Inequality and Growth in Latin America: Achievements and Challenges

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This paper is part of the Growth and Reducing Inequality Working Paper Series, which is a joint effort of the G-24 and Friedrich-Ebert-Stiftung New York to gather and disseminate a diverse range of perspectives and research on trends, drivers and policy responses relevant to developing country efforts to boost growth and reduce inequality. The series comprises selected policy-oriented research papers contributed by presenters at a Special Workshop the G-24 held in Geneva (September 2017) in collaboration with the International Labour Organization and the Friedrich-Ebert-Stiftung, as well as relevant sessions in G-24 Technical Group Meetings.

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Abstract

Since the early 2000s, Latin America has experienced significant improvements in income distribution, a remarkable development in a region where persistent inequality has long been a notable feature. Though with significant differences across countries, the decline in income inequality reflects labor markets developments and more progressive government transfers. However, as economic growth has slowed in recent years the pace of progress has declined. Recovering momentum will require a reexamination of public policies to transform productive structures, advance human capital formation, and high-quality job creation.

ECLAC has long affirmed the need to place equality at the center of development. The reduction of inequality and economic growth are not at odds. This paper provides an overview of recent trends in inequality in Latin America, discusses the factors that explain its decline, and the role of public policies in addressing inequality. The paper also highlights the limited redistributive capacity of the tax system of the region.

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Introduction

Since the early 2000s, Latin America has experienced significant improvements in income distribution, a remarkable development in a region where persistent inequality has long been a notable feature. Moreover, this improvement took place during a period in which inequality increased in the rest of the world. However, Latin America's levels of inequality remain among the highest globally, and the reductions achieved in the first decade and a half of this century have slowed down.

High levels of inequality are by no means a recent characteristic of Latin America. On the contrary, present inequality can be traced to the region's colonial past and its ensuing interactions with various economic, political and social forces. The economies of the region have been historically defined by highly heterogeneous production structures with large sectors of the workforce in low-productivity activities. High levels of inequality are associated with highly stratified access to quality employment and social protection.

Nonetheless, inequality is a phenomenon with multiple causes and an array of manifestations that transcend income or wealth. Discrimination based on gender, ethnicity, race, age, and other factors intersect, reinforce one another, and are reproduced from generation to generation. Understanding the different dimensions of inequality - "the social inequality matrix" - is key for the design of pro-equality public policies.

ECLAC has long affirmed the need to place equality at the center of development and has called for equality to be recognized not only as the overarching ethical principle of development but also a key tool for achieving it. Broadly, equality is a non-negotiable ethical principle - one that must be gauged in terms of entitlement to rights and understood in view of the rights-based approach that lies at the core of the 2030 Agenda for Sustainable Development - as well as a prerequisite for progress. The pursuit of equality and the enhancement of human capacities can contribute to learning, innovation, higher productivity and sustainable growth. Economic growth and the reduction of inequality are not at odds.

Concerns about equality have been a constant in ECLAC's work since the organization's earliest times. Since 2010, promoting equality has been a central focus of ECLAC's proposals as put forth in a set of institutional documents.[2] This paper provides an overview of recent trends in inequality in Latin America, discusses the factors that explain its decline, and the role of public policies in addressing inequality. The first section describes the economic and social context in which the decline in inequality took place, characterized by economic growth and innovations in social policy. The following section depicts broad regional trends in inequality and briefly discusses commonly used indicators that attest to the robustness of the observed decline across measures. It discusses the inadequacy of the available approaches and data and states that efforts need to be made, in particular, to better capture the incomes of the wealthiest population, to accurately measure wealth distribution, and to understand the multidimensional nature of inequality. The third section analyses the main reasons behind the decline in inequality. Generally speaking, though with significant differences across countries, the decline in income inequality reflects labor markets developments and more progressive government transfers. The limited redistributive capacity of the tax system of the region is highlighted. The last section offers concluding remarks.

[2] A full exploration of ECLAC's analysis of inequality is beyond the scope of this paper. ECLAC's main proposals are laid out in the following institutional documents: "Time for equality: Closing gaps, opening trails," (Santiago de Chile: Economic Commission for Latin America and the Caribbean, 2010b); "Structural change for equality: an integrated approach to development," (Santiago de Chile: Economic Commission for Latin America and the Caribbean, 2012); "Compacts for Equality: Towards a Sustainable Future," (Santiago de Chile: Economic Commission for Latin America and the Caribbean, 2014a); "Horizons 2030: Equality at the centre of sustainable development," (Santiago de Chile: Economic Commission for Latin America and the Caribbean, 2016a); and, "The Inefficiency of Inequality," (Santiago de Chile: Economic Commission for Latin America and the Caribbean, 2018d).

The context: economic growth and social progress

Boosted by the rise in the demand for raw materials and mineral products and easier access to international capital markets, for the first part of this century Latin America recorded one of the most successful periods of economic growth and social progress in the region's recent history.

The first years of the twenty-first century were extraordinary in economic terms, especially when compared to the region's own performance of the past two decades. Economic growth averaged 4.5% a year between 2003 and 2008 when the global financial crisis emerged, and although the region experienced negative growth in 2009 (-1.8%) it quickly recovered starting in 2010 (6.3%). This compares to an average annual rate of GDP growth of 1.8% in the 1980s and a 3.1% in the 1990s. After 2010, the pace of economic growth has been slower with an average of 2.9% between 2011 and 2014. In 2015 and 2016 the region experienced a contraction of 0.2% and 0.8%, respectively.

The external environment in the 2000s was very positive. Commodity prices experienced a marked increase between 2003 and 2008, fell briefly during the global financial crisis, but continued to grow until 2011. Since then, non-oil commodities prices fell and in 2014 oil prices started to fall as well. However, the 2016 price levels were still above those reached between the mid-1980s and early 2000s (Ocampo, 2018). Latin America benefited from this increase in commodity prices. In South America, the most dynamic economies were the exporters of metals and minerals (Peru and Chile) and oil exporters (Venezuela, Ecuador and Colombia). Other countries experienced a significant inflow of remittances up until 2008-2009 when the global crisis generally erased migration opportunities to both the United States and Europe. In addition, net direct investment and portfolio flows grew significantly during this period.

Sound macroeconomic policies contributed to economic growth as well. Most countries in the region managed to reduce fiscal deficits and decrease inflation rates from the three-digits characteristic of the 1980s to the single digits in the 2000s —since 2003, the average inflation rate has been consistently below 7%. During the first years of the twenty-first century, the region also succeeded in reducing debt-to-GDP ratios and accumulated a significant amount of foreign exchange reserves. The external debt, net of foreign exchange reserves, fell from an average of 28.6 percent of GDP in 1998-2002 to 5.7% in 2008, a level that only moderately increased since then (Ocampo, 2014). In a context of abundant international liquidity, the region's financial development advanced, access to international debt markets increased and financing costs fell. More attractive local markets; record low debt spreads;

a substantial improvement in credit quality together with plentiful liquidity in global markets contributed to the strong performance of Latin American capital markets in the 2000s.[3]

Investment also increased considerably and remained high during this period. According to ECLAC, investment rates grew 10% in real terms between 2003-2008, the largest surge in investment, coinciding with the commodities price boom. The global financial crisis impacted investment negatively, but the trend continued to be upwards until around 2015. More importantly, this upward trend was mainly due to the dynamism of the machinery and equipment components of investment as compared to construction. Investment in machinery and equipment embeds greater technological content and new machinery and equipment tends to be more productive and therefore contributes to long term economic growth more than investment in construction (ECLAC, 2018b).

Labor market indicators improved during these year's chiefly reflecting developments in economic activity. The unemployment rate – simple average - fell from 10.4% to 6.4% between 2002 and 2014, and the overall employment rate went from 52% to 57% during the same period. Job creation was strong, especially in wage work. The growth in total employment translated into a rise in the proportion of wage workers and employers, and a fall in the percentages of own-account workers in total employment. The percentage of workers employed in the formal sector of the economy also increased although labor informality remains extensive. In addition, affiliation to pension systems among the employed rose in almost all countries but also wide gaps remain among and within countries (ECLAC, 2014a).

However, as ECLAC has stated, weaknesses and lack of diversification in the productive structure were not overcome during the economic boom period. A warning sign of this is the fact that total variation in employment was mainly driven by increased employment in non-tradable, low- and medium-productivity sectors (commerce, construction and transportation). Moreover, much of the increase in productivity observed between 2002 and 2011 (12%) was due to increased productivity within sectors rather than shifts among sectors that would amount to virtuous structural change (ECLAC, 2014a).

As successful as the economic performance of the region was in the 2000s, this period was even more remarkable in social progress. As mentioned, better access to external financing in more favorable

[3] For a more thorough discussion of these issues see Inés Bustillo and Helvia Velloso, *Debt financing rollercoaster: Latin American and Caribbean access to international bond markets since the debt crisis, 1982-2012*, vol. 119, Libros de la CEPAL (Santiago de Chile: ECLAC, 2013).

terms and conditions together with sound macroeconomic management, improved the fiscal accounts and reduced the external debt-to-GDP ratio. Thus, most countries had the required fiscal space for a well-funded expansion of social spending.

From a social perspective, the relaxation of the stiff financial constraints on public spending of the "lost decade" and the return to democracy in the late 1980s prompted civilian governments across the region to respond to electoral demands for greater social inclusion. The various economic challenges of the late 1990s and early 2000s, including the financial crises in Asia, Argentina, and Uruguay, natural disasters in Central America, and falling international prices for grains, prompted a reformulation of social and anti-poverty policies. The need to guarantee economic, social and cultural rights, and the notion of a full citizenship influenced social policies. A gradual shift of policy priorities toward a more egalitarian distribution of the benefits of economic development and the reduction of the high levels of inequality started taking place.[4] New policy approaches favored more integrated forms of social policy and more coordinated programs.

An important feature of this shift was a revision of the opposition between the concepts of universality of rights and of targeting. The notion of targeting resources to achieve universal social rights or minimum social standards came to the fore of the agenda. This led to discussions on designing universal policies with differentiated services to meet diverse needs and close gaps of a heterogeneous population (ethnic, gender, age, place of residence) (Cecchini and Martínez, 2012).

How to extend the redistributive role of the state to major social sectors that had traditionally been left out became part of the agenda under discussion. For much of the twentieth century, social protection benefits were tied to formal employment which excluded particularly those working in informal or low-productivity activities. The focus of attention gradually favored the creation of mechanisms to provide a basic level of protection for those that remain outside the formal labor market. A growing number of countries phased in non-contributory redistribution mechanisms in pensions and health insurance (ECLAC, 2014b).

[4] For a comprehensive analysis on this issue see Simone Cecchini and Rodrigo Martínez, *Inclusive social protection in Latin America: a comprehensive, rights-based approach*, vol. 111ibid. (Economic Commission for Latin America and the Caribbean, 2012).

For example, the latest pension reforms (those after 2008 in Argentina, Plurinational State of Bolivia, Chile and El Salvador)[5] moved in the direction of strengthening solidarity mechanisms. Total pension coverage increased in the region by 17 percentage points between 2002 and 2015 largely from the expansion of non-contributory pension systems. By 2015, 70.8% of the Latin American population 65 years and over received some type of contributory or noncontributory pension up from 53.6% in 2002 (ECLAC, 2018e).

Non-contributory programs expanded as well the coverage of health insurance. Health-care coverage improved most among non-wage earners (doubling the percentage of access to health care over a decade) and for the lower quintiles of the income distribution resulting from efforts to achieve universal health care (Ocampo and Gómez-Arteaga, 2017).

Moreover, important social policy innovations worked to break the chain of intergenerational transmission of poverty by building human capacity in vulnerable families. One social protection instrument that originated in Latin America in the mid-1990s and attracted special attention is the conditional cash transfer (CCT). These non-contributory programs provide direct monetary transfers to families tied to certain conditions such as school attendance and medical check-ups, reducing poverty in the short term and also increasing the human capital of household members with a view to ending the intergenerational transmission of poverty. By their nature, CCTs are more progressive than other types of transfers and have been particularly effective in narrowing the poverty gap and in reducing the severity of poverty[6] (ECLAC, 2010a).

In 1997 CCTs were present in 3 countries, but by 2010 they were available in 18. Spending on CCTs rose steadily in several countries. By 2015, the regional average spent in CCT was 0.33% of GDP, with differences in the amount invested ranging from 0.59% of GDP to less than 0.1%. By 2015 as well, around 20% of the population was living in a household covered by CCTs (ECLAC, 2016b). Despite reaching important segments of the population, there is a need in some countries to expand the coverage of cash transfer programs and improve their design so as to enhance their reach and contribute to human capital formation.

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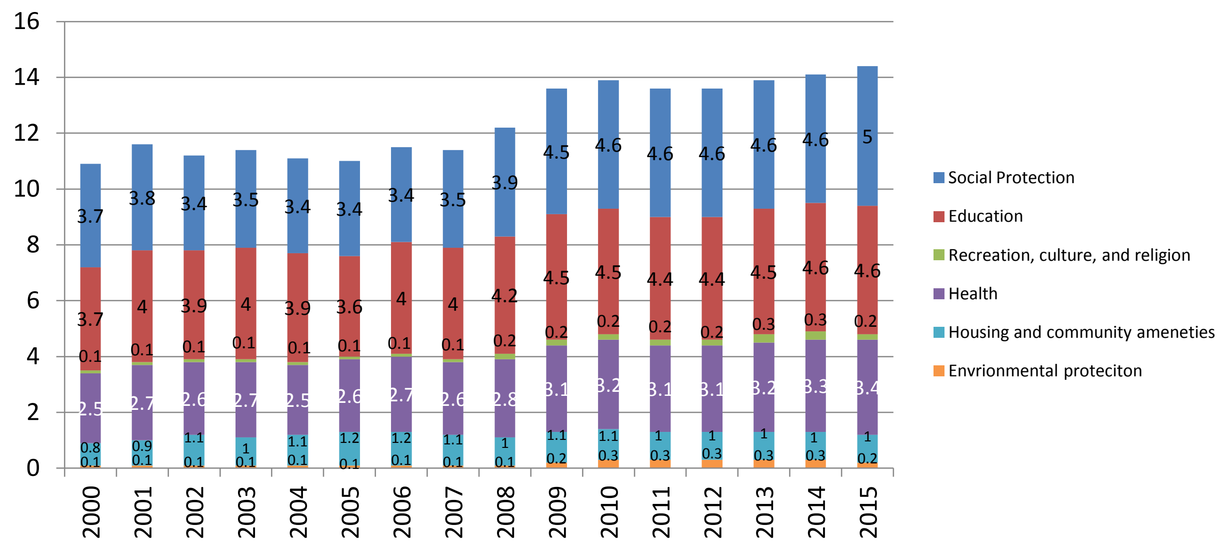
[5] For an analysis of pension systems in Latin America and recent reforms see ECLAC, "Social Panorama of Latin America 2017," (Santiago de Chile: Economic Commission for Latin America and the Caribbean, 2018e).

[6] For a detailed analysis of conditional cash transfers in Latin America see Simone Cecchini and Aldo Madariaga, *Conditional cash transfer programmes: the recent experience in Latin America and the Caribbean*, vol. 95, Libros de la CEPAL (Economic Commission for Latin America and the Caribbean, 2011). and Simone Cecchini and Bernardo Atuesta, "Programas de transferencias condicionadas en América Latina y el Caribe: tendencias de cobertura e inversión," in *Políticas Sociales* (Economic Commission for Latin America and the Caribbean, 2017).

As a result of the gradual reorientation of social policy and of economic growth, social spending as a proportion of GDP increased across the region, albeit with wide differences between countries. Latin America's GDP allocated to public social policies rose from 10.9% in 2000 to 14.4% in 2015 (figure 1). Most of the increase was due to social protection[7] that rose 1.3 points of GDP between 2000 and 2015 and education and health that increased by 0.9 during the same period (ECLAC, 2018d).

Figure 1
Latin America (19 countries): public sector social spending by function, 2000-2015
(Percentages of GDP)



Source: (ECLAC, 2018d)

Substantial improvements in wellbeing took place as result of the reformulation of social policies and increased spending. The coverage of compulsory education, health, and social security broadly increased throughout the region although with diversity across countries. However, for all that has been achieved, significant challenges remain. To mention just two examples, older populations still face deep inequalities and gaps in access to pensions and in the adequacy of the benefits they receive. In addition, the demographic changes underway pose additional challenges to social protection policies and pension systems. In 2037, the number of older persons will exceed those under 15 years; by 2050 those aged 60 and over will outnumber the population under 15 by 44%. In education, wide differences persist in access, performance, and completion among students of different economic strata, gender, ethnicity,

[7] Social protection spending in services and transfers to individuals and families that cover illness and disability, old age, survivors, families and children, unemployment, housing and social exclusion.

and territory. Also, despite some recent gains, education quality and learning outcomes are generally poor.

Moreover, sustaining or expanding social spending at a time of slower economic growth poses additional challenges. To do so will require not only more selective allocation criteria for social spending but also measures to strengthen the collection of revenues, particularly tax revenues, and improve their redistributive role.

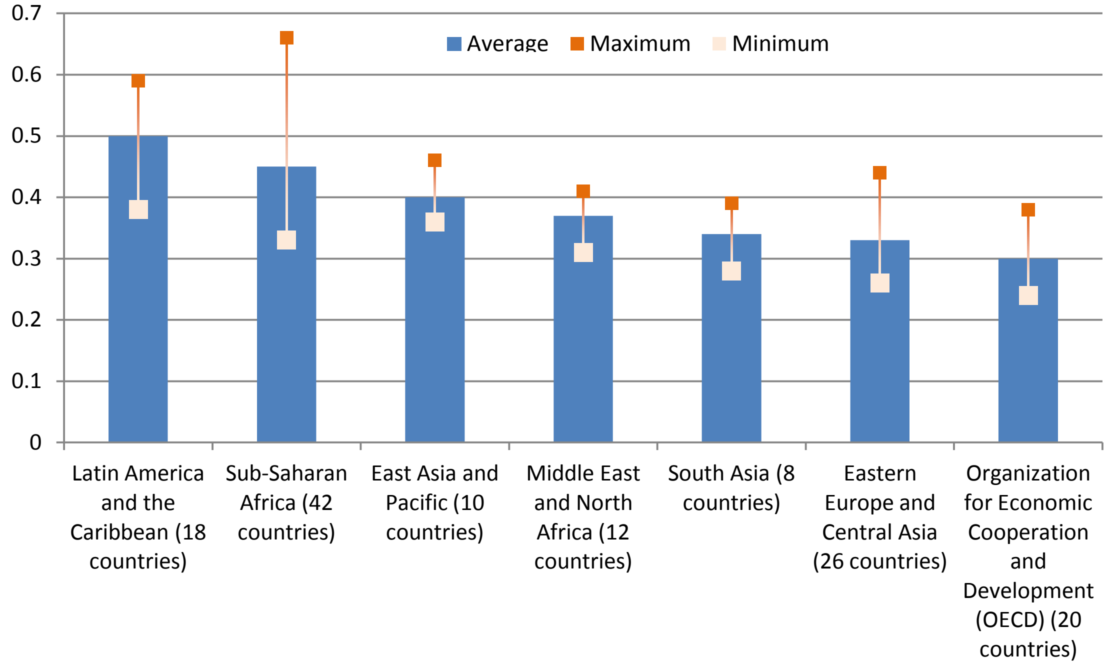
Recent trends in income inequality

As was previously discussed, high and persistent levels of inequality have historically characterized the Latin American economies.[8] Citizens in most countries experience large disparities in access to physical and financial assets as well as education, health and other basic services that in turn translate into income and consumption inequalities throughout their lifetimes.

Despite the improvement in income distribution observed over the last decade and a half, Latin America remains one of the most unequal regions in the world (figure 2). For example, the country with the most egalitarian distribution of income in Latin America, as measured by the Gini coefficient, still has a more unequal income distribution than any OECD member country except for Chile and Mexico, its two Latin American members. Also, almost every country in Latin America has a higher Gini coefficient than the average for all the other world regions except sub-Saharan Africa.

[8] For a historical overview of development in Latin America see Luis Bértola and José Antonio Ocampo, *The economic development of Latin America since independence* (OUP Oxford, 2012).

Figure 2
Gini Coefficient - Around 2012



Source: (ECLAC, 2018d)

In this section we focus on the most recent trends in income inequality in Latin America. Inequality can be measured in numerous ways and ECLAC has advocated for the use of different indicators to gain a more nuanced understanding of inequality in the region. Perhaps the simplest measure of inequality is the one that sorts the population (or households) by income from poorest to richest and shows the percentage of income attributable to each quintile. The ratio of the income of the top quintile to the bottom quintile is called the 20:20 measure of income inequality. The Gini coefficient, the most commonly used measure of inequality, summarizes the entire income distribution of a country in a number between 0 (complete equality) to 1 (complete inequality). It does not, however, show where the inequality occurs, therefore two very different income distributions can have the same Gini coefficient.

Although these measures can be constructed based on income, consumption, or wealth, this section refers mostly to income inequality because it is more readily available through household surveys. Wealth is arguably a better indicator of households' access to resources as it includes financial and non-financial assets, but the information needed to measure wealth inequality is still scarce and inaccurate in the region and as a result less suitable to region-wide analysis. Empirical studies that measure wealth or asset inequality suggest that it is larger, more ingrained and more persistent than inequality measured solely based on income (ECLAC, 2017b).

The wage share, which is the compensation of employees to GDP ratio, is another indicator of inequality that measures the relative dynamics in the distribution of income between labor and capital and is considered a good complementary measure to the household income inequality. Some efforts have been made to estimate this measure for the region.

Since the early 2000s, these measures show a significant decline in inequality in the region, albeit with significant differences among countries.

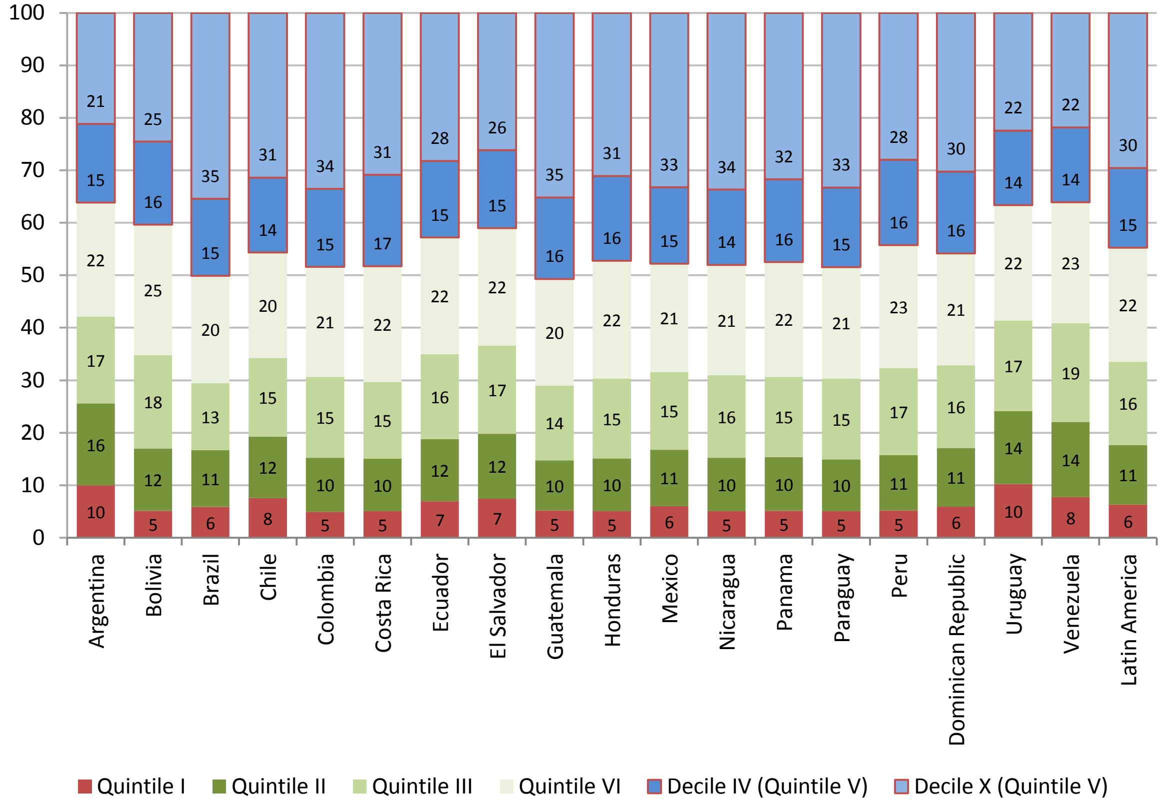
The income gap between the poorest and the richest – as measured by the 20:20 indicator - has narrowed since the early 2000s. Between 2002 and 2012, the ratio of the share of income of the top quintile to the bottom quintile in Latin America went from 10.7 to 7.2. The trend continued until 2016, albeit at a slower pace as the ratio decreased to 6.8 between 2012 and 2016.

In 2016, the most recent household survey available in the region indicates that the wealthiest quintile accounted for 45% of total household income while the poorest quintile for only 6% (see figure 3). That is, the 20% of the population at the top of household income distribution has more than 7.5 times the income of the 20% at the bottom of the income distribution. In other words, the 20:20 measure was 7.5 in the region in 2016. However, inequality varies significantly among the countries in the region. For example, in Argentina and in Uruguay, the wealthiest quintile earns about 3.6 more than the poorest quintile while in Honduras that ratio is 9.4 and in Brazil is 8.3 (ECLAC, 2018e).

Figure 3

Latin America (18 countries): share of total income, by income quintile, around 2016

(Percentages)

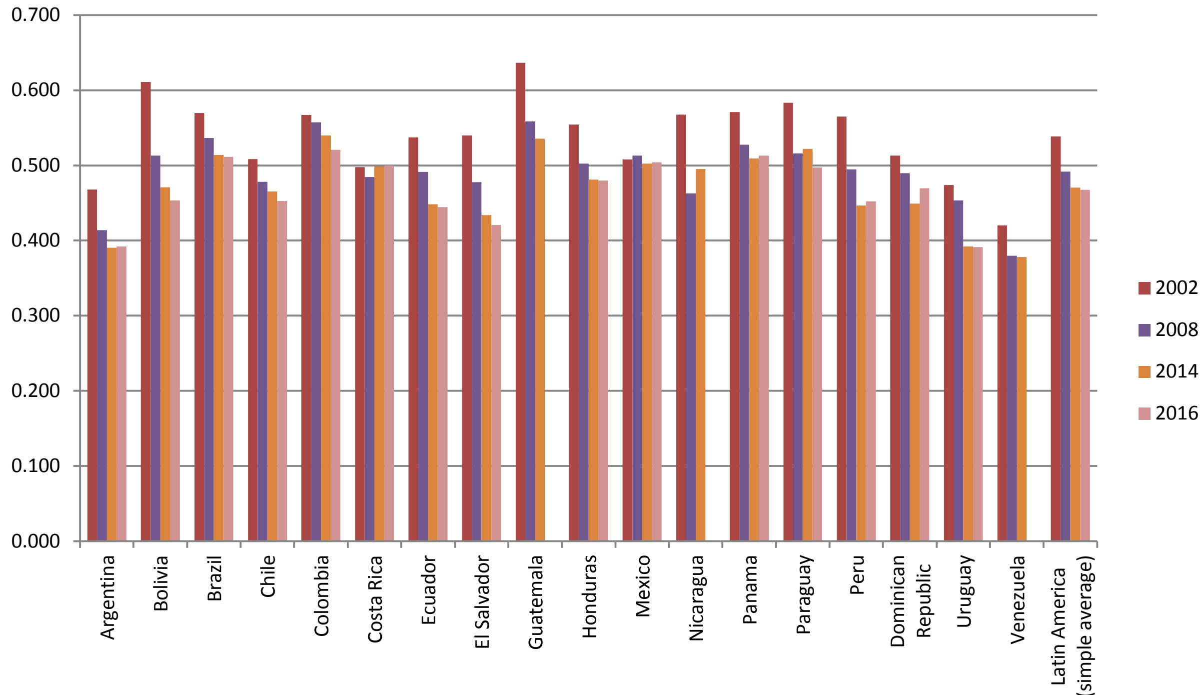


Source: (ECLAC, 2018e)

The Gini coefficient also shows a fall in income inequality over the same period from 0.538 in 2002 to 0.467 in 2016. The Gini coefficient fell, on average, 1.5% per year between 2002 and 2008, by 0.7% per year between 2008 and 2014, and by 0.4% per year between 2014 and 2016.

The regional average masks the heterogeneity of the countries in the region (figure 4). While some countries show significant improvements in their Gini coefficient throughout the period, others like Costa Rica and Mexico experience very little change. (ECLAC, 2018e).

Figure 4
Latin America (18 countries): Gini inequality index, 2002-2016



Source: (ECLAC, 2018e)

Measuring inequality solely on the basis of information collected through household surveys can be misleading however. Household survey data does not capture accurately the income of the upper end of the distribution as most households tend to underreport income from sources other than paid work - i.e. income from real estate, financial assets, land, etc., or report it with errors. Household survey data is therefore better suited to measure labor income distribution and transfers rather than property income.

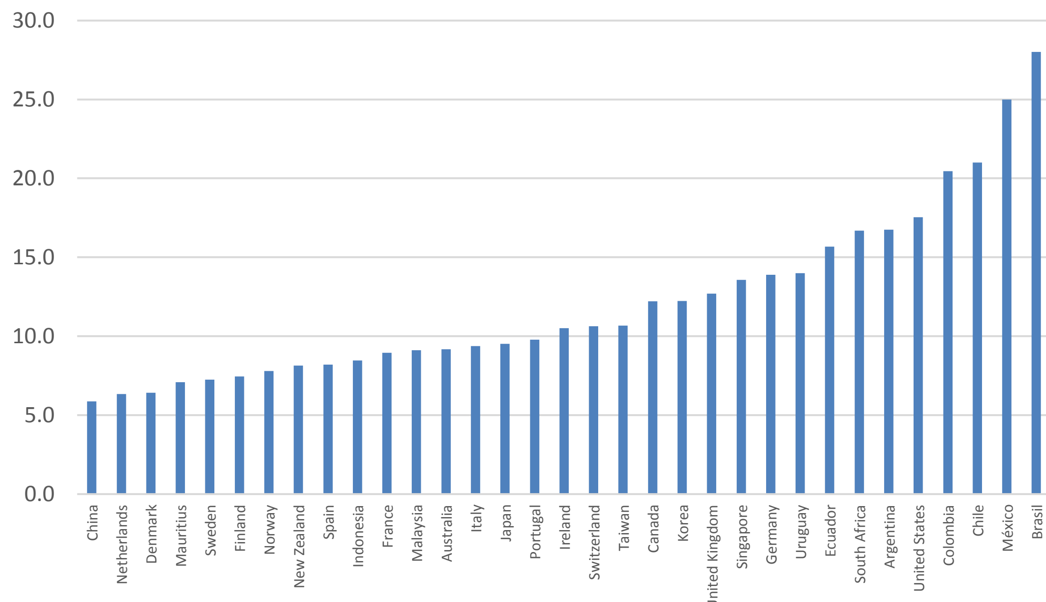
In response to this concern, in recent years other data such as information on income and wealth taken from tax records and national income accounts have been increasingly incorporated to the analysis of inequality. This has been done using a variety of approaches which also have their own limitations and biases (ECLAC, 2017b). One way of improving the estimation of household incomes is to adjust household survey income data with that of the System of National Accounts.[9] Researchers have also been trying to incorporate other sources of data into the analysis, and particularly data on incomes

[9] This path, proposed by Oscar Altimir, "Income distribution statistics in Latin America and their reliability," *Review of Income and Wealth* 33, no. II (1987), has been taken by ECLAC in recent decades.

and wealth from the fiscal records of tax administrations. In the region, several studies[10] found that values for the corrected Gini index, incorporating information on the top 1% based on tax data, are invariably higher than those yielded by household surveys. However, both indices - the one derived from household surveys and the one corrected by tax records - evolved in a similar manner. This is important because it indicates that the inability of household surveys to capture accurately the highest incomes is not the reason for the recent drop in inequality (ECLAC, 2014a).

The World Wealth and Income Database, which has the most comparable data, estimates inequality based exclusively on tax records. The data collected for Argentina, Brazil, Colombia and Uruguay, the only countries in the region included in the database reveal, as seen in figure 5, that income concentration among the wealthiest 1% is larger than that prevailing among the countries in the database. In fact, among the 22 countries in the database, the richest 1% of the population accounts for the largest share of total income in Brazil.

Figure 5
Selected countries: share in income of the richest 1% of the population, around 2014



Source: (ECLAC, 2018d)

[10] The studies referred to are: Facundo Alvaredo, "A note on the relationship between top income shares and the Gini coefficient," *Economics Letters* 110, no. 3 (2011); Facundo Alvaredo and Juliana Londoño Velez, "High income and income tax in Colombia, 1993-2010," *Revista de Economía Institucional* 16, no. 31 (2014); Gabriel Burdín, Fernando Esponda, and Andrea Vigorito, "Desigualdad y sectores de altos ingresos en Uruguay: un análisis en base a registros tributarios y encuestas de hogares para el período 2009-2011," in *Serie Documentos de Trabajo* (Montevideo, Uruguay: Instituto de Economía - Facultad de Ciencias Económicas y de Administración Universidad de la República - Uruguay, 2014).

In addition to the analysis of personal income and wealth distribution, there has been a renewed interest in the analysis of the distribution of income between labor and capital at the aggregate level. The functional analysis of income inequality, as it is known, can complement the analysis of personal income distribution and provide valuable information for understanding the dynamics of labor income and capital returns (ECLAC, 2017b). The wage share is the indicator used to perform this analysis. However, there are serious data limitations when trying to construct this indicator. National accounts provide information on the wage bill that either ignore the earnings of the self-employed or estimate their income in a way that mixes the returns to labor with the returns to capital. Given the prevalence of self-employment in the region the analysis of the wage share should be done with caution.

When applied to Latin America, the analysis confirms high levels of inequality. Labor earnings in the region generally account for a lower percentage of GDP than they do in developed countries but that, again, could be due to the underestimation of self-employed earnings which are a larger share of Latin American countries' GDP than of developed countries. The analysis also confirms a fall in income inequality as the wage share of GDP has risen in most countries in the region since 2006.[11] The increase in the wage share can be attributed to a better distribution of the value added between labor and capital, to a change in the labor intensity in the sectoral composition of the value added or to a combination of both. More research is needed to understand the underlying reasons.

Moreover, ECLAC has long advocated the need to comprehend the multidimensional nature of inequality (ECLAC, 2016c). Inequality in Latin America is heavily determined by the productive structure of the region that translates in very different quality of jobs created, wages, and health and pension coverage. However, inequality is also affected by gender, racial and ethnic factors, which cross-cut and cross-fertilize each other. Understanding those determining factors and their interrelations is essential in developing policies for making progress towards equality. For example, gender gaps go beyond income inequality. In ECLAC's view, gender inequalities arise from a sex-based division of labor that assigns women primary responsibility for the upkeep of the home and for caring for children and other dependents, which curtails their time and opportunities for participating in paid work, accessing the job-related benefits of social protection and attaining economic autonomy. This gives rise to a series of disadvantages faced by women in comparison to men, including a highly unequal load of unpaid domestic work, higher rates of unemployment and informality, wage discrimination, and inequalities in the access to and the use and control of productive resources. (ECLAC, 2016c). Inequalities are also seen

[11] The only countries for which this tendency was not observed are Mexico, Panama and the Plurinational state of Bolivia.

in pension benefits where in most countries the average monthly pension benefits received by women in 2015 were lower than those receive by men.[12]

Finally, any analysis of inequality in Latin America needs to address the difficulties relating to information availability. While the region has made significant strides in strengthening its statistical systems in the past two decades, specifically with respect to social indicators, a great many challenges remain. The region is still a long way from being able to construct metrics that can properly capture the more complex dimensions of inequality, and further still from having the information necessary to quantify them. In particular, the possibility of combining tax and national account data with household surveys can contribute significantly to the study of income inequality and to generating more accurate estimates of magnitude and trends. Hence, it is necessary to facilitate access to tax records and other complementary sources of data on household income, and to improve the quality and periodicity of household income and expenditure accounts. Also, the region should move towards the collection of information on wealth as a better measure of inequality.

Drivers of the decline in inequality

The reasons behind the fall in inequality in the region in the last decade and a half have been the subject of abundant research. Studies point out two main causes of the decline in income inequality since the early 2000s: a reduction in hourly labor income inequality and more progressive government transfers. In some countries, as recent research suggests, labor market institutions such as minimum wages also played a role in the decline in income inequality (Amarante and Arim, 2015; Amarante and Prado, 2017).

a) Changes in labor income

A better distribution of labor incomes is the main factor behind the reduction in inequality and is attributed to a large set of factors, including the improved macroeconomic conditions that strengthened the labor markets and employment since 2000, the expansion of coverage in basic education and stronger labor institutions (Gasparini and Lustig, 2011). The reduction in hourly labor income inequality was largely due to changes in the skill premium - as measured by the wage returns to tertiary versus primary education, which again followed a path that broadly mirrored—over the entire period –that of

[12] Differences go beyond gender. The pensions of rural residents are slightly less than half of the amount received by urban residents, and pensions of those with incomplete elementary school were about one quarter of those with completed post-secondary studies. For a comprehensive analysis of the multidimensional nature of inequality see "The social inequality matrix in Latin America," (Santiago de Chile: Economic Commission for Latin America and the Caribbean, 2016c).

labor income inequality.[13] Gasparini and Cruces (2013) show that in the 1990s and 2000s, returns to secondary education decreased, whereas returns to tertiary education increased in the 1990s before declining in the 2000s. They found that this reversal is due to both supply-side factors and the deceleration of relative demand of skilled workers.

The extent to which the drop in the education premium was caused by the increased supply of skilled workers, by the slowdown in relative demand for skilled labor, or by a combination of both, has been much discussed.

On one hand, the region's rising inequality of labor market earnings in the 1990s and falling inequality in the 2000s cannot be explained solely by supply-side factors such as the increasing number of more educated workers. The rate of increase in the supply of education was very similar in the 1990s when inequality increased and in the 2000s when inequality decreased. Therefore, demand factors must have also had an effect (De la Torre, *et al.*, 2017).

Several demand factors have been highlighted in the literature as important drivers of wage inequality, including changes in the industrial structure, technological change, outsourcing, and international trade. These factors - for given skilled and unskilled labor supplies - could decrease the wage gap between skilled and unskilled workers, and therefore earnings inequality, by expanding the demand for unskilled labor relative to skilled labor (Amarante and Colacce, 2018; Amarante and Prado, 2017; De la Torre, *et al.*, 2017). One possible explanation is that the rise in commodity prices experienced during this period could have shifted the relative demand for unskilled labor and driven down education wage premiums or that workers moving away from manufacturing and into service-intensive sectors could be having a similar effect. However, this cannot be the only reason for the fall in tertiary education premiums as countries that are semi-industrialized or heavily dependent on remittances also experienced such a fall (Amarante and Colacce, 2018). Technological change, particularly automation, was deleterious to skilled as opposed to unskilled occupations, leading firms to become less skill-intensive or move some of the more skill-intensive production and service tasks offshore. In other words, the productive structure of the region has had a significant effect on the relative demand of skilled workers relative to unskilled workers.

[13] See for example, Augusto De la Torre, Julian Messina, and Joana Silva, "The inequality story in latin america and the caribbean: Searching for an explanation," in *Has Latin American Inequality Changed Direction?*, ed. Luis Bértola and James Willamson (Springer International Publishing 2017; reprint); Nora Lustig, Carola Pessino, and John Scott, "The impact of taxes and social spending on inequality and poverty in Argentina, Bolivia, Brazil, Mexico, Peru and Uruguay: An overview," (CEQ Working Paper, 2013); Nora Lustig *et al.*, "Deconstructing the decline in inequality in Latin America," in *Tulane Economics Working Paper Series* (Tulane University, 2013).

b) The role of fiscal policy

A series of studies have examined the impact of social spending and taxes on inequality in the region. Some focus on the relative effectiveness of the types of spending and fiscal revenues on the reduction of inequality, others on comparing the distributive impact of fiscal policy in the countries of the region with that in OECD countries, and others on the characteristics of different protection systems.

A study that included 6 countries - Argentina, Bolivia, Brazil, Mexico, Peru and Uruguay - shows that the effectiveness of fiscal policy in reducing inequality varies greatly (Lustig, Pessino, *et al.*, 2013). The authors find that direct taxes and transfers reduce inequality and poverty in Argentina, Brazil, and Uruguay, but not so much in Mexico, Bolivia and Peru. The redistributive impact of direct taxes is found to be small due to their low share in these countries' GDP. As expected, cash transfers are found to be quite progressive in all countries where they are targeted to the poor. However, in-kind transfers in education and health reduce inequality in all countries by considerably more than cash transfers.

Hanni, Martner, and Podestá (2015) compare the redistributive impact of taxes and transfers with OECD countries, particularly with the average for 15 European Union countries. The authors find that the Gini coefficient before transfers and direct taxes in Latin America is initially slightly higher than the OECD average (0.50 and 0.47 respectively). After fiscal policy the Gini coefficient drops by 36% in the OECD. In contrast, inequality in Latin America drops by just 6% on average. On average, 61% of the estimated 6% reduction in the Gini coefficient is accounted by cash transfers (including pensions), while only one third is attributable to taxation (mainly in the form of personal income taxes and social security taxes). The finding that public transfers play a greater redistributive role than direct taxes is consistent with those of other regional studies.

Ocampo and Gómez-Arteaga (2017) suggest that the impact of social spending on inequality has been significant but varies considerably on the basis of the characteristics of the social protection systems. Higher social spending, universal coverage and progressive transfers have a higher redistributive impact. The authors estimate that, on average, countries with comprehensive social protection systems reduce inequality more through direct transfers (conditional cash transfers, subsidies, and non-contributory pensions) and through in-kind transfers (education and health) than countries with more limited social protection systems. Regardless of the characteristics of the social protection system, the redistributive effect of in-kind transfers such as education and health is higher than the effect of direct transfers. While targeted programs have been successful in reducing poverty, they have been less effective than universal benefits at reducing income inequality. This is explained by the fact that the budget allocated to health and education as a percentage of GDP is more than twice relative to spending on direct transfers.

Cecchini and Madariaga (2011) summarize the experience with conditional cash transfer programs over a period lasting more than 15 years. Regarding the distributive effect of CCTs, the authors note wide differences with results that vary significantly by country largely due to differences in design, coverage, and weight of the transfers in household income. For example, the effect is small in the case of Solidarity Chile, as the Gini coefficient drops by just 0.1 points. In Oportunidades in Mexico and Bolsa Familia in Brazil, in contrast, the results show a reduction of inequality of around 2.7 points in both cases. The key to the difference lies in the proportion of total income represented by the transfers, which is higher in Mexico and Brazil, but too small to have an impact on inequality in the case of Solidarity Chile.

Amarante and Brun (2016) also provide evidence for eight countries in Latin America regarding the effects of CCTs on income redistribution with CCTs lowering inequality between 0.5% and 1.1% depending on the country. Though these transfers represent a significant amount of household income in lower deciles, the authors show that their effects "in terms of reductions in the incidence, intensity, and severity of poverty are, in the best of cases, moderate and although their progressivity is high, their redistributive impact is limited." This is explained for the most part by the small budgets allocated to these kinds of programs.

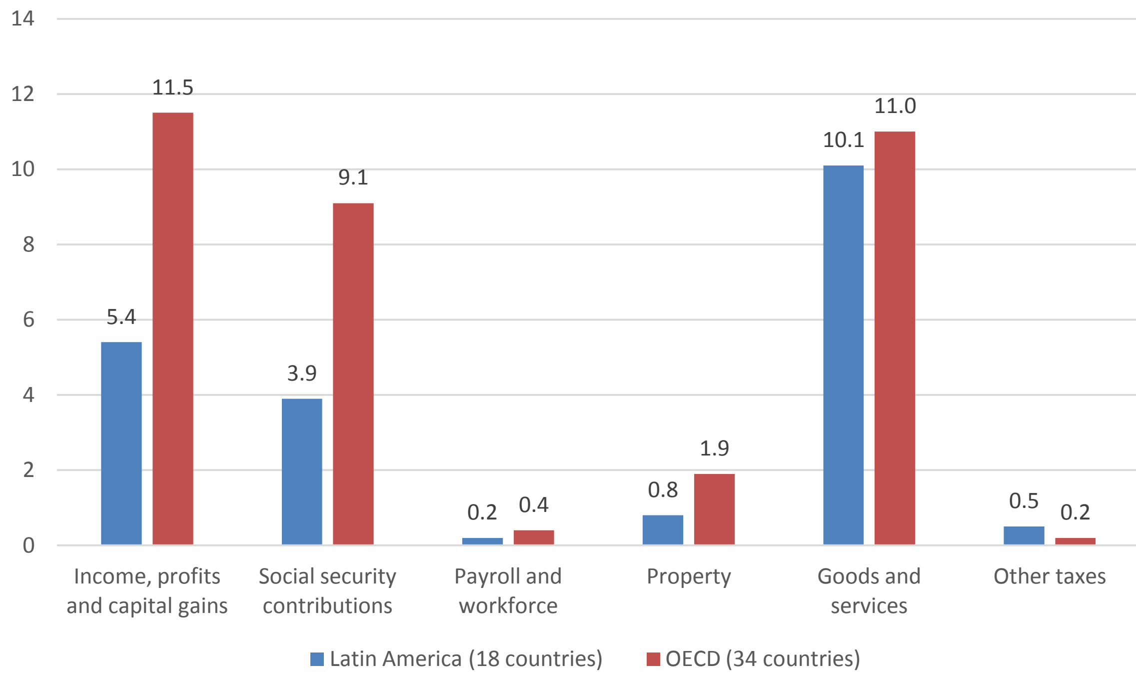
Moreover, the role of taxation in reducing inequality has been limited and raises serious concerns.[14] To a large extent this is due to a low average tax burden and a heavy reliance on indirect taxes that are typically very regressive. Tax non-compliance and high rates of evasion are pervasive through the region. This is in part due to the high level of informality that affects all countries, but also a reflection of the weakness of the tax system to collect taxes from a wider base of the population.

The region's average tax burden improved considerably since the early 2000s but is half the average reported by 15 European Union countries and 13.5 percentage points of GDP below the OECD average (ECLAC, 2018c). However, tax burdens vary significantly across countries. While some countries have tax burdens that exceed 30 percent of GDP, others lag considerably behind the regional average.

[14] See for example James E Mahon, Marcelo Bergman, and Cynthia Arnson (editors), *Progressive tax reform and equality in Latin America* (Wilson Center, 2015).

As seen in figure 6, the tax structure of Latin America differs significantly from that of OECD countries. The region collects less than one half of what OECD countries obtain from income tax and social security payments. The share of indirect taxes to GDP is about the same in both.

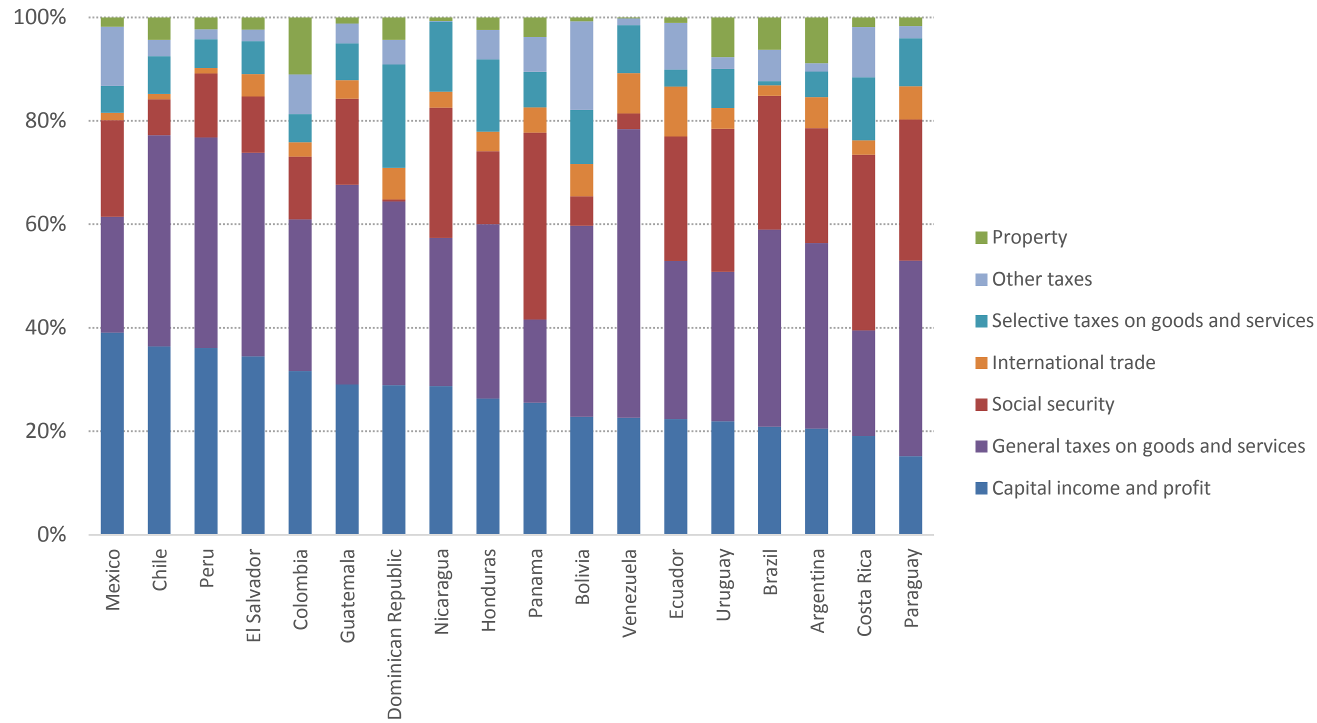
Figure 6
Latin America (18 countries) and OECD countries (34 countries): tax structure, around 2015
(Percentages of GDP)



Source: (ECLAC, 2018a)

Though there are considerable differences across countries in relative tax structures, and despite recent improvements, the bias toward indirect taxation prevails (figure 7).

Figure 7
Latin America (18 countries): relative structure of tax revenue, 2015
(Percentages of total tax revenues)



Source: (ECLAC, 2018c)

One distinctive characteristic of the region is the low tax burden of the wealthiest taxpayers as reflected by the fact that the effective tax rate for the top decile in Latin America averaged 4.8% in 2014 in contrast with 21.3% in the European Union. To a large extent this is because capital income is taxed at lower rates than earnings in the region, and in some countries not at all. Also, the richest taxpayers are best able to use aggressive tax planning to minimize the taxes they pay in their countries of residence (ECLAC, 2017a).

However, taxation of the middle class is also a serious challenge. Payment of personal income taxes is heavily concentrated in the top decile in Latin America, an average of 88.0%, compared with 39.2% in the countries of the European Union. This not only limits the ability of the tax system to raise revenues, but also has serious distributive consequences and weakens the social contract between citizens and the state.

Similarly, tax evasion is a serious constraint on resource mobilization and distribution. Estimates of income tax evasion average 47.5% for the region, with several differences between countries. While in

Costa Rica, the Dominican Republic, Ecuador and Guatemala the rates of income tax evasion are about 65%, in Brazil, Chile and Mexico the rates of evasion are between 28% and 31%.[15]

Overall, the low collection of personal income taxes can be explained by several factors. These include: a low average top marginal rate; a narrow tax base due to exemptions, deductions, simplified regimes and lower tax thresholds that leave out a large number of taxpayers and a great deal of income; and, high levels of non-compliance (Jiménez and Podestá, 2008). An important limitation of the personal income tax, that also affects the horizontal equity, is the fact that it is collected essentially from wage earners or formal sector employees who have it deducted from their wages at source. This differs from self-employed workers, who have greater scope for evasion and avoidance and from capital income benefits with preferential treatments, being generally taxed at a lower or zero rate (ECLAC, 2018c).

However, in recent years, several countries have adopted tax reforms many of which include measures to increase equity and progressiveness. This second generation of reforms started in the early 2000s and included specific considerations of distributional equity, with the income tax as the key player.[16] As a result, several countries have implemented reforms to expand the tax base and moved forward in implementing proportional taxes on capital income, which was formerly exempt, together with more progressive taxes on earnings. In addition, many countries are also taking steps to combat tax evasion and avoidance, and to improve the administration of tax systems.

Notwithstanding the strides made, countries continue to suffer from structural weaknesses with tax structures dominated by regressive indirect taxes, weaknesses in tax design and administration, and high rates of tax evasion which undermine the redistributive capacity of the tax system (ECLAC, 2018c).

Looking forward

Since the early 2000s, Latin America has made significant strides in social development, including a broadening of social protection coverage and important reductions in poverty and inequality. However, as economic growth has slowed in recent years, the pace of this progress has declined. Recovering momentum towards social development will require a reexamination of public policies to transform productive structures and advance human capital formation and high-quality job creation.

[15] ECLAC has estimated evasion of the value added tax to be equivalent of 2.4% of the region's GDP in 2015, while income tax evasion denoted 4.3% of the region's GDP, for a total, in monetary terms, of approximately US$ 340 billion.
[16] The first generation of tax reforms took place in the 1980s and 1990s and included consolidation of value added taxes, elimination of taxes on international trade and of a vast number of minor taxes.

The challenges to preserving social gains and continuing to advance towards economic equality are very large. Where social policies are concerned, notwithstanding important improvements and innovations that resulted in increased coverage and access in social protection, large gaps in social outcomes remain.

To address these gaps and strengthen the redistributive dimension of social policies, ECLAC advocates recasting social protection within a rights-based approach aimed at universality but sensitive to differences. A universal approach does not preclude using targeted policies to break down barriers specific to gender, ethnic, racial and other identities. In fact, differentiated treatment can contribute to social development by addressing obstacles unique to certain populations through selective social spending, inequality reduction, and rights promotion. In this regard, such strategies can disrupt vicious cycles between different dimensions of inequality and address the disparities that affect historically discriminated or excluded groups.

The possibility of moving towards universal coverage in social protection will depend on the creation of fiscal space—either through the reallocation of funding within existing budgets or the dedication of new resources. In particular, the low tax burdens and regressive biases of tax structures in some countries constitute significant challenges. As noted earlier, tax structures continue to be dominated by regressive indirect taxes and personal income taxes with low marginal rates, excessive exemptions, and extremely high non-compliance. Taxation with a clear redistributive impact is key in order to obtain more resources to finance public spending and in order to promote equality.

However, as ECLAC has argued, redistributive social policies alone will not bring greater equality–particularly in Latin American countries, which remain highly segmented economies with considerable levels of labor market informality. Sustainable and larger gains in equality will require structural changes that reduce informal employment and diversify production structures in favor of higher productivity activities while expanding employment in these activities. This requires active industrial and technological policies as well as provision of high quality education, goals that should be pursued simultaneously. Promoting formalization is key for consolidating social protection systems with universal coverage.

Significant work remains to be done to address the long-term causes and varied dimensions of inequality. Progress will depend on forging alliances –compacts for equality—to create the political space necessary to challenge the culture and practices that entrench inequality.

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