

Introduction

FACING UP TO INEQUALITY

It was a difficult year for Latin America and the Caribbean. The East Asian economic crisis and the financial rumblings in Russia generated unsettling aftershocks in emerging financial markets. The bottom fell out of prices for key commodities such as oil and metals, and even nature dealt its blow in the form of El Niño. Volatility has hit again. But thanks to a decade of structural reforms, the region has been better able to cope with economic disruption. Macroeconomic stability may have been at risk in some countries, but the prospects of growth and price stability remain strong.

Beyond these recent and hopefully transitory concerns, however, Latin America has a very sad tale to tell. And this is where we have cast our eyes this year. Instead of applauding recent advances, we once again have chosen to address a pressing regional issue. This year's Report on *Economic and Social Progress in Latin America* focuses on income distribution, an area where there has been much less progress and where the region still appears to under-perform significantly.

On average, the countries of the region suffer from the greatest income inequality in the world. True, there are some countries, such as Costa Rica, Jamaica and Uruguay, where inequality is relatively low by regional standards. But the region also has the countries with the widest income gaps in the world: in Brazil and Guatemala, the top 10 percent of the population amass almost 50 percent of national income, while the bottom 50 percent scrape up little more than 10 percent. More importantly, the problem shows no obvious signs of improvement. Our best measures indicate that income distribution improved in the 1970s, worsened considerably in the 1980s and has remained stagnant at high levels in the 1990s. Even these variations are small relative to the high overall level of income inequality. Thus, income inequality appears to be an enduring phenomenon with deep long-run causes.

Addressing income inequality in the region is important for social and political as well as economic reasons. Inequality contributes not only to high rates of poverty, but also to social tension and political disaffection.

When only a few can feast on the fruits of economic progress, social stress tears at the fabric of society and political support wanes for the policies that underpin that progress. The issue is on the table in most countries of the region. Despite relatively little evidence, and many unsatisfactory explanations, income distribution is an issue impassioned by strong opinions. This study attempts to assemble the available evidence on inequality, expand it with special statistical information, and use it systematically to test a wide range of potential explanations and remedies.

SURVEYING THE EVIDENCE

Much of the region's inequality is associated with large wage differentials. In other words, it results not only from differences between owners of capital and workers, but from a divergence of incomes among workers. Large wage differentials reflect, among other factors, unequal distribution of the quantity and quality of schooling. The inequality in wages also reflects gender differences, gaps between formal and informal employment and between rural and urban incomes, and other forms of labor market segmentation that are exacerbated by current labor legislation.

The evidence does not support the notion that high inequality in Latin America is simply a matter of a few rich families owning a disproportionate share of each country. If this were the case, it would be impossible to measure the high levels of inequality, given that the very rich are under-represented in the household surveys on which measures of inequality are based. But it is precisely these same surveys that point to Latin America as unequal relative to other parts of the world. According to these surveys, inequality primarily results not from the existence of a few people at the top but from a much more widespread social phenomenon.

In fact, much of Latin America's inequality relates to the difference between the top 10 percent of the population and the rest. While in the United States families in

the top decile have an average per capita income about 60 percent higher than those in the ninth decile, in Latin America they earn about 160 percent more. The top earners in Latin America are mainly employees and professionals who receive very high returns for their education and experience. Only 14 percent of them are employers. Why are the returns so concentrated at the top? After all, it is a full 10 percent of the population, a very large group of people who on average have barely completed 12 years of education.

Nonetheless, much of this gap between the top 10 percent and the rest reflects the region's slow and unequal progress in improving the level and quality of schooling. The second richest 10 percent of the population has three fewer years of education, and those in the bottom 30 percent have almost seven years less. Moreover, differences in schooling are transmitted from one generation to the next through the family. Human capital is, after all, a family affair. It involves an inter-generational transfer of resources, as parents limit their own consumption to pay for the education of their children, who go on to enjoy the benefits of their accumulated human capital in the future labor market. This transfer of educational attainment from one generation to the next has led many to fault the educational systems, which do carry part of the blame. But families also make decisions and choices that affect the educational attainment and welfare of their children.

Families play many roles in the complex relationships that sustain income inequality. They mitigate the effects of high inequality by sharing resources, often across generations. They also play a role in determining how many of their members should try to find work, how many children to have, and how much education to give them. Many of these decisions are influenced by relative prices in the economy, particularly wages.

A very important relative price in these choices is the return to a woman's work in the market. As this expected wage rises, more women tend to participate in the labor force. Under these circumstances, families also tend to have fewer children, and the children they do have complete more years of school. But this wage is not the same for everyone. Unskilled women can expect much lower earnings than their counterparts from higher-income families, since they have less education and because they are more likely to find informal than formal sector jobs. Furthermore, these wages will vary across countries, depending on the structure of each economy and trends in its particular labor market. Each country's particular economic structure generates differences—some large, some small—in the relative prices faced by different families, which in turn cause variations in the amount of human capital each family will accumulate.

From this point of view, educational attainment is not only the consequence of education policy but also reflects wage patterns in the labor market, family choices about working and having children, and other factors that vary across countries. Two couples with similar characteristics who live in different countries of the region can be expected to make very different choices about education, work and children. Furthermore, the income inequality they and their children will face varies by about a factor of three from one country to the next. Hence, inequality only partially reflects personal characteristics and family choices; it also reflects important elements of the economic environment where people live.

It is precisely this economic environment that we have tried to piece together in this study—a task made more difficult by the confluence of temporary and permanent phenomena. Our tentative diagnosis is that the malady of income inequality in Latin America reflects both growing pains typical of developing societies and congenital features peculiar to the region. This combination has exacted a high toll from the socioeconomic health of many countries in recent years. But there is hope. Latin America is expected to eventually outgrow the transitional income inequality that often accompanies the early stages of development. And countries can choose policy remedies capable of turning their inherent liabilities into important assets.

MORE THAN A TRANSITION

Economic development is a long process whose fruits may seem forbidden for large segments of developing societies. In fact, the somewhat perverse relationship between income distribution and the initial stages of development is at once unsettling and accepted. It has long been suspected that economic development worsens income distribution, at least in its early stages. After all, societies do not move as a whole along the development curve. On the contrary, certain development trends—education, for instance—give some individuals and groups an advantage over others, advancing them more quickly along the curve and introducing a source of inequality. After a certain point, the relationship between development and equality is a win-win situation, but until then, results can be frustrating at best.

Stage of Development

We have identified five development trends in particular whose effects on inequality follow just such a tortuous

path: capital accumulation, urbanization, formalization of the workforce, education, and the demographic transition. In each case, Latin American countries are either close to or on the crest of the development wave, suffering the transitional effects of greater inequality but poised for the long-term rewards.

Economic development is, to a large extent, the story of accumulating capital. In its early stages, capital tends to be very scarce, so its returns are very high. Initially, at low levels of capital accumulation, the share of national income going to profits is high. However, when enough capital has eventually been accumulated, the returns and the profit shares tend to decline. As a middle income region, Latin America is probably at a point in terms of capital accumulation where profit shares are still very high and will tend to decline as the development process continues and expands the capital stock.

A second characteristic of development is increasing urbanization. In underdeveloped societies, most people live in rural areas and most people are poor. Weak product and labor markets, lack of infrastructure and inadequate health and education services are just a few of the factors affecting poverty in rural areas. From this poor but generally equal baseline, a country urbanizes. But since incomes are higher and grow faster in the cities, the urbanization process will contribute to gradually increasing inequality. Near the end of the process, when most workers have made the transition to the urban sector, the rural-urban earnings gap will affect only a small fraction of the population, and its effect on the country's income inequality will thus be small. In Latin America, the rapid urbanization of the past four decades has, in most countries, contributed to rising inequality. But now that most Latin Americans are already city dwellers, the natural increase in the share of the population in urban areas will tend to reduce inequality in the future.

As an economy develops, it also becomes more formalized. Incomes in the formal sector tend to outstrip those of the informal sector, introducing a similar source of inequality in the initial stages of this process. But differences in hourly income among formal sector workers of similar characteristics are much narrower than those among workers in the informal sector. This means that, once a large share of the workforce is incorporated into the formal sector, inequality tends to decline.

A more educated society is also a more developed one. However, at low levels of development, most people have little or no education, and the absence of educational differences keeps income inequality low. As countries establish and expand their educational systems, new cohorts attain higher levels of education and earning potential, while uneducated cohorts are left behind. This

inter-cohort inequality is accompanied by unequal attainment within each cohort; those in areas (generally urban) with more schools enjoy more and better education than individuals of the same age in less privileged areas. Once again, Latin America is at a stage where inter-cohort educational inequality is still very high, while intra-cohort inequality has been falling. Over time, this should lead to less inequality overall.

Finally, the development process is marked by a demographic transition. As countries move from high to low fertility and mortality rates, a very powerful set of changes is unleashed. In the first phase, mortality declines but fertility remains high. More children survive to adulthood, the average age of the population is low, and much of the potential labor force is engaged in caring and raising children. In this context, educational progress is hampered by the large number of children relative to the low number of working adults. Families frequently need to depend on a single wage earner, limiting resources to improve the education of children. However, in almost every Latin American country today, fertility rates are on the decline, families are having fewer children, and women, in particular, are participating in the labor market in growing numbers. With more earners and fewer children, families can concentrate their resources on fewer children, helping them attain ever higher levels of education. Rates of population growth are still very high in some Latin American countries, but as this pressure recedes, income concentration will decline.

We will show how these five trends are closely inter-related. A large factor in diminishing family size is related to a rise in women's earning potential in the labor market. As women become more educated, they tend to have fewer children, participate more in the job market, and demand more education for their children. More education also means better access to those types of employment that offer higher wages and more security. More capital per worker means a higher value for women's work in the labor force. In urban areas, this process proceeds more quickly than in rural areas. Hence, the five trends interact in a reinforcing manner. They are not specific to Latin America, but clearly they are at work in the region and explain a substantial part of its high level of income inequality. Although it may be little solace for those riding in the last cars of the development train, most of Latin America appears to be turning the corner; as these trends continue, they should provide a basis to reduce income inequality in the future, as long as the adequate economic and social policies are in place.

However, our analysis suggests that inequality in Latin America is only partially explained as a hapless moment on the development time line. Only about one-third

of the gap in income inequality between Latin America and the industrial countries can be attributed to the region's stage of development vis-à-vis these five trends. Obviously, there is more to the story than a simple transition.

Endowments

Having found only part of the answer in the process, we turned to the characteristics and location of the region itself. What is it in the make-up of Latin America or in its particular history that makes it more unequal than other regions of the world? Important clues can be found in the region's geography and in its endowments of land and natural resources. Overall, tropical countries, especially when their economies are intensive in land and mineral resources, tend to be more unequal. The strong statistical relationship reflects a combination of factors whose relative importance is still under discussion. In more land-intensive countries, more of national income accrues to land, an asset whose ownership tends to be more concentrated than other assets such as human capital. At the same time, tropical land and the crops it supports offer larger economies of scale under more adverse climatic conditions with less technological innovation than temperate lands. The result has been relatively low labor productivity in tropical areas, which has depressed the wage level for unskilled labor across sectors and over time. All told, while temperate lands historically have promoted family-run farms and institutions aimed at fostering cooperation, the larger economies of scale and harsh labor conditions typical of tropical lands have generated plantation agriculture and promoted slavery. This in turn has promoted vertical relationships, hierarchies and class divisions rather than the horizontal linkages that build social capital and contribute to development and equity. Hence, while part of Latin America's inequality may have been inherited from its colonial past, this past itself may have been shaped by its geography and resource endowments.

Another intervening factor is the capital-intensive nature of the region's natural resources. Mineral resources and agricultural crops are capital intensive and act as capital sinks. They suck up scarce capital in the economy while offering few employment opportunities, thus making capital more scarce and labor more abundant for other activities. The low return to labor in tropical farming is thus reinforced by the region's exploitation of its natural resources.

Another factor that contributes to inequality is Latin America's history of volatility. Economic instability is strongly related to inequality. It slows the development process by limiting the accumulation of capital, interfering in the ability of families to educate their children, and

adversely affecting productivity. Moreover, weaker groups in society are less able to cope with volatility and become even worse off.

Hence, natural resources and volatility make inequality a more serious problem. The transitional stories are played out against this permanent backdrop, adding another layer of complications. If natural resources keep the wages of unskilled workers low, demographic and educational transitions are slowed. Inequality may increase distrust and make political agreement more difficult, preventing societies from reigning in the distributive pressures that interfere with fiscal prudence, which is the key to overcoming volatility.

Globalization can also affect the process of becoming more equitable societies. It has been argued that globalization drives down the price of unskilled labor, as populous countries such as China and India supply increasing proportions of goods that are labor-intensive. Globalization increases the relative price of Latin America's abundant natural resources to the detriment of labor, promotes technological changes that increase the returns to skilled workers, and limits the ability of governments to tax the now more mobile capital.

These challenges, to whatever extent they exist, provide even further justification for a development strategy that emphasizes the accumulation of skills and the use of the natural resource base in order to avoid competing in sectors dependent only on low wages for unskilled labor.

IT TAKES MORE THAN TIME

Many of the forces that keep inequality high will prove temporary, especially if the development process deepens. Over the long term, there are no tradeoffs between development and equality. Still, neither development nor equality are matters of destiny. It takes more than time to overcome income inequality and to advance a country along the development curve. This is particularly true in Latin America, where transitional concerns are superimposed on very special regional handicaps. For this reason, the third part of this study looks at policies aimed at furthering the five key development trends, promoting their mutual reinforcement, and converting the region's characteristic impediments to equitable growth into viable assets for reconciling development and equality.

The Demographic Window of Opportunity

Latin America is peeking through a unique window of opportunity in its demographic transition. Since fertility

is falling, the proportion of people of working age is rising faster than the number of children. The decline in fertility also means that more adult women will be working. Thus, there will be fewer students per worker, making it easier to finance a better educational system. But while this trend will persist for many decades, eventually it will be overtaken by the rise in the proportion of elderly people. Still, in most of Latin America over the next two decades, the declining ratio of children to workers will be more important financially than the rising ratio of retired to active workers. This leaves two decades to accelerate the development process. Not only should this allow Latin America to finance improvements in education, but it should also allow it to raise its savings ratio, as today's workers make provisions for their old age. Therefore, it is of the utmost importance that the region adopt fully funded pension systems. This will make it clear for the present generation how much must be set aside to provide for old age. If they simply pay as they go, they will be transferring the costs of old age onto the generation of their children, who will face far less favorable demographic trends. A fully funded pension system would generate over the next few decades a major stock of savings that could be used to accelerate the development process, so that pensions could be paid out of increased wealth and not increased taxation of the next generation. If, in addition, the social security system generates claims not only on the government but also on the broader economy, as the Bolivian capitalization program does, it will expand the constituency with a vested interest in market-oriented policies.

A Social Context for Human Capital Accumulation

The demographic and educational transition must also be hastened so that families gradually become smaller and more educated. To this end, female participation in the labor force must be facilitated to provide the incentives for smaller families and generate the resources for higher educational attainment. One line of action is to increase the productivity of housework by improving access to water, electricity and telecommunications so that appliances and information can be used in order to save time. Better urban transport will allow easier access to jobs and more time at home. More child care and longer school days and school years, although basically aimed at improving the quality of education, will also cut down on the need for women to be at home taking care of the children. Better preventive health will make for fewer days lost to children's illness. More flexible labor codes will allow women to overcome many of the limitations that currently prevent them from entering the formal sector.

It is also important to reduce the cost and increase the benefits of sending children to school and keeping them there, especially through the secondary level. In this respect, school lunch programs and subsidies for books, uniforms and transportation can reduce the out-of-pocket expenses of keeping children in school. Better quality education will raise the returns to schooling and hence the incentives to forgo work.

Educating Everyone

Educational inequality within each income level is coming down as educational attainment improves. Overall inequality is still high because of the widening gap between the educational attainment of more-educated younger cohorts and older ones. This process will continue to cause a significant amount of measured inequality. However, this can be seen as a positive trend, since it ultimately means that children are becoming more educated than the previous generation.

For most countries in the region, universalizing elementary education is a fait accompli. In a few, such as Brazil, Honduras and Guatemala, it remains a problem. For the others, the challenge now is to improve the quality of primary education and to universalize secondary education. This would increase returns to education and reduce the inefficiency of school repetition and dropouts. Better quality education may mean lengthening the school day and year, and therefore have the secondary effect of increasing female labor force participation.

The biggest educational differences today are related to secondary education. The poor drop out soon after primary school while the rich go on to higher education. Moving quickly in the direction of universal secondary education would upgrade the labor force, increase the incomes of the great majority, enlarge the pool of potential university students, and promote a different, more humanistic and capital-intensive kind of development process.

Inequality in Latin America is unusually concentrated in the top decile, which in part reflects the relatively high returns to higher education and the fact that relatively few people get that far. Moreover, returns to higher education in most countries have been rising in recent years with the recovery of growth. The market is giving clear signals that it needs more of this type of education. Consequently, any changes in higher education policy should not imply a reduction in the supply of graduates. Rather, policies should support better targeting of subsidies to higher education so as to use the resources to increase overall supply.

Finally, the governance structure of educational systems must be improved in order to align what societies seek from those systems with the incentives that providers have. This implies moving away from centralized monopoly provisioning by increasing school autonomy, empowering citizens with information, voice and choice, and making budgetary resources follow outputs, and not inputs.

Opening up the Labor Market

There is significant labor market segmentation in Latin America and it is an important contributor to inequality. Controlling for other observable factors such as education, experience and hours worked, rural workers make nearly 30 percent less than urban workers, urban formal workers make about 20 percent more than their informal counterparts, and within the informal sector women make a quarter less than men. In part, this reflects imperfections in the markets for products and for capital, as well as women's need for greater flexibility. But there is also increasing evidence that these income differentials reflect the rigidities caused by regulations regarding formal employment. These regulations were designed to protect workers from the greater power of employers and from labor market risks. They include restrictions to temporary or part-time work, extra hours, and high costs of firing. However, current legislation tends to protect prime-age urban formal male workers but restrict opportunities to other groups. Hence, initiatives to make labor market protection less discriminatory must be considered. These may include a more socialized solution to unemployment risk by substituting current severance payment schemes with contributory individual savings and credit accounts. Also worth considering is greater flexibility in the working day, fewer restrictions on temporary or part-time contracts, and a socialization of the cost of maternal leave to facilitate formal female employment.

In order to expand the social security system to workers outside the formal sector, a basic noncontributory pillar paid for by general taxation is needed. This will expand the system and reduce the current reliance on payroll taxes, which negatively impact on formal employment.

Expanding Financial Markets

A poor functioning capital market tends to generate high returns to the lucky few with access to capital, but opportunities lost for those with abilities and ideas but no ac-

cess to financing. Taxi drivers need not have enough capital to cover the full value of a car—they simply need to have access to credit at a reasonable rate. The same goes for many other activities. However, financial markets are underdeveloped in Latin America and the blame goes beyond the region's history of inflation and financial instability. Weak institutions to support the credit market are also at fault. Credit is a relationship based not only on an assessment of the borrower's ability to repay, but also on his or her willingness to do so. It is efficient for markets to price credit according to the borrower's ability to repay because this ability reflects the economic risks involved. Willingness to repay is different because it essentially reflects the availability of institutional arrangements that allow a person to commit to repay. Such arrangements must be provided by society and cannot be created by individuals. If these arrangements are not present, lenders will inefficiently restrict worthy customers from credit because they are unsure about their intentions to repay. Collateral, credit bureaus, creditor rights and group lending are mechanisms to deal with this problem that are sorely lacking in much of the region. Inadequate land titling is also an obstacle that limits not only access to credit but also mobilization of savings. In particular, rural land tenure and informal urban dwellings are assets that could be used as collateral but lack proper legal titles. A deeper credit market would increase the availability of capital to both the formal and informal sector, causing productivity to increase and boosting the incomes of the groups currently excluded.

Managing Natural Resources

Latin America's natural resource endowment of minerals and (especially tropical) land is strongly associated with its inequality, although there are policies that could alter this relationship. In general, restricting the development of natural resource-intensive sectors seems inefficient—there must be something better to do than to blame one's own good fortune. However, it can also be argued that tax exemptions and other incentives to exploit scarce natural resources are inefficient because they imply giving away, at below its opportunity cost, resources that are scarce and often nonrenewable. This would accentuate the capital sink characteristics of the natural resource sector with its negative distributive implications. Also, the natural resource sector tends to produce unstable revenues. Tax structures should not transfer all these risks onto the government so that the perceived risk by private investors is artificially lowered. The government should also adequately manage the risks involved in the revenues

generated by this sector so that they do not increase the overall volatility of the economy.

Using the Distributive Power of Fiscal Policy

Given Latin America's high level of inequality, how much can fiscal policy contribute to redistributing unequal revenues generated by the economy? If the government were to appropriate a larger share of national income and distribute it more equally, would that not improve income distribution? Latin America has a long history of attempting to make the tax structure more progressive. In doing so, it has severely limited its tax capacity, cutting down the resources the government can appropriate to promote its social agenda and maintain macroeconomic balance. It is much easier to achieve progressive spending than progressive taxation. After all, the top decile of the population uses neither the health nor basic education services provided by the government. Latin America has been able to collect more revenue from a relatively flat income tax than it used to collect from rapidly rising marginal tax rates. Value-added taxes with a broad base and few exceptions perform far better than those that exclude goods in order to make them more progressive. In this context, tax systems in the region would be far more progressive if collection were improved. The best way to improve the distributive power of fiscal policy would be to make tax administration more efficient and evasion more difficult by adopting simple tax structures.

CONCLUSIONS

Latin America is very unequal in its distribution of income and wealth. While this report helps us to understand why, there is still much to be learned about the underlying causes of inequality. The complicated multidimensional story of the region's stage of development, plus a discussion of its bittersweet natural endowments, suggests that the causes of inequality are deep and complex. They are not simply the consequence of denying

political representation to the majority and therefore ignoring the issue. On the contrary, Latin America has in fact been largely democratic for most of this century, and in keeping with the democratic tradition its governments have tried to cater to the median voter. This voter is far from the top of the income scale and, contrary to rhetoric, far from ignored. Government after government in Latin America has tried to appeal to this majority with policies they promised would achieve redistribution.

And that's the irony of it all. Latin American governments have tried hard to mitigate the unequal outcomes that economies tend to generate. They have long committed their countries to universal education and health care. Often their policy repertoire has been cluttered with large public enterprises, massive subsidy schemes, unmanageable progressive taxation, restrictive labor legislation, multiple exchange rates and price controls. This is the stuff of which Latin American populism has been made—populism directed not to the elite but to the vast majority of the people, the median voter. All these efforts were conceived as means of spreading the wealth and protecting the poor; most achieved very much the opposite. Clearly, the problem is less related to a lack of trying and more to a lack of effectiveness in the strategies and instruments adopted.

To break the stalemate in progress in this area, a deeper understanding is needed of the processes that have made Latin America unequal and of the dynamics that may usher in a more equitable region. Not only should equity be a goal in itself, but without it the region will fail to achieve sustainable development. To further the development process, broad support is needed for successful policies, yet this will be hard to achieve if the benefits of development are not widely shared.

Latin America has overcome difficult hurdles in the past decade. It has brought down inflation and begun to grow again. A hidden benefit of this effort is that it allows societies to think more about their long-term problems. Inequality has plagued the region for a long time and will take quite a while to quell. The first step is to increase understanding of its causes in order to be more successful in attempts to achieve equity.