costs of migration. Yet, as argued in Chapters 2, 7, and 8, migration may become equalizing in countries where it is state-sponsored or where large migrant networks develop in destination countries. This all suggests that the partial equilibrium effect of the improvement in external conditions is unlikely to explain the recent decline of inequality, with the exception of countries where such transactions were sizeable or the structure of these flows evolved over time.

### *1.3.2 The Growth Acceleration of 2003–2008 and 2010 and its Impact on Job Creation*

While the partial equilibrium impact of a more favourable global environment is unlikely to explain much of the region's recent fall of inequality, there is evidence that this positive macro shock relaxed the foreign-exchange constraint to growth and lowered interest rates, thus increasing employment, incomes, and revenue collection, subsequently helping (together with the policy changes discussed below) to improve regional unemployment, job informality, social security coverage, average wages, the ratio of informal/formal sector wages, and income inequality (see Chapter 2 as well as the evidence on Argentina and Brazil reported in López-Calva and Lustig 2010).

### *1.3.3 A Decline in Educational Inequality*

As noted by Guillermo Cruces, Carolina García Domench, and Leonardo Gasparini in Chapter 15 and as confirmed by the country studies included in this volume, a main determinant of the fall in wage inequality was the increase in secondary enrolment and completion rates that began in the early 1990s and accelerated during the 2000s, thanks to a substantial increase in public expenditure on education. This trend benefited in particular children from low-income families. For instance, SEDLAC data show that for the region as a whole, the probability that a child from the lowest quintile completed secondary education relative to that of a child from the top quintile rose from 27 per cent in 1990 to 59 per cent in 2009/10. The increase in secondary school attainments contributed to a near universal decline in wage inequality due