CHAPTER 1

Introduction: Motivation and Conceptual Framework

For as long as data on living standards have been available, Latin America has been one of the regions of the world with the greatest inequality.\(^1\) With the exception of Sub-Saharan Africa, this is true with regard to almost every conceivable indicator, from income and consumption expenditures to measures of political influence and voice, to most aspects of health and education.

Whereas the richest tenth of the population in the region earn 48 percent of total income, the poorest tenth earn only 1.6 percent. By contrast, in developed countries the top tenth receive 29 percent of total income, compared to 2.5 percent for the bottom tenth.\(^2\) Gini coefficients tell a similar story: whereas they averaged 0.52 in Latin America in the 1990s, the averages for the OECD, Eastern Europe, and Asia during the same period were much lower: 0.34, 0.33 and 0.41, respectively.\(^3\)

This trend implies that very high ratios of income accrue to the wealthiest segments of the population relative to the poorest. In Guatemala, the ratio of the top to the bottom tenth of the population was 58.6 in 2000. In Panama, it declined from 71.6 in 1991 to 53.5 in 2000. Even the lowest 10/1 ratio in the region in 2000—15.8 in Uruguay—is higher than most figures found in Europe. (For example, the closest comparison is a ratio of 11.2 in Italy.)

Such enormous differences in the incomes of citizens of the same country clearly imply correspondingly different degrees of access to the goods and services that people consume in order to satisfy their needs and wants. However, disparities extend much beyond private consumption. Following the terminology of Amartya Sen, there are profound differences in the freedom, or capability, of different individuals and groups to follow lives of their choosing—to do things that they have cause to value (Sen 1985a, 1992, 1999). Private resources and patterns of public provisioning affect such capabilities, while social and political arrangements affect the capacity to participate meaningfully in society, influence decision-making, or live without shame.

Note: All tables and figures with the designation “A” referred to in the text can be found in the Statistical Appendix at the end of this report.
With respect to education, even though public systems exist in most countries in Latin America, the disparities of attainment are equally striking to those in income. In Mexico, the average person in the poorest fifth of the population has 3.5 years of schooling, as compared with 11.6 years for the average person in the richest fifth. These numbers are likely to underestimate actual educational differences because of marked differences in the quality of education. In many countries, educational attainment also differs among gender, ethnic, and racial groups. In most places, differences between men and women are becoming less marked with time and have even reversed for young cohorts, but severe disparities still exist among older people. In Bolivia, for instance, average years of schooling for persons age 61 or older are 4.1 for men and 2.4 for women.¹⁴

Health outcomes also vary dramatically along with income distribution, resulting in enormous impacts on life opportunities and quality. In Brazil, children born to households in the poorest fifth of the population are three times as likely to die before they reach the age of five as are children born to households in the richest fifth. In Bolivia, this figure is more than four times as high among the poor, with children in the bottom fifth of the population experiencing under-five mortality rates of 146.5 per 1,000, which is as high as the South Asian average.

In fact, it is not an exaggeration to say that every aspect of life is affected by pervasive inequality. A Guatemalan family whose income places it in the bottom fifth of the income distribution has on average three children, whereas its counterpart in the top fifth has 1.9 children. In the former household, 4.5 people live in each room, compared to 1.6 in the latter. The former household has a 57 percent chance of being connected to water mains and a 49 percent probability of having access to electricity. The corresponding probabilities for the latter household are 92 and 93 percent, respectively.

In every conceivable way, the lives of these two families have very little in common. The very meaning of being a citizen of a country is almost certainly substantively different for the families. A poor Guatemalan household has at worst experienced violence and repression, and at best “low-density” citizenship and the “unrule” of law in recent decades.⁵ Poor Guatemalan families are predominantly indigenous and have experienced centuries of exploitation and exclusion, with weak influence over local and national decision-making. The richest 20 percent of the population is more likely to be white and to have enjoyed at least some measure of normal citizenship. Although Guatemala is at the upper end of the inequality league in Latin America, and has particularly unequal and weak social and political institutions, the picture in most of the region is qualitatively similar. Worryingly, even in countries that were distinctly more egalitarian by Latin American standards (such as Argentina, Uruguay, and Venezuela), the recent trend has been one of growing inequality, at least in terms of income.

In this report, the World Bank seeks to do three things. First, facts related to inequality will be presented, to the extent allowed by the data. The authors build on an array of unit-level household survey data sets in order to construct an up-to-date picture of the distributions of income and other indicators of living standards across twenty countries in Latin America. For three-quarters of these countries, the pattern of change during the 1990s is examined. In so doing, the authors look at the levels of and trends in personal
distributions (of income or other indicators), as well as at group-based differences, whether by race, ethnicity, or gender. In addition to private incomes, the authors consider goods and services provided publicly and the taxes levied to finance their provision.

Second, the authors investigate the causes of Latin America’s extreme inequality by considering the historical roots and current processes that result in the reproduction of the problem. This takes us to questions of the social, cultural, and political sources of inequality that have interacted systematically with economic mechanisms.

The third and final objective of this report is to consider some of the options available to policymakers in the region for breaking with the long history of inequality that has characterized the countries studied. In so doing, the authors suggest policies and policy directions that can help reform economies and societies in such a way as to make them more equitable, without detracting from economic efficiency.

To prepare readers for the journey contained in the rest of this report, the remainder of this chapter is divided into two parts. The first poses the question “inequality of what?” and defines the realm of concern and conceptual framework. The second section considers the question “why should we care?”

1.1. A conceptual framework

The idea of inequality generally refers to a measure of dispersion in a distribution. Most economic analysis is concerned with inequality in the distribution of some measure of individual well-being, with household income (or consumption expenditure) per capita the most commonly used proxy. In light of the growing recognition that well-being has many dimensions besides income, inequalities are discussed with regard to other variables, such as education, health, safety, and access to services. In addition, the report is not concerned only with economic welfare. Political power, or influence within a society, is also unequally distributed, and these “inequalities of agency” are powerfully intertwined with economic inequality.

One of the themes considered in this report is that differences in voice, influence, and power are both driven by economic differences and a key element in ensuring the resilience and adaptability of such differences. While much of the focus will be on differences across the whole distribution, there is often particular interest in “horizontal” inequalities in all these dimensions between groups, for example between races, indigenous and nonindigenous groups, and men and women (discussed in particular in Chapter 4).

In addition to looking at the distribution of outcomes (such as incomes, health indicators, or safety from crime), it is also possible to look at the distribution of assets and opportunities. Opportunities are crucial determinants of outcomes. In fact, a long-standing view among students of theories of social justice is that “equity” and “fairness” are more properly defined in terms of opportunities than outcomes, since the latter
depend also on a range of variable human characteristics, including age, gender, talent, physical ability, social background and preferences.

Sen (1992) argues that it is of great importance to distinguish between “achievement” and “the freedom to achieve” in assessing both the extent and normative significance of inequalities. Among achievements, Sen emphasizes the doings and beings (or “functionings”) that constitute well-being rather than the means with which to achieve well-being, such as incomes and resources. Such achievements can range from quite basic functionings, including “being well-nourished, avoiding escapable morbidity and premature mortality, etc. to more sophisticated ones, such as having self-respect, being able to participate in the life of the community and so on.” The “capability set” represents the range of potential functionings that an individual can achieve, or the “overall freedom a person enjoys to pursue her well-being.”

A core theme of this report is that the profound differences in capabilities among individuals and groups in Latin America are based on interactions between economic assets, economic opportunities, political forces, and sociocultural processes. One aspect of this line of thought concerns the moral assessment of which differences are fair. It is sometimes argued that differences in outcomes that may be morally offensive or “socially unjust” if they are caused by disparities in opportunities or life chances beyond the control of the individual may actually be much less objectionable if they are due instead to choices made in the level of effort—for example, studying or working hard rather than enjoying more leisure—or to differences in needs.

In this context, it may be useful to draw a distinction in the way societies judge outcomes between the poor and other segments of the income distribution. It is probably possible to gain widespread consensus about valuing strongly any outcome that reduces the number of people living below a minimum income level (that is, below a socially accepted income poverty line) and that guarantees everyone’s access to, say, basic education and health services and social security of a minimum quality. Governments around the world have already taken a strong stance on these issues by committing to the Millennium Development Goals as a guide to their own actions and the actions of international organizations. In many countries in the region, broad consultations have led to strong endorsements of these goals by political parties, nongovernmental organizations, the private sector, and other social actors.

It is probably harder to construct a similar consensus about valuing equality of outcomes across the entire distribution. However, it may be easier to instead form broad coalitions in favor of the concept of equality of opportunities, even if such a concept means different things to different people and is more difficult to operationalize (see below). In many chapters in this report (notably Chapter 5), the authors stress the need to build effective coalitions that bring together the poor, the middle classes, and enlightened elites to support policies and programs oriented toward reductions of inequality and, in particular, of poverty. It might be easier to achieve such coalitions if objectives are defined in terms of two key outcomes, income poverty reduction and minimum access to basic services, as well as greater equality of opportunities for all.
In this report, the authors take the position that the distributions of both outcomes and opportunities matter and therefore provide information on both aspects, leaving the reader to make his or her own social judgments. In addition to the existence of different views on valuation, there is also a practical reason for adopting this approach. While an approach based on freedom to achieve, or capabilities, has important conceptual and ethical attractions, it also poses significant measurement challenges. Sen (1992) argues that using a capability-based approach to assess freedom to achieve has to rely heavily on measures of actual achievements.

The measurement challenge is illustrated by the application of a specific approach to the question of opportunities. This example follows Roemer (1998) in defining opportunities as the set of circumstances that affect people’s outcomes, but that do not depend on their own efforts or decisions and are instead determined beyond their control. Even this apparently simple conceptual definition, however, turns out to be rather difficult to operationalize. Box 1.1 presents the results of a 1996 study in Brazil, one attempt to empirically identify the share of inequality that is due to opportunities. The study highlights both the methodological difficulties and the potential insights inherent in focusing on the inequality of opportunities, which account for a considerable share of Brazil’s high level of income inequality.

**BOX 1.1. Measuring inequality of opportunities in Brazil**

The Pesquisa Nacional por Amostra de Domicílios (PNAD) is Brazil’s main household survey instrument. In 1996, it contained a set of supplemental questions on the parents of respondents, including their level of educational achievement and occupation when the respondents were 15 years old. Using this data, Bourguignon, Ferreira, and Menéndez (2003) seek to decompose total income inequality into both a component based on inequality in observed opportunities and a residual.

Roemer (1998) defines opportunities as the set of circumstances that lie beyond an individual’s own control. The key question is delineating what is and is not beyond an individual’s control. To provide the basis for this determination, Bourguignon, Ferreira, and Menéndez (2003) estimate an augmented Mincer earnings equation, regressing an individual’s labor earnings on several variables: a constant, race, parental schooling (mean and difference between parents), the father’s occupation, region where the individual was born, years of schooling (linear and squared), and a dummy if the individual had migrated at some point in his or her lifetime. These regressions are estimated separately for men and women. In both cases, the sample is restricted to workers aged 26–60 living in urban areas of Brazil.

The authors then classify the last two variables (education and migration) as efforts, on the assumption that they were at least in part under the individual’s own control. The remaining variables are treated as circumstances. However, education and migration may also be influenced by circumstances (for example, parents affect the education of their children). To partly account for this, the authors regress education and migration on the vector of circumstances as well and use a Monte Carlo simulation procedure to correct for the attendant endogeneity bias. This effectively treats education and migration as being partly due to circumstance and partly to effort. They end up with a system that looks as follows:
\[ \ln w_i = C_i \alpha + E_i \beta + u_i, \]
\[ E_i = C_i \delta + v_i. \]

In this equation, \( w \) denotes earnings, \( C \) is a vector of observed circumstance variables, \( E \) is a vector of observed effort variables, and \( u \) and \( v \) are unobserved determinants that might in principle be either circumstance or efforts. The method used to estimate inequality of observed opportunities in this setup is to simulate the distribution of predicted earnings when each and every circumstance variable is assumed to be equal to a constant (for example, an average \( \bar{C} \)) in both equations of the system. The resulting inequality is clearly not due to any variance in observed circumstances. It must instead be due to effort made and to any unobserved circumstances, such as family wealth, which might be included in \( u \) and \( v \). Inequality of observed opportunities—denoted by \( T \)—would, under the assumptions, correspond to the difference between observed income inequality and the simulated inequality when circumstances are equal for all: \[ \Theta = I(y) - I(y|C = \bar{C}). \]

The authors test a variety of specifications and assumptions about the nature of the residual term \( v \). They present results for earnings and household incomes per capita under various assumptions. The figure below presents the results of the preferred specification for the seven cohorts most active in the Brazilian labor market in 1996. The height of the bar is overall observed income inequality in household incomes per capita, as measured by the Theil-T index. The bottom part is residual inequality after observed circumstances are equalized. The upper part thus corresponds to one estimate of inequality of observed opportunities in Brazil in 1996.

An estimate of inequality of opportunities as a share of total inequality, 1996

<table>
<thead>
<tr>
<th>Cohorts</th>
<th>Residual inequality</th>
<th>Inequality of observed opportunities</th>
</tr>
</thead>
<tbody>
<tr>
<td>b1936-40</td>
<td>0.363</td>
<td>0.803</td>
</tr>
<tr>
<td>b1941–45</td>
<td>0.294</td>
<td>0.805</td>
</tr>
<tr>
<td>b1946–50</td>
<td>0.261</td>
<td>0.750</td>
</tr>
<tr>
<td>b1951–55</td>
<td>0.28</td>
<td>0.779</td>
</tr>
<tr>
<td>b1956–60</td>
<td>0.278</td>
<td>0.767</td>
</tr>
<tr>
<td>b1961–65</td>
<td>0.294</td>
<td>0.753</td>
</tr>
<tr>
<td>b1966_70</td>
<td>0.229</td>
<td>0.684</td>
</tr>
</tbody>
</table>

Source: Bourguignon, Ferreira, and Menéndez 2003.
Even though a number of important circumstances (such as family wealth and contacts, cultural history, or the quality of the school where a child is first placed) are not explicitly controlled for, inequality of opportunities still appears to be high in Brazil. According to this measure, it accounts for 36–45 percent of total inequality for the older cohorts and 33–39 percent for the younger ones. There is a slight but perceptible downward trend in the share of inequalities accounted for by opportunities, which seems closely connected to a reduction in the degree of intergenerational transmission of educational inequality.

More generally in this report, the authors note that opportunities are highly correlated with the set of assets on which people can draw, as well as on the set of markets they can access and the institutions that surround them. For this reason, the report presents information on the distributions of individual assets and access to services and markets, and discusses the operation of a range of formal and informal institutions likely to affect people’s opportunities. The authors list inequality measures for a wide range of outcomes and assets, including, among others, distributions of household per capita incomes; household per capita consumption expenditures; individual earnings; hourly wages; hours worked; access to various public services; years of schooling; and land owned and farmed.

The authors do not attempt to classify, for example, educational attainment as either an asset or an outcome because it clearly is both things. Education, like health, affects worker productivity and remuneration, and is thus a human capital asset. But, as Sen (2000) and others have forcefully argued, health and education are also of value in their own right, both as functionings and as determinants of capabilities. This is equally true of power and influence: political rights are valuable as such, and can thus be thought of as outcomes with intrinsic value. However, they are equally important as capabilities that influence the set of opportunities available to agents.

Opportunities, assets, and outcomes are also related in causal ways. This report clearly cannot attempt to provide an exhaustive treatment of the determinants of inequality. After all, as just stated, even “simple” income inequality refers to dispersion in the distribution of all incomes. This distribution is determined within the general equilibrium of complex modern economies in which market imperfections, incomplete information, strategic interactions, and political processes simultaneously occur. Going beyond static economics, the institutions that mediate a number of these economic processes have long historical roots and reflect cultural patterns that are often deeply ingrained.

Pretense to an exhaustive discussion of the causes of inequality is thus a shortcut to failure. Instead, a very simple, general framework of the circular interaction between the distributions of assets and opportunities, incomes and other outcomes, and power and influence in society is schematically presented in Figure 1.1. The (joint) distribution of assets and opportunities is depicted at the top. These assets include not only physical and financial wealth such as land or stocks, but also human capital endowments such as education. Individuals may inherit some of these, but others are produced during a person’s lifetime. Education is of particular interest since it is, for most people, the main productive asset and is primarily acquired early in life.
People then make choices about the use of their assets in the specific markets in which they are remunerated. Financial savings generate interest or dividends in bonds or stock markets; land generates returns through rents or profits; and human capital is remunerated in labor markets. The combination of incomes arising from the remuneration of assets in these different markets combines to form individual incomes. Primary household incomes depend on how individuals match to form households and on decisions related to family size and composition.

Finally, secondary incomes are also affected by taxes and transfers, grouped together here under the category of public redistribution. There are obviously feedback loops in all these processes—notably from market processes—and this linear presentation should be treated as a way of organizing thinking, and not as a unidirectional view of causation. This part of the framework is obviously a highly stylized way of seeing economic influences on household per capita incomes. However, it is also one that is useful for the authors’ attempts to understand just where along the chain of assets, markets, households, and governments Latin American countries generate so much more inequality than others. These economic processes will be further examined in Chapter 6.

**FIGURE 1.1.**
A simple conceptual framework

These economic processes do not take place in a vacuum. At every step of the way, they are mediated by social and political institutions that are very broadly understood to encompass the rules and norms of behavior in society, as well as more specific institutions that formally or informally regulate markets and affect governments. This approach includes both the “macroinstitutional” arrangements in societies and the sociocultural processes that are products of interactions between different groups in a society, notably those that occur between dominant and subordinate groups. As sociologists such as Charles Tilly and Pierre Bourdieu have emphasized, the latter are essentially *relational*, and are deeply intertwined with both the organization of economic
production and the structure of power. Social arrangements and sociocultural processes are the sources of large “inequalities in agency” of different groups, or differences in their capacity to shape and influence the conditions in which they live.11 These political and social forces are discussed in Chapter 5.

In turn, formal and informal institutions are neither immutable nor indifferent to economics. Income and wealth— or “economic power”—is closely linked to political power, influence, and voice. This report represents these latter aspects through the link between income and power and considers them to be mediated by political institutions and sociocultural processes. In Figure 1.1, both the economic processes on the hypotenuse of the triangle and the social and political processes on the other sides of the triangle succinctly summarize broad traditions of economics, social science, and political economy in an extremely reduced form. The concepts underlying this figure are considered in more detail in Chapters 5 and 6, while salient aspects of group-based differences (that is, those related to race, ethnicity, and gender) are discussed in Chapter 3.

In addition, power can be used to shape economic realities in a number of different ways. Both historical and contemporary experiences vividly illustrate the linkages between power, asset accumulation, market functioning, and fiscal action. Despite the magic of the “invisible hand,” markets themselves never really operate independently of regulatory institutions or the purposeful activity of different groups holding greater or lesser degrees of political and market power—a theme that Adam Smith himself forcefully emphasized.12

At the most basic level, the enforcement of law and order is necessary to secure the property rights of those who sell, as well as of those who buy. At a more sophisticated level, a number of markets (in particular some financial and “knowledge-intensive” markets) would be highly incomplete, or missing altogether, in the absence of regulatory and enforcement institutions that guarantee the rights of creditors, investors, or innovators. The use of power, or political agency, to effect change will therefore typically work through specific policy actions. A significant part of the report is concerned with the ways in which policies can influence inequality. In terms of economic policies, this can work through a number of the points summarized in the hypotenuse of the triangle in Figure 1.1.

First, policy can affect the distribution of assets, either through direct redistribution (such as land reform or privatization processes), through taxation and subsidies (as in the direct provision of education and health services) or through regulations that facilitate access to information, credit, and insurance. The overall economic incentives with which agents are faced are influenced by political forces through mechanisms ranging from the design of taxes and subsidies to the enforcement of property rights and the general investment climate. In turn, economic incentives shape differential rates of accumulation, which then influence how asset distributions evolve. Some policy options referring to asset distributions are discussed in Chapter 7.
Second, policy can influence how markets work. Even in the most minimalist view of
governments (that is, in the tradition of Hobbes, Locke, and Nozick), room was always
made for a “night-watchman” state. As commodities themselves and the markets in
which they are traded become increasingly complex—moving, for example, from apples
in a farmers’ market to microenterprise credit or financial derivatives—the enforcement
of property rights and the need to correct for informational and other market failures also
grow. Financial regulators, inspectors of working conditions in labor markets, and
antitrust investigators are examples of governance institutions through which political
systems provide a framework for the activities of markets, which in turn shapes economic
processes and outcomes. Of particular importance to Latin America are the interactions
between policies and macroeconomic conditions. Some of the policy mechanisms
available to increase equity through markets and other institutions are considered in
Chapter 8.

Third, governments inevitably affect the distribution of disposable household incomes
through the need to finance their operations. Taxes serve to raise the revenue that
supports the regulatory roles discussed above, but may also finance a number of
redistributive services and transfers, whether in kind (such as through the provision of
free education or health care) or in cash (such as in the form of unemployment insurance
or various cash subsidies). Chapter 9 considers policy options in this realm.

By treating policies as emanating from a given social, cultural, and political context—
which itself reflects a certain distribution of power and influence and underlying
distributions of income and wealth—the authors acknowledge that policies are not
designed in a vacuum. The usefulness of this contribution to the policy debate will be
enhanced by the recognition that the context of a society places important constraints on
what can be done and helps shape preferences about desirable outcomes. As Figure 1.1
indicates, the policies arising from social and political institutions affect both the
economic opportunities available to people and the market processes in which they
engage.

Such “circular causality” between wealth, income, and power mediated through
institutions evolves throughout time and history. The position of a country at a given
point is powerfully shaped by the initial distributions of assets, as well as by the past
history of institutions that exist today. A brief treatment of the historical roots of Latin
American inequality is provided in Chapter 4.

While acknowledging the importance of history and of existing social and political
institutions is crucial in order to avoid policy-related mistakes, a fatalist view of the
world is both wrong and counterproductive. To propose policies without an
understanding of history and the specific contexts in which they were developed often
leads to failure. However, this is not equivalent to the view that no policies should be
suggested at all because they will emerge endogenously from historically predetermined
institutions. Such a view fails to recognize the major role played by purposeful social and
political action in achieving significant policy and institutional changes, and would
ultimately result in fatalism and inaction.
A core theme of this report is that the circular causality that underpins the resilience of inequality can be altered by both economic forces and the social agency of different groups (see, in particular, Chapter 5). The authors believe that the possibility exists for domestic policymakers to break with Latin America’s long history of persistently high inequality by advancing equity-enhancing policies in the economic, social, and political realms. They also believe that chances of success are higher if policymakers are equipped with a deep historical understanding of the social and political norms and institutions that shape societies.

1.2. The consequences of high inequality

Before embarking on an entire volume on inequality, it may be worth pausing to ask a central question: “Why should we care?” The mission of the World Bank is to help countries eliminate poverty. However, poverty and inequality, although related, are very different phenomena. It is therefore legitimate to ask why the World Bank should be concerned with inequality. There are three key reasons, namely:

- The peoples and governments in World Bank client countries dislike inequality per se, both in terms of outcomes and opportunities.
- For a given level of mean income, greater inequality generally means greater poverty. Perhaps worse, for a given rate of growth in mean incomes, greater inequality usually implies a slower rate of poverty reduction.
- Evidence suggests that—in addition to reducing poverty more slowly for each percentage point in the growth rate of the economy—high inequality of opportunities and outcomes reduces the rate of growth itself. In cases of extreme inequality and significant negative influences of inequality on growth, the combination of these two effects may imply that high inequality countries find it difficult or even impossible to escape absolute poverty (see Ravallion 1997). There is also evidence that inequality is associated with a greater prevalence of conflict and violence and may impair an economy’s ability to respond effectively to macroeconomic shocks.

Each of these three issues is discussed in turn below.

**Inequality is a bad thing in itself**

Both in economics and in political philosophy, there is a common presumption that a unit increment in the income of a poor person should be valued more highly than the same increment accruing to a richer person. This normative view was initially associated with utilitarian thinkers dating back to Jeremy Bentham, who attributed it to the process whereby utilities increase with income or consumption, but at a decreasing rate. This property of “declining marginal utility” is consistent with a preference for equity, but it is not its sole source.

Beyond this consideration, there is also a generalized agreement among economists around social welfare functions that value greater increases of utility (and hence of
incomes) among the poor than among the rich. Other thinkers, such as John Rawls, have derived grounds for even stronger degrees of inequality aversion from different philosophical and ethical sources. However it is ethically motivated, the fact is that aversion to inequality or, conversely, a preference for equity, has been a dominant (although not consensual) view in political philosophy and the theories of social justice.

Recent evidence suggests that this view is not restricted to rarefied intellectual debate. Opinion surveys support the view that most Latin Americans are unhappy with the extent of inequality that exists in the region, which is consistent with what economists call “concave” social welfare functions. The results of a region-wide opinion survey conducted in 2001 by Latinobarómetro, a public opinion project based in Chile, indicate that on average, 89 percent of Latin Americans regard the income distribution in their countries to be unfair or very unfair. With the exception of Venezuela, no country had fewer than 80 percent of respondents answering affirmatively in those categories. Figure 1.2 reports results for the 17 countries for which they are available.

Such high levels of disapproval of income distribution are a cause for concern. They imply that the vast majority of the population believes that the way the national income is divided up is not just. Nor is it necessarily the case that such disapproval will go away with sustained growth. While relative differences in income often change little with growth, absolute income differences systematically increase. There is evidence that many people think about inequality in such absolute, rather than relative, terms.

Moreover, it would not be surprising if this belief also implied a general lack of ownership of or belief in the entire set of institutions that are responsible for income distribution. Indeed, evidence from other opinion surveys indicates that the level of trust for institutions in Latin America is unusually low. The first reason the World Bank should care about inequality is thus a rather simple one: the Bank’s clients do. Inequality makes people unhappy and reduces their faith in national institutions.

**High inequality makes poverty reduction harder**

The second reason governments and international institutions may care about inequality is that high levels are associated with high poverty levels. This is true in two different, although related, senses.

**FIGURE 1.2.**
Perceptions of fairness of the income distribution in Latin America
First, poverty will rise if the poverty line in a given society is below the mean of the income distribution, and if inequality increases in that distribution in a way that affects the poor without affecting the mean. Figure 1.3 illustrates this point: if society moves from the less unequal distribution A to the more unequal distribution B, and both distributions have the same mean, then the incidence of poverty will rise from area C to area C + D.

This argument is based on theory. It is consistent with empirical observations of historical experiences of the relationships between distributional and poverty changes. On the basis of a sample of 114 episodes for 50 countries, Bourguignon (2002) confirms previous findings that higher rates of economic growth are unambiguously associated with higher rates of poverty reduction. However, he also finds that the impact of growth on poverty (that is, the negative growth elasticity of poverty reduction) becomes smaller in absolute value as initial inequality rises.

**FIGURE 1.3.**

Inequality and poverty with a constant mean

*Source: Latinobarómetro, 2001. Responses to the question: “Do you think that the income distribution is…”*
In other words, more unequal countries convert a percentage point of growth in mean household income into a smaller reduction in the incidence of poverty than do more egalitarian countries. Conversely, in order to obtain a 1 percent reduction in the number of people living in poverty, more unequal countries need to grow faster than do more egalitarian countries. Bourguignon (2002) analytically establishes this negative impact of inequality on the rate of poverty reduction for the case of lognormal distributions, which are the most common functional form approximations for empirical income distributions. At the same time, he also finds strong empirical support (under various alternative model specifications) for the negative relationship within his sample. Drawing on the same data set, Figure 1.4 illustrates the basic result: after controlling for initial income levels, the growth elasticity of poverty reduction falls in absolute terms (that is, it becomes less negative, so that more growth is needed to reduce poverty) along with the Gini coefficient. The result is statistically significant at the 10 percent level.

Bourguignon (2002, p. 14) concludes that “… income redistribution plays essentially two roles in poverty reduction. A permanent redistribution of incomes reduces poverty instantaneously [through the effect described in Figure 1.2]. But, in addition, it also contributes to a permanent increase in the elasticity of poverty reduction with respect to growth and therefore to an acceleration of poverty reduction for a given rate of economic growth.” (Emphasis in the original; comment added.)

FIGURE 1.4.
Growth elasticities become less negative with inequality
In a similar exercise, López (2003) corroborates the finding that the absolute value of the theoretical growth elasticity of poverty reduction (again under a lognormal assumption) declines with inequality and with the ratio of the poverty line to mean income. These results are reported in the first panel of Table 1.1 below. The second panel of the table reveals that the magnitude of the direct (that is, instantaneous) effect of inequality on poverty also falls with initial inequality. In other words, the effect depicted in Figure 1.2 of an inequality reduction on poverty is concave.

**Inequality impairs the development process itself**

The third and final reason development practitioners should care about inequality is that there is evidence that it may have negative consequences for the overall process of development, including slowing down the rate of economic growth. In fact, it likely has an effect on a number of other development goals and processes—such as the capacity to resolve conflict without resorting to violence and the ability to manage aggregate shocks effectively. Effects on growth must therefore be considered along with other aspects contained in the broader category of the impact of inequality on the development process.

**TABLE 1.1.**

*Theoretical elasticities of poverty with respect to aggregate income growth*
The first aspect to consider is economic growth. After all, as Robert Lucas famously wrote (Lucas 1988, p. 5), “Once one starts to think about [economic growth], it is hard to think about anything else.” Whereas during the 1960s, 1970s, and 1980s, most of the thinking about economic growth ignored distributional considerations, in the last 10 years or so the distribution of income and wealth has returned to center stage of the concerns related to growth (Atkinson 1997). While there is as yet no consensus throughout the economics profession on this question, it is probably fair to say that the balance of academic opinion leans toward the view that high levels of inequality in incomes or in assets are causally related to lower rates of growth in mean incomes.

There are two main conceptual reasons why this might be the case. First, if credit or insurance markets are imperfect, people may depend on their initial wealth to undertake important investment decisions. If this indeed happens, a situation may in turn arise in which the poorest people in society are unable to invest in socially efficient (that is, profitable) projects, while richer individuals receive lower returns on the marginal dollar of their wealth. Credit market imperfections refer precisely to the reasons why intermediation might fail, preventing the rich from lending to the poor and enabling both groups to gain from higher returns. Economists refer to such a situation—in which both parties might be made better off without anyone losing out—as a Pareto inefficient allocation.

Why would credit markets fail in this way? Largely because lenders do not have all the information they might like to have about borrowers and because contracts may not be fully enforceable. Because enforcing credit contracts may be costly, interest rates may be higher for borrowers than for lenders. This difference may mean that poorer agents
borrow too little. If some projects (such as a child’s education) require minimum “lumpy” investments, the result may be aggregate underinvestment and an inefficient overall equilibrium (Galor and Zeira 1993).

Credit market imperfections may also manifest themselves through collateral requirements. If loan amounts increase with the collateral available to an agent, the poor will again be at a disadvantage. Some people may not be able to start projects with positive expected social returns—including investments in human and physical capital, land, and housing,—and the result will be inefficiency. Indeed, if there are “too many” such people, they may drive down the aggregate wage rate, with additional implications for the long-term steady-state of the economy (Banerjee and Newman, 1993). A third variant on this story is that those agents who need to borrow the most (that is, the poorest) are faced with such a large “debt overhang” that they have very little incentive to work on their projects. Lenders ration excessively large credit burdens because they may have a “moral hazard” effect on effort supply (Aghion and Bolton 1997). Similar arguments explain how the poor may be rationed out of insurance and other financial markets.

In sum, economists have modeled a variety of ways in which the combination of imperfect financial markets and unequal wealth distributions lead to outcomes which are not efficient in the “first best” sense. The specifics of financial markets may vary, but the essential issue is that inequality generates allocations through which the poor do not have the means to undertake projects that, if undertaken, would have high expected social returns. At the same time, the rich are left receiving lower marginal returns on their wealth. Further, income and wealth inequality, coupled with imperfect financial markets, will also limit the capacity of the poor to acquire assets such as human capital, land, and housing, which will in turn limit their future opportunities and the possibility of smoothing consumption in the presence of large shocks. Such indirect effects will also reduce overall growth and welfare.

The second conceptual reason that inequality may lead to lower growth involves questions of political economy. In societies with high degrees of concentration of power and wealth, elites may have more leeway to choose strategies that benefit themselves rather than middle- and lower-income groups. Within the economics literature, this has often been developed in terms of the links between the credit market failures (discussed above) that might be remedied through effective public action. The private costs of education, for instance, can be considerably reduced (thought never eliminated) through a variety of government actions, such as the provision of free public schooling or the good roads and public transportation by which students can reach schools. However, unequal societies in which political power is intertwined with wealth may be less likely to choose policies that reduce those inefficiencies than to allocate scarce resources to alternative uses. These can include private consumption of the rich (through lower taxes) or public spending on alternative programs that do not reach the poor (Bénabou 2000).

One study, inspired by a Latin American brand of political economy, characterizes the links between wealth inequality, income inequality, and political inequality as follows (Ferreira 2001). Wealth inequality means that some children attend good private schools, while others have no choice but to enroll in lower-quality public schools. Those who
attend public schools enter the labor market with lower levels of human capital and thus command lower incomes. If decisions about public spending are influenced by incomes, the inequality in incomes that arises from large educational inequalities in turn leads to political outcomes in which a richer, better educated minority blocks the votes for more funding for public schools.

The authors show that there are multiple equilibria at play in this system, with societies where initial wealth inequality is lower ending up being more egalitarian than those with higher initial levels of inequality. Furthermore, a change in political regime leading to less influence of income on political decisions (that is, a process of real democratization such as that discussed in Chapter 5) could lead to equilibrium-switching in this model. The result would be a shift from a high-inequality, lower-welfare equilibrium to one that is dominant both in inequality and welfare terms.

The mechanisms whereby elites act in ways that do not serve the interests of all segments of the population may be more pervasive than can be captured in these economic models. A strand of thought in the political science and sociological literature that is relevant to parts of this report is that elites help form and perpetuate institutional structures that are characterized by governance, limited accountability, and high levels of corruption. Such “weak” institutional arrangements, rather than being symptomatic of immature institutional evolution, may be functional for the rich (Heller and Mahoney 2003). In addition, where institutions are weak, it is the poor who suffer most, since the rich can use their political power and financial influence to further their interests (Glaeser, Scheinkman, and Schleifer 2002). Such processes would have powerful adverse impacts on overall growth and other aspects of the development process.

Do the data support the hypothesis that high inequality is bad for growth and efficiency? Most studies do find a negative coefficient of initial inequality when this aspect is included as an explanatory variable in empirical growth models. In regressing the average growth rate during 1960–1985 on Gini coefficients for income and land around 1960, Alesina and Rodrik (1994) find statistically significant coefficients for both. Persson and Tabellini (1994) employ an alternative measure: using the share of income accruing to the middle fifth of the income distribution as a proxy for equality. The coefficient for that variable is statistically significant and positive, which is consistent with the Alesina and Rodrik results. Although Perotti (1996) uses a larger set of countries and tests additional specifications, the results remain significant.

More recently, this budding consensus has been challenged by Forbes (2000) based on analysis of a new data set known as the Deininger and Squire “high-quality” data set. Forbes found a positive relationship between lagged inequality and growth. There are, however, a number of reasons why these findings, although important, remain a minority view in the economics profession. First, as the author herself points out, this study differs from the others in considering the effect of time-varying lagged inequality rather than some fixed, initial level of inequality. The interpretation thus has a more short-run effect. Second, questions have been raised both about the data set and the econometric technique employed (see Aghion, Carroll, and García-Peñalosa 1999).
Finally, other studies have continued to find significant negative coefficients for measures of wealth and asset inequality in growth regressions. For example, Birdsall and Londoño (1997) use a subset of the Deininger-Squire data set and conclude (p. 35) that “Initial inequalities in the distribution of land and human capital have a clear negative effect on economic growth, and the effects are almost twice as great for the poor as for the population as a whole.” López (2003) uses a similar econometric approach as Forbes and the Deininger-Squire data. Taking into account the simultaneous nature of the determination of growth and inequality dynamics, he finds no sign of an effect of growth on inequality—in keeping with work by Ravallion and Chen 1997 and Dollar and Kraay 2002—but rather statistically significant evidence that initial inequality reduces growth.

In addition, it seems that the harmful effects of high inequality on economic development are not restricted to economic efficiency and growth, important though these aspects are. A broader view of development includes more than output per capita, considering, for instance, a country’s institutional ability to cope with economic and other aggregate shocks, such as a change in terms of trade or a key foreign interest rate. Rodrik (1999) suggests that countries suffering from more pervasive social divisions—whether ethnic and racial in nature or income and class-based—seem not to adjust to large shocks as well as other, more egalitarian and cohesive societies. The implicit mechanism is that the institutions responsible for sharing the burdens of adjustment work less well in economies in which distributions are more unequal.

In order to understand the process of adjustment to the first oil-price shock of 1973, Rodrik (1999) regresses the difference between the per capita growth rate during 1975–1989 and the same rate during 1960–1975. He finds a significant negative coefficient on the dummy variable for Latin America, suggesting that the region suffered more from the shock (in terms of reduced ex-post growth) than did developed or East Asian countries. Interestingly, this effect disappears (that is, the coefficient becomes insignificant) when three specific aspects are controlled for: income inequality in the 1970s; land inequality; and the murder rate (the latter of which serves as a general proxy for the prevalence of violence or weakness in conflict resolution in a society).

This result is interpreted as indicating that the prevalence of high inequality in Latin America (when compared to, for example, East Asia) was partly to blame for the region’s poorer performance in adjusting to the severe terms-of-trade shocks of the 1970s. Institutions were not able to achieve closure on the incidence of the costs of adjustments. In the meantime, fiscal and current account deficits grew, planting the seeds for the ensuing debt crises of the 1980s. Chapter 8 discusses the continuing importance of crisis management and the links with inequality in Latin America.

The link between high inequality and weak institutions, which may appear tenuous at this stage and which is treated in a much reduced form in Rodrik (1999), is further explored in Chapters 4 and 5. In those chapters, the theme emerges that Latin America is, in a range of areas, characterized by institutions that are weak and controlled by unequal power structures. Both these aspects tend to lead to sub-optimal levels of development and to perpetuate unequal gains from development that does occur.
Returning for a moment to the significance of the murder rate variable in Rodrik’s specifications, it is important to note that the fact that it mimicked the effect of the omitted inequality variables in the growth regression is not a coincidence. Evidence across countries suggests that high inequality is significantly and positively associated with the prevalence of violence.\footnote{Fajnzylber, Lederman, and Loayza (2000) regress homicide rates (from the World Health Organization database) on income inequality (measured by the Gini coefficient) and a number of control variables in a panel data set of about 40 countries and 140–190 observations (depending on the specification). Results show that income inequality is always positive and strongly significant, and remains so even when educational inequality and income polarization are added as controls. Both social conflict and personal violence are associated with higher levels of inequality, especially when institutions of conflict management and the rule of law are weak.}

Finally, it is worth noting that interaction occurs between possible effects of inequality on the growth rate and the adverse effects of inequality on poverty reduction. If inequality is sufficiently high, countries that would have good growth prospects with strong poverty-reducing potential at low levels of inequality will experience little or no growth or poverty reduction. Ravallion (1997) calculates that about one-fifth of observations in a data set for developing countries could fall into a category in which there would be no absolute poverty reduction.

The balance of the evidence is therefore that high levels of income and wealth inequality observed in Latin America are:

- Considered unfair by large majorities of the continent’s population.
- Slow down the pace of poverty reduction in the region by lowering the growth elasticity of poverty reduction.
- Slow down economic growth and development itself.
- Possibly hamper the region’s ability to manage economic volatility and worsen the quality of its macroeconomic responses to shocks, which are unfortunately all too frequent.
- Make violent crime more pervasive.

These are the main reasons why a better understanding of inequality is important. Most people and governments in the region regard Latin American levels of inequality as too high. They would like to reduce them in terms of both outcomes and opportunities. In addition, such a reduction would likely help policymakers become more effective in fighting poverty and promoting broader economic development.

**An overview of the report**

The remainder of the report is divided into three parts, one for each objective outlined above. **Part I** establishes basic facts about inequality in Latin America, to the extent allowed by the available data, in terms of both evidence on differences across individuals and households (Chapter 2) and between groups, across ethnic, racial, and gender lines (Chapter 3). **Part II** turns to the causes and determinants of high and persistent inequality
in Latin America, from its historical origins (Chapter 4), contemporary social and political influences (Chapter 5), and economic forces for the reproduction of inequality (Chapter 6). **Part III** considers what can be done in terms of specific policies in the domains of assets (Chapter 7), market institutions (Chapter 8), and the redistributive role of the state through taxation, services, and transfers (Chapter 9).
Notes

1 General statements about Latin America throughout this report refer to continental Latin America, excluding Belize, French Guyana, and Surinam. Unfortunately, the authors are unable to make general statements regarding the Caribbean, since household surveys are available for only three Caribbean countries: the Dominican Republic, Jamaica, and Trinidad and Tobago. Nonetheless, results for these three countries are reported and included in the regional averages presented. However, there would be no statistical justification for making inferences for the Caribbean sub-region as a whole on the basis of the primary data analysis for those three countries.

2 This refers to unweighted averages for the distribution of household per capita income in 1992, with estimates based on Bourguignon and Morrison 2002. See Table A.18 in the Statistical Appendix.

3 The Gini coefficient is a standard measure of inequality in a distribution. It ranges from zero to one, and increases with inequality. A value of zero corresponds to perfect equality and a value of one corresponds to a distribution in which a single unit receives all of the income and the other units receive nothing.

4 These figures refer to the national 1999 survey. See Table A.22 in the Statistical Appendix.

5 See O’Donnell 1999 for discussion of low-density citizenship and Méndez and others 1999 for the unequal reach of the rule of law in much of Latin America. The most recent and important symbolic change in Guatemala was the signing of the peace accords in 1996. However, major institutional weaknesses and patterns of social exclusion remain; see World Bank 2002b.

6 Most measures frequently used in the economics literature evaluate dispersion in ways that are consistent with certain desirable attributes, known as axioms of inequality measurement. For a discussion of measurement issues, see Cowell 1995 or 2000.

7 This report does not focus on full multivariate welfare analysis. For more on this subject, see Bourguignon and Chakravarty 2003.

8 Quotes in this paragraph are from Sen 1992, pp. 4–5 and p.150.

9 The literature on the theories of social justice is vast. See Sen 2000 for a recent survey.

10 See North 1990 for a classic treatment of institutions as norms and “rules of the game.”

11 See Heller and Mahoney 2003 for a review, Tilly 1999 and Bourdieu 1990 for key examples, and Rao and Walton (forthcoming) for a discussion of “inequality of agency” from a cultural perspective. A related strand of the economics literature on measurement of inequality concerns the development of the theory and measurement of polarization. This starts from the conceptual insight that individuals’ evaluation of the salience of inequalities is linked to differences between the groups with which they identify relative to the groups from which they feel alienated (see Esteban and Ray 1994).

12 See Rothschild 2001 for a rich account of how Adam Smith and other enlightenment thinkers were greatly concerned with the abuse of unequal influence and the role of the purposive agency of different groups in shaping economic and social outcomes.

13 In technical jargon, this refers to the “concavity” of social welfare functions.

14 In experiments on attitudes toward inequality, Amiel and Cowell (1997) found that 40 percent of participants thought of inequality in terms of absolute, rather than relative, differences.
An increase in overall inequality could occur solely through increases in differences above the poverty line, for example shifts from the moderately rich to the very rich. This type of increase would not affect poverty, although it would be judged as a worsening in social welfare under most welfare functions.

That result was established for the same data set by Ravallion and Chen 1997.

Forbes also used a different econometric technique, applying the Arellano and Bond (1991) Generalized Method of Moments (GMM).

There are, of course, other factors that influence the effects of shocks on countries, such as the overall degree of openness, which tends to be associated with lower long-term impacts of adverse external shocks.

However, there is some evidence that the Caribbean is an exception to this pattern. Inequality levels are often lower in that sub-region than they are on the continent, although crime rates can be rather high in particular countries due largely to the drug trade.