Inequality in Latin America is extensive: the country in the region with the least income inequality is still more unequal than any Organization for Economic Cooperation and Development (OECD) or Eastern European country. Latin American inequality is also pervasive, characterizing every aspect of life, including access to education, health and public services; access to land and other assets; the functioning of credit and formal labor markets; and attainment of political voice and influence. Inequality is also resilient; in its modern form, high inequality is rooted in exclusionary institutions that have been perpetuated ever since colonial times and that have survived different political and economic regimes, from interventionist and import substitution strategies to more market-oriented policies. Significant racial and ethnic differences also continue to persist even today.

High inequality has major costs. It increases poverty and reduces the impact of economic development on poverty reduction. It is probably bad for aggregate economic growth, especially when associated with unequal access to credit and education, and with social tensions. A large majority of Latin Americans judge current levels of income inequality to be unfair. Inequality of opportunities is especially unacceptable. For all these reasons, Latin American countries must make an effort to break with their long history of inequality.

Can this be done? This report suggests that the answer is yes, if there is decisive action to tackle the range of mechanisms that reproduce inequality. First and foremost, there is a need to reduce inequality in access to productive assets. Equalizing access to quality education is central because of its influence on economic opportunities, social status, and political influence. However, more equal education will take decades to subsequently transform other inequalities. Also important is the achievement of more equal access to land, property rights, and other assets such as infrastructure.

Second, there is a need to make market institutions work better for everyone through deeper financial and product market, and more inclusive labor institutions that balance flexibility with protection for workers. In the macroeconomic domain, a concern with distribution reinforces the case for sound management, since crises tend to be highly regressive. Attaining this will require building institutions and rules to reduce the risk of crisis, and to make the distribution of losses less unequal when crises do occur.
Third, the state needs to strengthen its capacity to redistribute. For most countries in the region this will imply increasing their (low) tax efforts, and, over the longer term, making taxes more progressive through effective collection of personal income and property taxes. Increased taxes only make sense if they are used effectively. Despite some progress and the increased progressivity of social spending in the 1990s, much public expenditure remains highly regressive (for example subsidies to tertiary education and the “truncated” welfare state, especially with respect to pension payments). Redistributive transfers have a role to play precisely because asset-based strategies take time to implement. A particular area of promise is conditional cash transfers, which can have a significant impact on income redistribution today, while at the same time extending social protection against shocks to the poor and encouraging investment in the human capital of the poor. These and other instruments can provide the basis for a truly progressive social protection system in Latin America.

Given the deep historical, institutional roots of high inequality, progress on all these fronts will require decisive social action and political leadership. This implies making progress toward more inclusive political institutions, since inequalities in influence lie behind many of the mechanisms that reproduce overall inequality.

This is no easy task. But it may be more possible to accomplish today than in the past, given increased social demands for deeper democracies, more equal sharing of political influence, broader access to education and health, and greater recognition for Afro-descendants and indigenous groups. These demands are palpable across the region, and are partly a consequence of the globalization of information, economic opportunities, and human rights. There are promising examples of change underway, notably at subnational levels, with new alliances between progressive elites, public officials, middle classes, and the poor currently spurring the establishment of more inclusive and efficient institutions.

These are the main messages of this report, on which the rest of this summary section elaborates. Readers interested in the evidence and analysis that underpins these conclusions will have to immerse themselves in the entire, extensive text. We hope they will find it worth the effort.

Latin America suffers from extreme inequality—on many dimensions

Inequality is a pervasive feature of Latin American societies in terms of differences in income, access to services, power and influence and, in many countries, treatment by police and justice systems.

According to household surveys, the richest 10 percent of individuals receive between 40 and 47 percent of total income in most Latin American societies, while the poorest 20 percent receive only 2–4 percent (see Table 1). These differences are substantially higher than in OECD countries, Eastern Europe, and most of Asia. Moreover, the most
distinctive attribute of Latin American income inequality is the unusually large concentration of income at the very top of the distribution. (Only some countries in Africa and the successor states of the former Soviet Union have comparable inequalities.) By way of comparison, the richest 10 percent in the United States receive 31 percent of total income, and in Italy they receive 27 percent. Even the most equal countries in Latin America (Costa Rica and Uruguay) have significantly higher levels of income inequality. Inequality in consumption—where it can be adequately measured—also appears to be higher in Latin American countries, although differences with other regions seem not to be as sharp as in the case of inequality of incomes.²

### TABLE 1.
Indicators of inequality for selected Latin American countries, the United States, and Italy

<table>
<thead>
<tr>
<th>Country</th>
<th>Gini coefficient</th>
<th>Share of top 10 percent in total income</th>
<th>Share of bottom 20 percent in total income</th>
<th>Ratio of incomes of 10th to 1st decile</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brazil (2001)</td>
<td>59.0</td>
<td>47.2%</td>
<td>2.6%</td>
<td>54.4</td>
</tr>
<tr>
<td>Guatemala (2000)</td>
<td>58.3</td>
<td>46.8%</td>
<td>2.4%</td>
<td>63.3</td>
</tr>
<tr>
<td>Colombia (1999)</td>
<td>57.6</td>
<td>46.5%</td>
<td>2.7%</td>
<td>57.8</td>
</tr>
<tr>
<td>Chile (2000)</td>
<td>57.1</td>
<td>47.0%</td>
<td>3.4%</td>
<td>40.6</td>
</tr>
<tr>
<td>Mexico (2000)</td>
<td>54.6</td>
<td>43.1%</td>
<td>3.1%</td>
<td>45.0</td>
</tr>
<tr>
<td>Argentina (2000)</td>
<td>52.2</td>
<td>38.9%</td>
<td>3.1%</td>
<td>39.1</td>
</tr>
<tr>
<td>Jamaica (1999)</td>
<td>52.0</td>
<td>40.1%</td>
<td>3.4%</td>
<td>36.5</td>
</tr>
<tr>
<td>Dominican Republic (1997)</td>
<td>49.7</td>
<td>38.6%</td>
<td>4.0%</td>
<td>28.4</td>
</tr>
<tr>
<td>Costa Rica (2000)</td>
<td>46.5</td>
<td>34.8%</td>
<td>4.2%</td>
<td>25.1</td>
</tr>
<tr>
<td>Uruguay (2000)</td>
<td>44.6</td>
<td>33.5%</td>
<td>4.8%</td>
<td>18.9</td>
</tr>
<tr>
<td>United States (1997)</td>
<td>40.8</td>
<td>30.5%</td>
<td>5.2%</td>
<td>16.9</td>
</tr>
<tr>
<td>Italy (1998)</td>
<td>36.0</td>
<td>27.4%</td>
<td>6.0%</td>
<td>14.4</td>
</tr>
</tbody>
</table>

*Source: Statistical Appendix Tables A.2 and A.3, World Bank Development Indicators Database, World Bank.*

Inequalities with respect to education, health, water, sanitation, electricity, and telephony are also typically large and correlated with differences in income. For example, differences in average years of education between the top and bottom income quintiles ranged between 5 and 9 years for 31–40 and 51–60 year-olds across the region (Figure 1). Standard surveys do not provide comparable material on inequalities of power or influence within a society, but a wealth of political, historical, and sociological information attests to both their salience and association with wealth.

### FIGURE 1.
Difference in average years of education between top and bottom quintiles, around 2000, for 31–40 and 51–60 year-olds
A further divide that cuts across all these dimensions is that of race and ethnicity, that affects all societies with a significant indigenous or Afro-descended population, as discussed further below.

Is inequality improving? During the last decade, diverse patterns have emerged with respect to income differences, with more countries experiencing a worsening than an improving trend. On balance, relatively equal countries experienced some worsening, with a dramatic deterioration for Argentina both before and during its economic crisis. At the other end of the scale, Brazil, historically the most unequal country in the region, experienced a modest but significant decline in income inequality (see Figure 2). In previous decades, there was a trend toward reduced inequality in the 1970s and a more pronounced trend toward rising inequality during the crisis-ridden 1980s. However, the more striking fact for the long term is the resilience of high inequality in the face of diverse economic and political regimes.

Source: Statistical Appendix Table A.22.
FIGURE 2.
Trends in income inequality in Latin America between the early 1990s and early 2000s
(Gini coefficients for equivalized household income per capita)

(a) South America

(b) Central America and the Caribbean

Source: Statistical Appendix Table A.22.

With respect to services and human investment, the general tendency in the past decade was more positive. Most of the region experienced at least some equalization in terms of access to services and basic education status. However, in one key area, that of access to college education, the dominant pattern was of widening differences between the rich and the poor as attendance rose faster for members of households at the top of the
distribution. This is important for future income dynamics, in light of the high and rising premium placed on tertiary education in the labor market. The wave of democratization in the 1980s brought, at a basic level, some equalization in citizenship, and potentially in differences in power. However, inequalities in influence and in the application of the rule of law remained large in most of the region, even under democratic auspices.

**High inequality hurts both poverty reduction and development**

Most people would agree that some degree of inequality in a society is necessary to provide incentives for work and investment. However, the levels of inequality prevailing in Latin America are clearly costly for well-being. There are three broad reasons for concern. First, higher inequality, whether in income or other dimensions of well-being, means more poverty at any given point in time. High inequality also implies a lower dynamic impact on poverty from development, unless significant redistribution takes place (Figure 3 provides a numerical illustration of the relation between economic growth and income poverty reduction). For example, Brazil could reduce poverty to half in ten years with 3 percent growth and an improvement of 5 percent in the Gini coefficient (the most common measure of income inequality); it would take the country 30 years to achieve the same objective with 3 percent growth and no improvements in income distribution.

**FIGURE 3.**
The elasticity of poverty reduction with respect to growth for different levels of inequality

![Graph showing the elasticity of poverty reduction with respect to growth for different levels of inequality.](image)

*Note:* The elasticity is the percentage change in poverty corresponding to a one percent change in mean income.

*Source:* Authors’ calculations; see Chapter 2.

Second, inequality can slow the overall development process. In contrast to some earlier strands of development thought, most economists (and other social scientists) now see high inequality as a potential drag on development for a variety of reasons: unequal access to credit implies missing highly profitable investment opportunities for the economy as a whole; unequal educational opportunities limit the potential contribution to
society of some of the most talented individuals; distributional conflicts are heightened, especially in the context of managing adverse shocks; crime and violence increase; and, under some conditions, the institutional underpinnings for growth become weaker, for example with respect to property rights.

Third, according to surveys from Latinobarómetro, the public opinion survey organization, high inequality is widely disliked: in almost all countries surveyed, some 80–90 percent of citizens consider prevailing levels of income inequality to be unfair or very unfair.

Inequality of opportunities is especially unacceptable in ethical terms—implying that individuals at birth face totally different life options—and is particularly harmful for the overall growth potential of societies. Although it is difficult to disentangle the effect of inequality of opportunities from the effect of other factors (such as differences in preferences and efforts) on the inequality of outcomes, some attempts indicate that they do indeed explain a significant fraction of inequality of income distribution outcomes in countries such as Brazil (see Chapter 1).

**Latin America’s inequality has deep historical roots and pervades contemporary institutions**

The genesis of current structures of inequality lies in Latin America’s colonial past, and in particular in the interactions between European colonists and subordinate populations. During the early colonial period, influences on inequality were reinforced by economic conditions and power differences. European settlement was initially concentrated in areas where natural resources—especially mining and sugar production—could be exploited with the use of unskilled labor. Labor was provided either by subjugated indigenous populations or imported African slaves. The colonists developed institutions—notably those related to labor management (including slavery), land use, and political control—that consolidated and perpetuated their influence and wealth. In the post-independence period, domestic elites continued to shape institutions and policies to maintain their privileged positions, for example in the areas of restricted suffrage, access to education, and land policy.

In those parts of the Americas where there was no economic potential for combining subordinate labor with valuable natural resources, the evolution of inequality was different. This is most clearly the case in North America, where immigrant smallholders (which were able to pursue settlement with lower mortality rates) successfully resisted attempts to impose authoritarian forms of government. (Nonetheless, the use of slavery in the American South was a story similar to that found in Latin American sugar-producing countries.) Similarly, in Costa Rica and the Southern Cone, the depth of social divisions was less than that found in the areas where indigenous and slave populations were concentrated. However, in the latter countries, a range of forces, including abundant land and high concentrations of power among elites, led to these societies pursuing paths that also fostered relatively high levels of inequality. The granting of suffrage and extension
of education in Argentina and Chile, for example, substantially lagged behind that of the United States and Canada, but was ahead of countries such as Brazil, Peru, and Mexico.

Despite the immense political, social, and economic changes of the past century, these historically-formed sources of inequality persisted until the present time, albeit in shifting institutional forms. In countries with indigenous or Afro-descended populations, differences remain large: incomes of these groups are half that of their “white” counterparts in Bolivia, Brazil, and Guatemala. (See Figure 4; Guyana is an exception, with relatively small differences between Afro- and Indian-descended groups.) These disparities in turn reflect differences in education and other assets of disadvantaged ethnic and racial groups. At the other end of the scale, elites have perpetuated their position through a variety of mechanisms, including in the realm of social relations. One example is the high propensity of people to choose marital partners with the same education (Figure 5).

FIGURE 4.
Wages of Afro-descendents and indigenous men and women in relation to “whites” (or Indo-Guyanese in Guyana)

Source: Authors’ calculations; see Chapter 4.

FIGURE 5.
Marital sorting and income inequality
Of particular importance for the design of public action is the historical heritage in the capacities of the state. At the end of the 20th century, most Latin American states still conformed most closely to a model of patronage and clientelism that was embedded within a broader pattern of unequal societal relations, albeit with islands of high levels of technical competency. This pattern is associated with high degrees of inequality of influence, with disproportionate influence over the state by wealthy individuals or corporations while poorer groups typically interact with the state through vertical relations of patronage, or are excluded. Few states have effected the transition to programmatic parties and autonomous bureaucracies that was a feature of institutional change in much of Europe and North America. This is further reflected in the relatively weak capacity of Latin American states to deliver key public goods (especially macroeconomic stability, safe property rights, and citizenship) and a broad-based provisioning of services financed by taxes. Such failures in the provisioning of public goods and services are almost always disequalizing.

But a “break with history” is possible...

While this report emphasizes the influence of history and its contemporary reflection in institutional structures, it is not deterministic. Economic, political, and social analyses indicate the potential for change, and of political agency as a source of change, whether with regard to experiences within Latin America or comparisons with other societies. The speed of potential change varies across dimensions of inequality. It is intrinsically slow for education and, in part as a consequence, is also likely to be slow for overall...
income inequality. However, change can be relatively fast in terms of patterns of service provision, for specific parts of the income distribution (including among the poorest), and, under some conditions, in reducing inequalities of power. In addition, precisely because change takes time, concerted, early action is of great importance. A range of economic policy levers that are key to making a difference are outlined below, followed by consideration of the underlying political and social changes that will be required to support and sustain shifts in economic policy.

...through a range of economic policy levers.

Guidance for economic policy choice is provided by an analysis of the correlates of high inequality in the region, drawing both on international comparisons and diagnoses within countries. This analysis indicates that there is no single economic reason for excess inequality in Latin America. In economic terms, high levels of inequality are reproduced via interactions among several influences: moderate levels of inequalities in education (exacerbated by low and unequal educational quality); high market returns on education, especially college education; high levels of concentration of land and other productive assets; unequal access to critical markets (particularly financial and labor markets); and weak redistribution through the state. An economic strategy to reduce inequality needs to reflect these interactions. This in particular implies complementary actions in the following three areas: asset inequalities; the institutions that shape market access and returns; and use of the redistributive potential of the state. In some areas, policies to reduce inequality will support higher aggregate growth and even bring gains to all (or almost all). In other areas there will be tradeoffs, if not in aggregate growth then in reducing the privileges of those who currently benefit from inequality.

Broadening asset ownership: redistribution with growth

Democratizing education. Education is the most important productive asset most people will ever own. Apart from its economic effects, education is intimately linked to sociocultural and political inequalities. More equal education has potentially multiple influences on more equal outcomes and practices. In addition, it has two important advantages as a strategy: its distribution can be improved without the need to redistribute it away from someone else, and improvements in its distribution (which go hand-in-hand with increases in overall mean levels of education) are good for efficiency and growth.

Although the importance of education is now largely accepted by governments, implementation has not always been easy. In particular, the recent “massification” of basic education appears to be associated with new forms of inequality, in particular those associated with high variance in quality (see Figure 6), and with the fact that elites have the financial means to opt out of public systems.

FIGURE 6.
Distribution of mathematics and reading test scores, 15 year-olds in Brazil, Mexico, and OECD countries
Despite widespread experimentation, the magic bullet for raising educational quality has yet to be found. Furthermore, the key divide in terms of market returns is now the attainment of a college education. The increased value of higher education is driven by the skill-biased nature of technological change. But higher education remains largely the preserve of the children of the rich, with, as noted above, increases in inequality of enrollment in the past decade. In this context, an important element of a deeper education strategy could be the introduction of a civic drive, involving both the public and the business sector, to achieve a significant jump in both coverage and quality across the public school system at both primary and, in particular, secondary levels.

While there is no specific institutional blueprint for this strategy, successful actions are likely to involve mechanisms to increase the accountability of teachers and schools. These may be take the form of incentives for results (as is the case with Chile’s school contests and vouchers), special funds to supplement school budgets (as with Brazil’s FUNDEF program), or greater participation by local communities (as with El Salvador’s EDUCO approach). Such supply-side measures can be complemented by demand-side incentives that encourage kids to stay in school, as with Oportunidades (previously Progresa) in Mexico and Bolsa Escola in Brazil. (These latter measures can also serve the purpose of broadening social protection systems to poorer groups, as discussed further below.) All these experiments will have to be accompanied by ongoing evaluation of which approaches have the highest impact on student learning, in order to guarantee an efficient use of education spending.
For tertiary education, the challenge is to increase the access of bright children from poor backgrounds. Part of the problem in this regard is low quality and lack of coverage at lower levels. However, there is also potential for tackling the credit and informational constraints that limit entry. Measures such as sharply expanding the availability of educational credit, targeted scholarships for students from poorest families, state exams, accreditation programs, and labor observatories would greatly facilitate the required expansion of tertiary education. In this context, higher cost recovery in public universities and performance-based budget support would be important complements.

In addition to such general measures, there is a need for action to deal with the exclusionary structures faced by historically subordinate groups. A case can be made for investing in the curricula and teachers to provide multicultural and multiracial education, including bilingual education in areas with a strong presence of indigenous people. At the tertiary level, there is a prima facie case for use of affirmative action programs, especially for such excluded groups such as Afro-descendants in Brazil. However, such programs can lead to backlash and stigmatization and need to be carefully discussed, designed, and monitored.

Although a push toward equalizing access to quality education is critical for the distribution of income in the long run, the effects of education will take time. Since children who benefit from better schooling now will enter the labor market in the future, it will take decades to transform the educational composition of the entire labor force. During the transition, tertiary expansion could even lead to increased inequality, if the high returns to tertiary level graduates persist. There is also uncertainty over what will happen to the pattern of returns on education over the long term. A comparison between Brazil and the United States (see Chapter 6 and Table 6.3) found that differences in the pattern of education in the labor force “explained” about a third of the difference in income inequality, with another third explained by differences in the pattern of returns on education. However, a comparison between Chile and Italy found that differences in the structure of income were related more to differences in returns than to differences in the distribution of years of education. While these comparisons are only statistical exercises, they suggest that many factors influence the effect of education on income inequality.

The distribution of land and the security of property rights. Unequal distribution of land was historically a major source of both high levels of economic inequality and unequal political influence. With the enormous rise in urbanization and, in most countries, the disappearance of landed elites as a major source of political influence, rural landholdings are less important than in the past. However, rural land distribution still matters for an important, and relatively poor, minority in middle income countries, as well as for larger groups in the poorer countries in the region.

Latin America can be categorized as a region of extensive but incomplete land reform. Some past efforts succeeded in breaking up haciendas, but almost all failed to transform the position of poor peasants, because of shortcomings in design and the political context. When property rights became more insecure, landed elites often used other means to preserve their economic position, such as evicting tenants and securing subsidies on
capital or outputs. In addition, newly reformed areas were not supported by the infrastructure and other economic services necessary to generate a vibrant small-scale sector.

There is scope for rural land reform, but its nature and degree depend on the country. Where property rights for land are generally recognized and legitimate (as in most of the Southern Cone, for example), coercive action would be undesirable and counterproductive. However, there are many countries that have regions of land settlement where rights are ill-defined or illegitimate. In those cases, redistribution can potentially go hand-in-hand with a strengthening of property rights if the process is well-managed. This is likely to involve a range of techniques, from repossession and redistribution of land owned by druglords to the changed use of land that is still in public hands. In Brazil and Colombia, processes of state purchase for redistribution and experiments in community and market-based land reform are ongoing. In terms of post-reform designs, indigenous groups sometimes prefer to maintain traditional collective forms of land management, with the issue being how to provide adequate access to credit and services in the context of these property and governance structures. In all areas, it is essential to complement small-scale production with infrastructure and other support services, to integrate new schemes within territorial strategies for development, and to provide the legal underpinnings for rental markets.

Issues of urban land and housing have increased in importance with urbanization. An important divide is that of the security of property rights, since poorer groups are more likely to suffer from lack of legal title. Experience from Peru indicates that it is possible to run large-scale titling programs, an approach that needs to be complemented by measures to make housing markets work better, provide local infrastructure, and ensure that local governments are responsive to poor urban dwellers.

In both rural and urban areas, strengthening property taxes is an important area for public action. Latin America’s property taxes are low by international standards, even after controlling for incomes. Increased property taxation can both be a valuable source of revenue for local governments and provide incentives for more efficient land use.

**Broadening the provision of infrastructure.** Unequal access to public infrastructure is another important determinant of inequality dynamics. Recent cross-country work indicates that the more infrastructure a country has in place (including electric power, telecommunications, roads, and railways), the less unequal it is. Evidence suggests that this relationship is causal, and that the effects can be large over the long term (Calderón and Chong 2003). The sharp reduction in investments in infrastructure during the 1980s and 1990s in many countries in Latin America (see Calderón, Easterly and Servén 2003) is thus cause for concern from the perspective of both growth and equity. This trend has in turn led to large and growing gap in terms of infrastructure between Latin America and both OECD and successful East Asian countries. The decline was driven by large declines in public spending on infrastructure, first during the debt crisis of the 1980s and then within a context of bullish expectations related to the potential of privatization in the
1990s. Although private provisioning did increase, it only fully compensated for public declines in the case of telecommunications.

Tackling inequalities in the future will require a judicious mix of public provisioning and privatization. The privatization process has become highly politically charged. In many areas, pure private provisioning is unlikely, especially in such areas as rural road networks and water supply. In these subsectors, public and private investments in infrastructure are complements, not substitutes. The issues here are analogous to the challenges of making any public service responsive to the needs of all citizens. In many areas, however, a case for privatization can still be made, including on grounds of equity.

Many public utilities have been part of clientelistic structures and have been both inequitable and inefficient. Privatization efforts can break through these barriers, but will only succeed if they are well designed and subject to strong, autonomous regulation. Evidence of past privatizations of utilities suggests that most tend to lead to more equal access and higher quality services, but price effects have varied from case to case depending on initial conditions and the quality of regulation. In addition, the process is key: in most cases, privatization processes have not been used to distribute ownership more broadly and, where transparency and competition have been weak, regressive wealth transfers and corruption have occurred. This is particularly the case in noncompetitive sectors, in which the establishment of sound regulatory structures alongside privatization is essential to achieving both efficient and equitable outcomes.

Developing deeper markets and more equitable institutions

Deeper markets. Promarket reforms are often accused of favoring the rich at the expense of the poor. While this tends to ignore the fact that most nonmarket institutions in Latin America were historically shaped to favor the rich, it is important to understand the distributional impacts of market reforms in light of their importance for the growth agenda. A survey of the literature finds no strong general pattern associated with the impact of structural reforms on inequality. On balance, market-based reforms have been associated with greater income inequality more often than not, but the effects are not large and often not statistically robust. The big picture is that inequality has been notably resilient to a range of policy experiments, from import-substituting industrialization to populist policies and market-oriented reforms.

More can be said when specific reforms are considered individually. Whenever fiscal reforms have led to price stabilization, the result has been a reduction of inequality. Furthermore, the effects of privatization on distribution have often been positive (see discussion above). However, many countries in the region experienced rising inequality in the wages of individual workers in the past decade or so, which appears to have been mediated by an opening up of trade and foreign direct investment (De Ferranti et al. 2003). Trade liberalization, in addition to the unequal distribution of education, has been associated with increased wage disparity because it has led to faster adoption of new techniques and production processes that are intensive in skilled labor. However, there is some evidence that this is a once-off effect, with a recent leveling off in wage inequalities
in the case of both Chile and Mexico, two of the most internationally integrated economies in the region.

The best response to such inequality-augmenting forces is not to avoid the use of markets, but to tackle the underlying sources of inequality. Doing so involves broadening and equalizing the asset base—notably in education and infrastructure—and reforming social protection systems to make them more inclusive. It is also important to extend and deepen the reach of markets. Part of the problem is that market access is very different for poorer households and informal sector workers than for the rich and established companies. Financial markets are of particular importance in this regard, both for improving equality of opportunities in productive investment and facilitating more equal access to assets such as land, housing, and education. Transparency, disclosure, good corporate governance, credit bureaus, and strong property rights for creditors and minority shareholders have proven to be important determinants of financial deepening, and thus of greater access to financial services. There are also a host of specific institutions, products, and collateral regulations that may increase access to credit by micro- and small-scale enterprises.

Inclusive and efficient labor markets. The labor market is the most important domain for income determination for most households. Labor market institutions can have a significant influence in this area, particularly with regard to the quality of work. Current labor market and social security institutions in Latin America (such as unions, minimum wage rules, and employment benefits) protect the interests of formal sector workers and largely exclude informal workers and most of the unemployed. In contrast with conditions in OECD countries, formal sector workers in Latin America seldom make up a majority of the working class, and are usually located in the middle or upper parts of the income distribution. In almost all countries, a majority of poor workers are employed (or self-employed) in the informal sector, where they are not protected by formal benefits, minimum wage rules, or unions. Organized workers sometimes effectively practice a form of “opportunity hoarding,” or protection of their privileges, that can limit the scope for equitable reforms. Examples include efforts to protect favored public sector pensions in Brazil and the resistance of some teachers’ unions to quality-enhancing reforms in basic education that could benefit all children.

There is a need to move towards a labor and social security framework that is both more inclusive and less distorting. Such a framework should seek, on the one hand, to extend basic labor rights and security protection to all workers while, on the other hand, increasing labor flexibility, especially in areas where groups have significant, entrenched privileges. This approach is consistent with an active role for unions within competitive environments.

Avoiding crises and regressive workouts from macroeconomic shocks. A notable finding of this report is the regressivity of financial crises. Crises are regressive because the wealthy and better informed move money out of their countries first, sometimes enjoying capital gains in terms of purchasing power at home. Crises are also regressive because of the fiscal costs of the resolution mechanisms that have been adopted to deal with recent
banking problems in Latin America. During the 1980s and 1990s, public transfers to large depositors and bank shareholders, undertaken as crisis-resolution mechanisms (that is, bailouts), were in the range of 13–55 percent of gross domestic product (GDP). These transfers dwarfed poverty-targeted programs and were financed by a combination of higher taxes and lower public benefits and services. Since the incidence of overall tax systems is generally proportional (or possibly mildly progressive) and the marginal incidence of service expansion in the 1990s was typically progressive, these transfers were strongly regressive. It is unlikely that such large regressive transfers to large debtors and depositors—and even shareholders on occasion—were actually needed to avoid the collapse of banking systems.

Policies to reduce the likelihood and severity of crises are thus a necessary part of an agenda to reduce inequality. Latin American economies have remained excessively vulnerable to reversals of capital flows due to a combination of moderate to high public debt levels, excessive reliance on foreign and dollar-linked debt, low export and tax ratios, weak prudential regulation and supervision, and procyclical fiscal policies. The best course for macroeconomic policy in the region, from the point of view of reducing poverty and inequality, would most likely be one of increasing public sector savings and adopting “super-prudent” regulatory and supervisory practices in the financial system during good economic times, while at the same time increasing the level of openness of the economies, developing long-term domestic capital markets, improving debt management, and increasing tax ratios. Since the latter objectives will take time to achieve, it would also be desirable to generate cyclically adjusted public sector surpluses for a period of time in countries with high debt burdens, in order to reduce vulnerability to shocks and the likelihood of crisis.

A key element is the establishment of rules and institutions that would allow for the operation of countercyclical fiscal policies, by mitigating the political economy and informational problems that lay behind procyclical fiscal policies. In turn, this would overcome the procyclicality of social expenditures and avoid their reduction when they are most needed.

Pursuit of fiscal prudence on equity grounds may seem surprising to those who have long equated propoor governance with budget deficits. This view is consistent with the need for substantial amounts of public action—and public spending—to reduce poverty, inequality, and various sources of inefficiency across Latin America. However, financing for these expenditures should not be generated through larger fiscal deficits because doing so would increase the likelihood of inflation and balance-of-payment and banking crises, both of which have highly regressive resolutions. Instead, financing should come from other sources, including higher taxes and the redirection of existing spending, some of which is almost certainly wasteful and much of which is regressive.

Finally, since crises can never be avoided entirely, it is critical to have in place ex ante efficient and equitable crisis resolution mechanisms (especially with respect to potential financial problems) in order to avoid the wasteful and highly regressive transfers that have characterized the management of most banking crises in the past. These
mechanisms should be complemented by safety nets that automatically kick in to protect the poor when crises do hit (De Ferranti and others 2000).

Using the redistributive power of the state

*Raising taxes for an effective state.* A healthy tax system is a vital ingredient for an effective state. Currently, most countries in Latin America have low tax-to-GDP ratios given their level of development (see Figure 7). Some, notably Uruguay and to a lesser extent Chile and Costa Rica, have moderately high taxes and significant and somewhat redistributive public provisioning. Brazil stands out as a case in which a relatively high tax effort coincides with highly unequal public provisioning. While methodological problems bedevil incidence analysis and little can be stated with confidence, a reasonable working assumption is that, given very low collections of personal income and property taxes, most tax regimes in the region are proportional or only mildly progressive or regressive. This situation implies that the poor, middle class, and rich pay roughly the same proportion of their incomes in taxes.

FIGURE 7.
Tax revenues in relation to GDP per capita

What kinds of changes in tax policy are desirable will depend on the initial position of a country. In poorer countries, often the greatest priority lies in developing a reasonably well-functioning tax administration in order to expand the resources available to the state. Where this has not yet been done, there is a case to be made for moving indirect tax systems in the direction of applying broad-based value-added taxes (VATs) that can combine strong revenue-generating capacities with reasonable levels of efficiency. In order to achieve modest levels of progressivity, a new VAT system should have a simple rate structure, possibly consisting of a few product exemptions (largely for food), a basic
rate for most other products, and a higher rate for luxury items. Excise taxes may be imposed on goods that carry high negative externalities, such as tobacco, alcohol, and motor vehicles. However, some excise taxes (such as those placed on kerosene and tobacco) are typically quite regressive, implying the need to balance equity with other objectives.

There is also an important long-term role for personal income and property taxes to play, since tax collections are very low in most Latin American countries in comparison to the OECD. Income tax structures need not have many rates to be progressive. Efforts to tax the rich a little more should focus largely on improving enforcement and closing loopholes and exemptions in order to reduce tax avoidance and evasion. This is also true for property taxes, which exist in many countries but generally raise almost no revenue, and which are critically important to financing local public services. Reform efforts should not focus on raising the rates of these taxes, but on eliminating exemptions and devising disclosure mechanisms to improve collection and enforcement.

Providing services for all. Given the limits on redistribution from taxes, especially in the short term, the spending side of the equation is of fundamental importance. Evidence confirms what historical and political analyses often suggest: most public services reach the rich before they reach the poor. The average incidence of a large number of services remains regressive in most countries in Latin America. The good news, however, is that during the 1990s, the expansion of access to basic education and health was quite progressive. To a large extent, this is simply because expansions automatically brought in poorer people, since the rich already had access to such services. In many cases, however, this shift also resulted from deliberate, well-meaning, effective public action.

Given the weight of these basic services, the overall increase in social spending that took place in almost every country in the region in the 1990s (due to both increases in the ratio of social expenditures to GDP and growth) was in general progressive, in spite of the fact that an important chunk went to pension subsidies, which are in general highly regressive. Nonetheless, problems remain. There are still very large differences across programs with regard to their distributional impact. As noted above, the subsidized expansion of tertiary education enrollments has been disequalizing. This also seems to be true for any service for which the initial access rate is low. Figure 8 shows the average and marginal incidence of health programs, and indicates how marginal incidence is more progressive for those programs that have initially high access rates. In infrastructure sectors with low coverage (such as telecommunications in most of the region and electricity in the poorest countries), expansions have also tended to favor richer groups first.
Latin American countries also have significant experience in the use of targeted delivery mechanisms. Some programs are highly successful in targeting the poor, but they tend to remain small. Indeed, there appears to be a tradeoff between effective targeting and the degree of coverage of programs among the poor (see Figure 9 for examples from Brazil). Such a tradeoff may be partly due to administrative difficulties, but is also likely to be an outcome of interactions with political and economic institutions. Progressive policies generally need to be based on broad coalitions of support. Thus, targeted programs probably should be linked or “packaged” together with universal access programs that also benefit the middle class. The use of transfers to the poor that are conditional on children participating in general schooling and health systems is a good example (see below).

Source: Ajwad and Wodon 2002.
Finally, the historical pattern of social spending has been far from optimal in relation to the business cycle. Social spending per poor person is in fact highly procyclical almost everywhere in Latin America, which means that resources are scarce exactly when they are most needed. This is not a pattern unique to this region, and it is easy to understand the political processes that may lead to this outcome. Yet the fact remains that it has high costs for overall economic activity, and especially for the poor. Hence the importance of adopting fiscal rules and institutions that would help overcome the procyclicality of fiscal policies in general, and of propoor social expenditures in particular.

Reforming and extending the truncated welfare state. Transfers have an important role to play in all societies in helping households manage risks—for example those related to health, unemployment, and the failure of crops—and in redistributing resources to the poor. The case for redistributive transfers is heightened by the fact that the transition to more equal societies through broadening asset ownership is likely to take time. Yet Latin America’s historical evolution has led to the formation of what might be described as “truncated” welfare states that provide benefits only to formal workers. Such states tend to be highly unequal; for example, Mexican social security systems for public and private workers result in some of the most unequal programs in the country.

Many countries have been reforming their welfare states to make them more efficient and less burdensome. The concern here is to design instruments that make states more inclusive, while simultaneously minimizing efficiency costs. This is likely to involve a range of policies, depending on the area of vulnerability. For example, reaching poor

Source: World Bank (2000e); see chapter 9.
senior citizens is best achieved through basic pensions financed by general revenues, as illustrated by Brazil’s pension system for farmers. Dealing with unemployment risks is likely to involve a range of employment-related transfers—including unemployment insurance systems that already exist—and workfare programs targeted to poor, informal sector workers, such as Trabajar in Argentina (which was redesigned as Jefas y Jefes de Hogar during the recent economic crisis), A Trabajar in Peru and Manos a la Obra in Colombia.

Particularly promising are cash transfer programs that are targeted toward certain groups on the basis of need and delivered only when recipients have taken a set of actions, which usually consist of investments in their own human capital. Evidence underscores the capacity of some of these programs (such as Oportunidades in Mexico, Bolsa Escola in Brazil, and the Red de Protección Social in Nicaragua) to reach the poor in an efficient manner and to have positive effects on their accumulation of human capital. In addition to effecting redistributive transfers, such programs also have potential as risk management instruments, and could become an effective part of a comprehensive and equitable social protection system. As mentioned above, coupling conditional cash transfers to the poor with overall expansions of basic education and health services makes eminent sense both from the point of view of efficiency (since otherwise the poor may not demand these services) and the political sustainability of targeted programs.

**Policy reform must be underpinned by political and social change**

The economic policies described above provide a potentially potent set of instruments to make Latin America societies substantially more equal, especially over the long run. But neither the design of policy nor its implementation is a purely technocratic affair. Analysis of history and current social and political conditions shows that redistributive and efficient economic policies are only likely to be chosen and effectively implemented if underpinned by supportive political and social conditions. To varying degrees most Latin American societies do not have such conditions today. Public action needs to foster shifts to a new political equilibrium.

**From clientelistic and weak to effective and redistributive states**

History bequeathed Latin America with unequal social relations and weak states, in degrees that vary across the region. This has been a fundamental source of the characteristic mix of underprovisioning of the public goods of macro stability, property rights, and citizenship, as well as low levels of provisioning of broad-based services. Democratization was probably necessary for transformation, but has not been sufficient. Clientelistic relationships tend to continue under democratic auspices, especially when associated with unequal cultures across groups. This pattern is by no means unique to Latin America: the political machines of major U.S. cities also persisted for a significant part of the 20th century.
Both international and Latin American experiences underscore the potential for change. This is most likely to occur when there are both shifts in the opportunities for political influence (including via electoral competition) and strengthening of the capacities of poorer groups to articulate their interests and organize for effective action. These processes may take various forms. In the long run, frequently maligned political parties have a crucial role to play, provided they are formed along programmatic or policy lines rather than on a vertical, patronage-oriented basis. There are also important complementary relationships between programmatic demands and the development of autonomous bureaucracies. Chile is the best example in the region of a case in which the combination of programmatic parties and bureaucratic competency helped support important shifts to a more effective and redistributive state following the transition to democracy—with the result that progressive consequences flowed from the improved provisioning of key public goods and both broad-based and targeted services. Other national cases, including Brazil over the past decade, appear to be moving along this path.

Where programmatic parties are absent, change is often effected by outsiders, generally in the form of political entrepreneurs or movements that can be catalysts for breaking with history. However, such outsider-driven changes are only likely to be sustainable if they are embedded in formal institutions, especially those that create the capacity of lower and middle groups to articulate and organize for an effective, redistributive state. Important complements to—but not substitutes for—change from within or outside the prevailing system include measures to increase transparency, promote public debate, and strengthen public administrative capacities. These aspects both sustain societal pressure and increase the capacity for developing and maintaining a responsive government.

The subnational state has become an increasingly important arena of action for political change and economic policy, owing to the combination of political decentralization (including the introduction of elections for mayors) and devolution of responsibilities. In this context, a number of cases of major changes in performance of the state have occurred in just a few years, notably in Bogotá, Colombia and Porto Alegre, Brazil. These cases show signs of a real shift toward a new political equilibrium, with large, redistributive improvements of services, reductions in patronage and corruption, and increases in tax efforts.

**Confronting ethnic and racial divisions**

History has also left some countries in Latin America with major divides between ethnic and racial groups, in particular indigenous and Afro-descended groups. (Although gender differences are still present, tangible progress appears to have been made in this area.) While this report could not deal with these issues in depth, tackling group-based divisions is clearly an important part of the overall agenda of reducing inequality in the region. As with the transition to democracy, most countries have made formal moves in this direction, for example by recognizing multiculturalism in national constitutions.
The real issues now lie in changing the social dynamics that perpetuate such group-based inequalities. One area for action, noted above, is bilingual and multicultural education. There are also rising demands in a range of other areas, including land rights and judicial and health practices. In the recent past, these demands have been forcefully articulated by indigenous movements, especially in the Andes, Mexico, and Central America. However, in many countries there is a related but distinct agenda around Afro-descended groups, as evidenced by growing public recognition of the issue in Brazil. In many cases movements representing indigenous and Afro-descended groups have an “outsider” quality. A challenge for the coming decade and beyond will be their inclusion within core political and social processes.

**Alliances, open-minded elites, and economic dynamism**

Latin American societies have the economic policy instruments to make, over time, major changes in their embedded patterns of inequality. Sound choices and the effective execution of these policies will only occur when they are associated with inclusive political and social structures, a process that may first require a shift in the political equilibrium. That this can happen at all is illustrated by developments both within and outside the region. The forging of alliances between poorer and middle groups, and with progressive elements of elites, will be essential. A key consequence of such alliances will be the equalizing of economic and political opportunity, including moving toward societies with more open elite structures. History suggests that this will be good for economic and societal dynamism, and certainly for equity.
Notes

1 General statements about Latin America throughout this report refer to continental Latin America, excluding Belize, French Guyana, and the Surinam. Unfortunately, the authors are unable to make general statements regarding the Caribbean, since household surveys were available for only for 3 of the 15 Caribbean countries: the Dominican Republic, Jamaica, and Trinidad and Tobago. However, results are reported for these three countries, and they are included in the regional averages presented. However, there would be no statistical justification for making inferences for the Caribbean subregion as a whole, on the basis of a primary data analysis for those three nations.

2 Although higher volatility in income and consumption may overstate the degree of excess inequality that exists in Latin America (in comparison to other regions), the underreporting of capital income in household surveys, particularly in top deciles, may tend to understate it. For a detailed discussion of such measurement problems, see Chapter 2.

3 There is, of course, wide variation within the region, with Chile probably closest to such a model.

4 Unequal social relations can exacerbate these influences—as in the example of marital sorting, which can cause household inequality to magnify individual inequality—and can also be sources of economic differences, for example by playing a key role in the processes that determine educational levels and market returns.

5 Nonetheless, rising wage inequality did not necessarily translate into rising household income inequality, for many reasons. For example, the increased participation of women in the labor marker at low wages can increase wage inequality without increasing household income inequality.