# Democracy and Income Inequality:
# Latin America during the ‘Left Decade’ of the 2000s

by

Giovanni Andrea Cornia and Bruno Martorano, University of Florence

## 1. Introduction

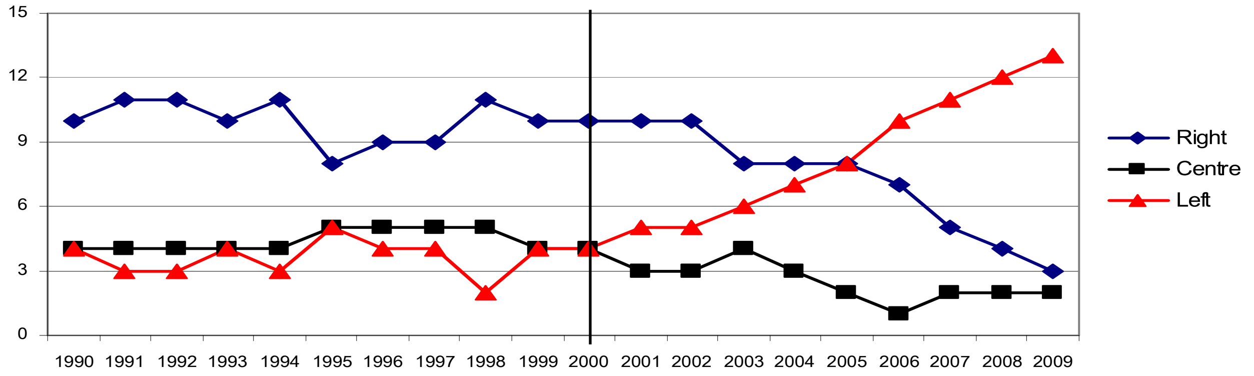
Starting from the early 2000s, Latin America has witnessed profound economic and political changes. While during the 1990s the region experienced slow growth followed by the ‘half lost decade’ of 1998-2002, between 2003 and 2008 it recorded a GDP growth of 5.5 percent a year, lower only to that registered over 1967-74. Secondly, contrary to the growing polarization observed during the 1980s and 1990s, between 2002 and 2008 income inequality declined in almost all the region. Thirdly, the last decade recorded a consolidation of democracy and a shift towards the election of Left-of-Centre (LOC) governments (Panizza 2005)[1]. This note explores the interaction between these trends, paying particular attention to the factors which help explaining the recent inequality decline.

## 2. The ‘Left Decade’ of Latin America

Traditionally, Latin America has been a symbol of authoritarian politics, unequal distribution of assets and income, and limited redistribution by the state. However, during the last twenty years, the political landscape has gradually changed as a result of a steady drive towards democratization, its consolidation, and a shift in political orientation towards LOC regimes. As documented by Latinobarometro[2], such shift was to a large extent due to rising frustration with the poor results of the Washington Consensus policies implemented in the 1980s and 1990s.

The beginning of the leftward political shift can be traced to the election in 1990 of Patricio Alwyn in Chile, but it gradually intensified with the election of Lula in Brazil in 1998 and accelerated sharply since then (Figure 1). As noted by Panizza (2005), the LOC regimes differ substantially among each other. Some are ‘social-democratic’ in nature, as in is the case of Chile’s *Partido Socialista*, Uruguay’s *Frente Amplio* and Brazil’s *Partido dos Trabalhadores*. These parties have their roots in organizations of the working class, but have evolved into broad coalitions comprising

**Figure 1.** Trend in the number of left, right and centre governments in 18 Latin American countries, 1990 - 2009




Source: authors’ compilation on Keefer (2006) and data reported by Wikipedia for 2006-9. For more details on the assignment of governments to left, right ands centre see the footnote to Figure 5 in Cornia and Martorano (2009).

[1] The LOC countries (those ruled for at least four of the six years spanning 2002-2007 by left-of centre regimes) are Argentina, Brazil, Chile, Costarica, Ecuador, Panama, Uruguay and Venezuela. The NO-LOC countries are Bolivia, Colombia, Dominican Republic, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Paraguay and Peru.

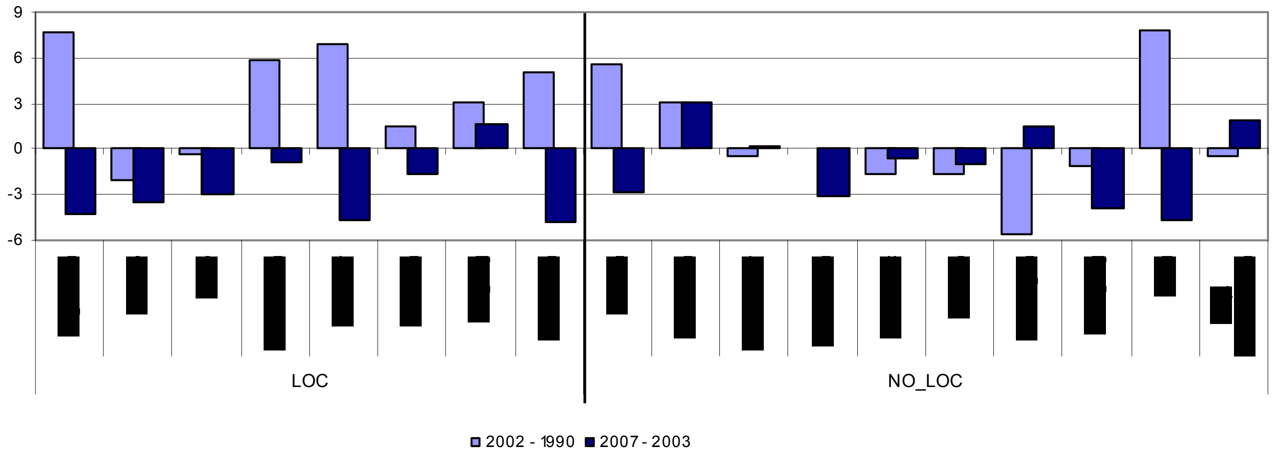
[2] Corporación Latinobarómetro is a non-profit NGO based in Santiago, Chile (http://www.latinobarometro.org).

sectors of business and the middle classes, the urban and rural poor, the unemployed and the informal sector workers. In contrast, a second group of LOC countries (such as Argentina and Ecuador) developed left-nationalist platforms, while Venezuela, Bolivia and Nicaragua elected radical-populist regimes aiming also at redistributing assets. Matters of social justice and economic development are at the core of the LOC parties' identity. The economic model they adopted is eclectic: it incorporates into its paradigm some liberal objectives such as low budget deficit and inflation. Likewise, measures to reduce the glaring wealth concentration existing in the region have seldom made their way on the LOC governments' agenda, with the exception of Bolivia and Venezuela. At the same time, the concern for poverty and inequality of the new policy paradigm, the recognition of market failures, implications of low taxation for the supply of public goods, importance assigned to strengthening state institutions, and dangers of external indebtedness are in sharp contrast with the neo-liberal emphasis on shrinking the state and the self-sustained role of the markets. All together, the new LOC model resembles more the 'Redistribution with Growth' approach (Chenery et al. 1978) than to the more radical 'Redistribution before Growth'.

## 3. Trends in the Distribution of Income

Historically, the Gini coefficients in Latin America region were among the highest in the world. This acute income polarization was rooted in a very unequal distribution of land, industrial assets and educational opportunities that benefited a tiny agrarian, mining and commercial oligarchy. During the 'lost decade' of the 1980s, inequality in Latin America was affected by the 1982-4 world recession, the debt crisis, and the recessionary adjustment policies introduced to respond to them. Despite the return to a moderate growth, income inequality increased in the 1990s, and especially during the "half lost decade" of 1998-2002. In contrast, during the 2000s income inequality fell in most of the region (Figure 2). Indeed, over 2003-2007 inequality declined in seven of the eight LOC countries and in seven of the ten NO-LOC regime. While the average decline in the Gini coefficient was of 3 points, in countries ruled by LOC governments, the drop was more pronounced. Lustig (2009) comes to similar conclusions, noting further that the inequality decline was greater among the 'populist' than the 'social-democratic' regimes.

**Figure 2.** Changes in the Gini coefficients of the distribution of household income per capita, between 1990 and 2002 (light blue bars), and between 2003 to and 2007 (dark blue bars) in LOC vs NON LOC countries.




Source: authors' elaboration on SEDLAC data and other sources when SEDLAC data were missing.

## 4. What factors can possibly explain the recent decline in income inequality in the region?

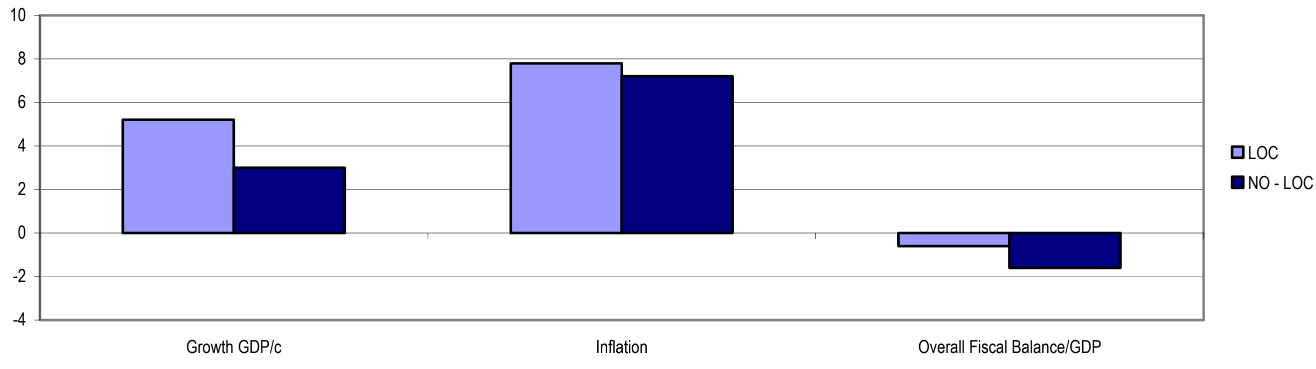
Four groups of factors are discussed hereafter: a favorable external environment, the rapid regional growth of GDP, the improvements in human capital formation and its distribution, and the changes in economic and social policies part of the 'new LOC model'.

**4.1 A Favorable International Environment**
Since the beginning of the new century, the rapid growth of the Asian countries exerted a favorable impact on the export and economic performance of Latin America. As a result, in 2007 the regional terms of trade index exceeded by 33 percent its average for the 1990s. What was the impact of these changes on income inequality? A partial equilibrium analysis suggests that, given the high concentration of the ownership of the land and mines, the gains in terms of trade generated a disequalizing effect on the distribution of income. This conclusions holds even when considering the impact of rising international commodity prices on the tax and non tax revenue and the possibility of the state of redistributing 'rents' to the poor. Indeed, the revenue effect was comparatively limited and confined to eight countries. Overall, the impact of gains in terms of trade on income inequality does not seem sufficiently general and particularly strong.

Migrant remittances also grew strongly during the 2000s, to reach 2.3 percent of the regional GDP in 2007 (CEPAL 2007b). This increase benefitted in particular the Central American and Caribbean countries, Mexico and Ecuador. For these countries, one may be tempted to establish a causal link between rising remittances and falling inequality. Yet, the literature suggests that their short and medium term effect tends to be disequalizing. Indeed, in most developing countries only middle-class people are able to finance the high costs of illegal migration. Equalizing effects may be observed only over long term when the creation of migrant networks reduces migration costs, thus making it accessible also to unskilled workers. In all, one would not expect that remittances plaid a central role in reducing income inequality, either directly or indirectly. Between 2002 and 2007 there were also capital inflow amounting to 2.4 percent of the region's GDP (Ocampo 2008). Yet, the availability of external finance benefitted mainly large capital- and skill-intensive companies and banks while it did not ease the problems of access to credit by labor-intensive small and medium enterprises, inducing therefore adverse distributional effects.

**4.2 Business Cycle Effects**
Growth of GDP/c doubled between the 1990s and 2003-7 in South America and rose by half a point in Central America, with LOC countries performing better than the NO-LOC ones (Figure 3). A return to growth may induce a decline in inequality, as in developing countries an increase in GDP/c improves labor absorption and, under certain conditions, the wage rate. Yet, such effect is far from automatic, as it depends on whether the growth pattern is pro-poor, neutral or immiserizing. Overall, the evidence for the 2002-2007 period confirms that the vigorous recovery of those years, generated an equalizing effect on the distribution of wages in both LOC and No-LOC countries.

**Figure 3**. 2007 macroeconomic and 2003-7 growth performance of LOC versus NO-LOC regimes




Source: Author's elaboration on ECLAC's Badecon for the growth of GDP/c and fiscal balance/GDP, and IMF's World Economic Outlook 2008 for inflation. Notes: The inflation rate of LOC countries would be 6.6 % (i.e. lower than the NO-LOC countries' average) if Venezuela (which recorded an average inflation of 21% during this period) is excluded.

#### 4.3. An Improvement in the Distribution of Educational Achievements

A third factor which could explain the recent decline of inequality in the region was the rise in enrolment rates in secondary education recorded since the mid 1990s, the subsequent reduction in enrolment inequality, the increase in the average number of years of education of the work force, and a reduction of the inequality of their distribution. All in all, Latin America made substantial inroads in the field of human capital formation and in reducing many dimensions of inequality in education. In this regard, an IPEA study (cited in CEPAL 2006) concluded that two thirds of the inequality decline recorded in Brazil between 2000 and 2006 was due to a fall in wage inequality due to a drop in educational inequality among workers and in the wage premium by education level.

#### 4.4. The New Left Paradigm

The new economic paradigm and social contract emerging in the region definitely contributed to a reduction of inequality. The macroeconomic, labor market, and redistributive policies part of the new paradigm are discussed hereafter.

**Macroeconomic policies.** The measures introduced were broadly inspired by the 'pro-poor macroeconomics' paradigm. A decline in the budget deficit was targeted in all countries, despite an increase in public expenditure. As a result, in 2006 and 2007 the central government budget for the region as a whole was in equilibrium, suggesting a shift towards a countercyclical fiscal management. A strong version of such policy was followed in Chile, Peru and Argentina. A weak version, consisting in balancing the budget or achieving a small surplus, while spending the extra revenue collected during the upturn was followed in the other countries. Tax policy aimed at raising the tax and non-tax revenue/GDP ratio which, for the region as a whole, rose from 15 to 20.2 percent of GDP. This constitutes a major achievement, as inability to raise taxes was a key factor in the debt accumulation of the 1970s, debt crisis of the 1980s, and instability of the 1990s. The increase resulted from a widespread reduction in excises and tariffs, a rise in indirect taxes and income tax, and stagnation of wealth taxes and social security contributions (Table 1).

**Table 1.** Tax revenue and non-tax revenue/GDP ratio of the central government in 1990, 2002 and 2007.

| Tax revenue/GDP | | | Non-tax revenue/GDP | | | | Changes over 2002-7 (% points of GDP) | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 1990 | 2002 | 2007 | 1990 | 2002 | 2007 | Country Group | Trade taxes | Excises +other ind tax | VAT | Direct Taxes | Social Security |
| 17.5 | 19.2 | 23.7 | 5.4 | 5.3 | 5.9 | LOC | +0.38 | -0.23 | + 1.35 | + 2.56 | + 0.45 |
| 9.9 | 14.2 | 16.1 | 2.8 | 2.5 | 3.4 | NO-LOC | - 0.20 | - 0.72 | + 1.19 | + 1.49 | + 0.13 |

Source: Authors' elaborations on CEPALSTAT database

With a steady decline in inflation rates, monetary policy was either accommodating, tolerating (with the exception of Brazil) low or negative real interest rates. Monetary policy aimed also at reducing the dollarization of the financial system, strengthening of Central Bank independence, and introducing capital controls to prevent the appreciation of the real exchange rate, as in the case of Argentina over 2002-8, Colombia in 2007 and Brazil in 2009.

With few exceptions, most LOC and some other countries opted for a managed floats aiming at preventing a real appreciation of the exchange rate. In 2006 and 2007, this policy approach came under pressure owing to large increases in export revenue, capital inflows and remittances, and several countries experienced a mild-to moderate real appreciation. Yet, without the huge accumulation of reserves and sterilization efforts, several countries would have shown stronger symptoms of Dutch Disease and accelerating inflation which would have generated an adverse growth and distributive impact. In turn, the free trade policies adopted in the past were not overturned. Yet, the NAFTA seems to have stalled, while regional trade integration and new trade agreements with industrialized and Asian countries were developed rapidly. LOC governments also attempted to reduce their dependence on foreign borrowing. Till 2009, short-term stabilization agreements with the IMF were generally not renewed, while Brazil and Argentina prepaid their outstanding debt to the IMF. As a result, Latin America's gross foreign debt/GDP ratio net of currency reserves fell from 33 to 8 percent.

**Income and labor market policies.** The LOC policy model explicitly addressed the problems inherited from the 1990s, i.e. unemployment, job informalization, and rising skill premium. Minimum wages were raised in a sizeable but far from excessive way (Table 2)[3]. In contrast average wages rose slowly. Such wage restraint may reflect the greater concern for creating jobs and the recognition that, unless backed by productivity gains, nominal wage raises may fuel inflation with scant effect on real wages. The emphasis on job creation is confirmed by the rapid decline in unemployment and fast rise of wage employment. Moreover, the wage premium declined due to a growing supply of educated workers and a shift in production towards the unskilled labor-intensive sector. Finally, several countries revived the collective institution for wage bargaining.

**Table 2**. Labour market trends for LOC and No-LOC countries in Latin America , 1990-2007

| | | **1990** | **2002** | **2007** |
|---|---|---|---|---|
| LOC countries | Unemployment rate (%) | 8.9 | 13.2 | 7.9 |
| | Share of informal employment | 40.5 | 38.9 | 38.1 |
| | Average wage index (2000=100) | 92.2 | 98.6 | 103.4 |
| | Minimum wage index | 86.1 | 100.4 | 138.6 |
| NO-LOC countries | Unemployed | 8.5 | 10.0 | 8.0* |
| | Share of informal employement | 48.5 | 53.7 | 49.2 |
| | Average wage index** (2000=100) | 79.5 | 102.2 | 102.0 |
| | Minimum wage index (2000=100) | 104.1 | 104.2 | 109.9 |

Source: Cornia and Martorano (2009).

**Redistributive policies**. Public social expenditure started rising already in the early-mid 1990s and continued growing in the early 2000s. Such rise generated positive redistributive effects, as shown by analyses of the incidence of social expenditure by income quintile for 18 countries over 1997-2003 (CEPAL 2007b, Gasparini et al 2007). During the last 15 years, the region experienced also a major strengthening of targeted social assistance programs (Barrientos and Santibanez 2009). This new emphasis entailed the development of large scale programs focusing on unconditional income transfers such as non-contributory pensions, conditional transfers such as most of those listed in Table 3, and integrated anti-poverty programs. These new transfers are well funded by the state, and cover a large share of the population at risk. Several studies document their favorable impact.

**Table 3**. Summary of some main social programs introduced in recent times in the region

| **Program (reference year)** | **Cost (GDP)** | **N. Beneficiaries** | **Monthly subsidy ($)** |
|---|---|---|---|
| Plan Jefas y Jefes (Argentina, 2002) | 0,80% | 1.85 millions workers | US$45 (2002)<br>US$ 150 (2007) |
| Bolsa Familia (Brazil, 2005) | 0.36% | 11.1 million families | 62 R$ for poor families<br>15 R$ for children; 30 R$ for youth |
| Oportunidades (México, 2006) | 0,40% | 5 million families<br>(18% of pop) | 12-74 $ depends on educ.level<br>17$ family health |

Source: Cornia and Martorano (2009)

Regression analysis (Cornia 2010, Table 9) allowed to decompose the effect of the various factors and policies reviewed above on the inequality decline recorded in the region between 2002 and 2008. Overall, the evidence shows that the biggest impact on income inequality was generated by

[3] An assessment of the impact of minimum wages in Latin America over 1997-2001 (Kristensen and Cunningham, 2006) suggests that their recent rise likely produced an equalizing effect.

(in descending order): improvements in educational enrolment and inequality over 1990-2007 which affected the skill premium; the choice of a competitive real exchange rate; the labor market and social expenditure policies; and the 'social democratic' and 'populist' dummies which measure the effect on inequality of other policies. The terms of trade gains and growth recovery also contributed to the decline in inequality over 2002-2007 but in a less important way, while migrant remittances, portfolio and FDI had no impact on it. These results contradict the conclusions of some commentators who argue that the recent decline in inequality is driven by favourable international conditions and not by policy changes.

**5. Distributive Impact of the Financial Crisis**

Unlike in the 1980s and 1990s, the region did not suffer a financial crisis because of the greater solidity of its financial sector following a reduction in foreign debt, accumulation of reserves and improved macro management. Yet, the region suffered a series of real economy shocks including a considerable decline in terms of trade and export volumes. The regional primary deficit worsened from + 1.4 to -1 percent of GDP between 2008 and 2009, while the regional growth rate of GDP dropped from 4.2 in 2008 to -1.7 in 2009, to recover to an estimated 4.3 percent in 2010.

How about the distributive impact of the global crisis? Data for 2008 show that income inequality continued decreasing in six countries while it remained constant in three. Nevertheless, inequality likely rose in 2009, though such increase was likely smaller than initially feared. Indeed, the regional output contraction was accompanied by a modest 0.8 percent increase in the regional unemployment rate. Also, the fall in world commodity prices reduced substantially inflation with the effect that real wages grew on average by 4.6 percent in 2009 as opposed to their stagnation in 2008. Finally, the targeted social spending programs introduced during the 2000s in South America and Mexico effectively moderated the consequences of the crisis (CEPAL, 2009).

**6. Conclusions: the Future of the New Left**

At this moment in early 2010, it is unclear whether the LOC regimes in the region are here to stay. The recent coup in Honduras, election of a centre-right president in Panama in July 2009 and Chile in January 2010 may signal that such trend has reached its zenith. At the same time, the recent re-election of LOC candidates in Brazil, Bolivia, Costa Rica and Uruguay suggests that progressive governments may be able to endure the problems entailed by the crisis and the resistance of powerful interest groups. Beyond the problems posed by the current crisis, the Latin American governments face formidable hurdles in deepening the reforms underway. First of all, the trend towards rising taxation and social expenditure needs to continue with the objective of building a comprehensive but lean welfare state. Secondly, the additional revenue needed for this objective will have to come from a diversification of the economy into new labor- and skill-intensive sectors, and a diversification of exports by industry and areas of destination. Thirdly, an intensification of the new policy model by LOC governments will have to overcome considerable political opposition. The main danger of the current crisis is that it may dig a gap between the responses expected from LOC governments and what they can actually do. This may undermine support for LOC governments, and push the region towards its traditional path of unequal development or towards more radical solutions, possibly overturning in this way the inequality gains of the recent past.

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