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ECONOMIC GROWTH AND INEQUALITY

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# Economic Growth and Inequality

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## Abstract

High levels of inequality and significant social mobility problems still exist in Latin America, despite recent improvements in the distribution of income. Beyond ethical implications, inequality has repercussions on macroeconomic, institutional and social variables. This policy brief analyzes some of the channels through which inequality affects these variables and offers public policy options that could foster improvements in the distribution of income and opportunities. These policy options could be discussed during the next Summit of the Americas as a topic for regional agreement, with the objective of uniting political and economic forces to reduce the high levels of inequality facing the region.

## Essentials

- The high levels of inequality in the region have negative repercussions on economic growth, the quality of institutions, and political and social stability.
- To achieve a reduction in income disparity and an increase in social mobility, concrete efforts are required to reduce the inequality of opportunity, in particular in the areas of education, health care, access to the financial system, and safety.
- Universalization of health-care services and education is essential, as are significant improvements in the provision of public goods linked to infrastructure.
- It is necessary to develop more progressive taxation systems to improve income distribution, redesigning those subsidies aimed at high-income individuals.

## Introduction

During the last few years, Latin America has made significant progress in the area of income distribution. With the exception of Colombia, where high levels of disparity persist, income distribution indicators have improved in Latin American countries. Thus, for example, according to figures from the Economic Commission for Latin America and the Caribbean (ECLAC), between 2003 and 2009 Brazil made the most progress in the region by reducing its Gini coefficient from 0.621 to 0.576. Peru follows, having reduced its Gini from 0.506 to 0.469 in the same period.

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**LATIN AMERICA CONTINUES TO BE THE MOST UNEQUAL REGION OF THE WORLD. SUCH INEQUALITY OCCURS IN A CONTEXT OF LOW SOCIAL MOBILITY IN WHICH POVERTY IS INTER-GENERATIONAL.**

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Notwithstanding this progress, Latin America continues to be the most unequal region in the world (see Figure 1). The problem is particularly serious when one considers that such inequality occurs in a context of low social mobility

in which poverty is inter-generational. Several studies, in particular those by academics such as Lykke Andersen, Jere Behrman, and Nathan Graue carried out in 2001, indicate that there is a very close relationship in the region between the educational level of parents and children. This suggests that the low levels of education that characterize the poor are perpetuated over time.

Advances in education are, of course, the main social mobility mechanism. There is evidence in Latin America of an inverse relationship between social mobility and disparity of income distribution, where high levels of inequality are associated with low levels of social mobility. There are, however, exceptions to this rule, such as in Chile and Argentina, countries that in 2001 were characterized by high social mobility and an elevated Gini coefficient (i.e. high income inequality).

Income disparity is generated through differences in opportunities and levels of effort. Differential access to services such as education, health care and public infrastructure is normally related to differences in income, gender, race and location (urban/rural). There are also factors linked to effort such as dedication to work and studies. A fundamental task of

the state should be to minimize the inequality of opportunities. In a study to be published in 2011, economist Francisco Ferreira shows that between 44 per cent and 61 per cent of income disparity in Latin American countries can be explained by the inequality of opportunities, with the greatest inequality of opportunities found in Guatemala (see Table 1).

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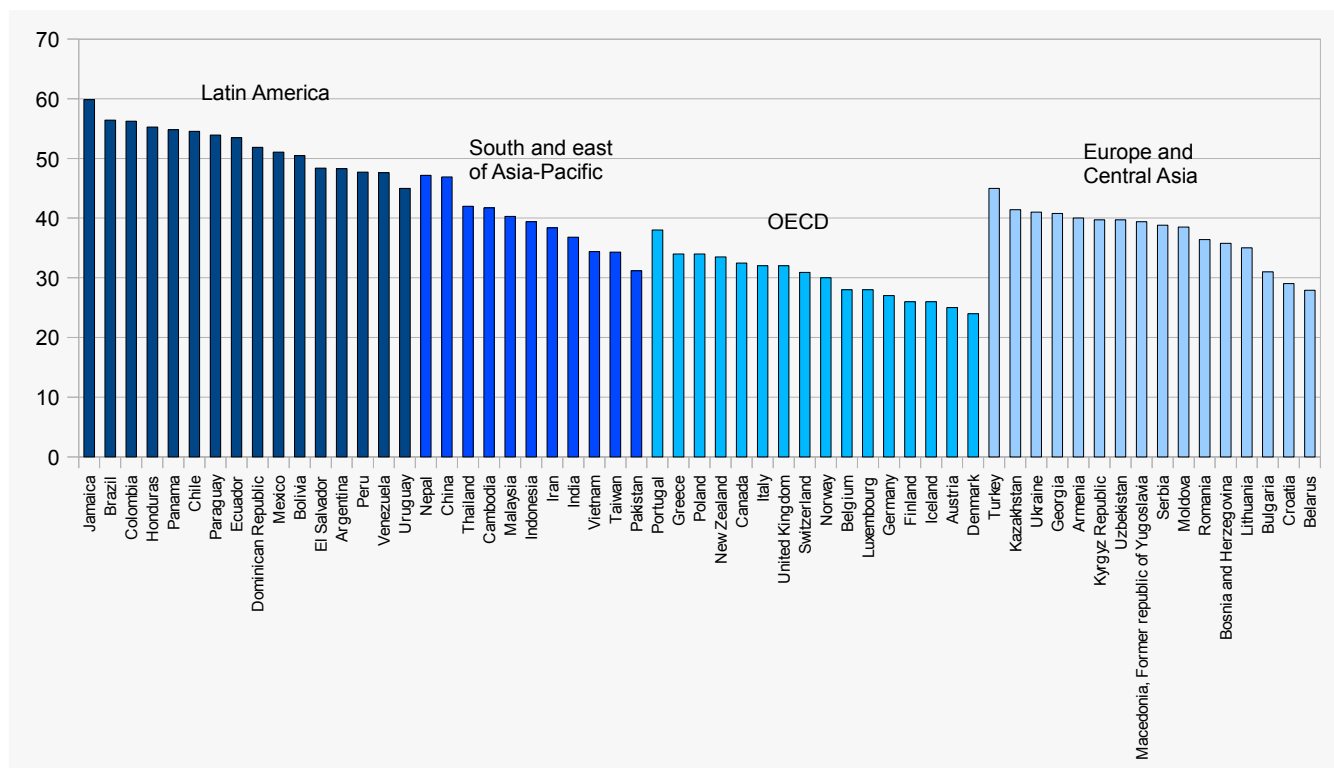
**DIFFERENTIAL ACCESS TO SERVICES SUCH AS EDUCATION, HEALTH CARE AND PUBLIC INFRASTRUCTURE IS NORMALLY RELATED TO DIFFERENCES IN INCOME, GENDER, RACE AND LOCATION.**

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## Impact of inequality in Latin America

Beyond the ethical implications of inequality that affect the core of a society and which are outside the scope of this policy brief, inequality has enormous economic and social implications. Its impacts on economic growth, the quality of institutions and on political and social stability are significant. An

**Figure 1**  
**Gini coefficient worldwide (decade of 2000)**



Source: United Nations University-World Institute for Development Economics Research (UNU-WIDER). The information corresponds to the last data reported by each country during the period 2000-2006.

academic article written by William Easterly in 2007 states that a high degree of income inequality leads to low economic growth and even to poor institutional quality and educational coverage. Robert Barro also reported in 2000 that high rates of inequality reduce growth in developing countries but increase it in developed economies. In 2010, Gustavo Marrero and Juan Rodríguez broke down the Gini indexes into two components and found that the component caused by inequality of opportunity is

associated with less growth, while the other component, more closely related to effort, is associated with greater growth. It is possible that very high levels of income disparity reflect high levels of inequality of opportunity, as occurs in Latin America, while at the other extreme, very low levels of income disparity may be associated with weak incentives for individual effort.

In this context, it is interesting to analyze the channels through

which inequality negatively affects macroeconomic, social and institutional variables. A primary channel is human capital, since income disparity gives rise to inequalities in access to the education system. According to ECLAC, 81 per cent of men belonging to the highest income quintile in Latin America have received a secondary education, while this rate is only 23 per cent for men in the lowest income quintile. Only 20 per cent of indigenous women have a secondary education, while

**Table 1**  
**Household income disparity, selected Latin American countries**

Country	Brazil (1996)	Panama (2003)	Guatemala (2000)	Ecuador (2006)	Colombia (2003)	Peru (2001)
Total Inequality*	0.692	0.630	0.593	0.580	0.572	0.557
Inequality of Opportunity	47.5%	53.7%	60.5%	48.8%	44.1%	52.6%
Other Aspects	52.5%	46.3%	39.5%	51.2%	55.9%	47.4%

Source: Francisco Ferreira . "Measurement of Inequality of Opportunity: Theory and an Application to Latin America", to be published in 2011. World Bank.

\*The measure of inequality falls between 0 and 1, with 0 representing total equality.

the proportion of non-indigenous women with secondary education is 11 percentage points higher.

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**VERY HIGH LEVELS OF INEQUALITY AND POVERTY, TOGETHER WITH UNDERDEVELOPED CAPITAL MARKETS, ARE IN FACT ASSOCIATED WITH LOWER LEVELS OF GROWTH.**

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Not only are there inequities in education coverage, there are also inequities in the quality of education. Upon analysis of the results of the tests performed through the Organization for Economic Co-operation and Development (OECD) Programme for International Student Assessment, it was found that the individuals in the richest quartile of the population produced better results, on average, than those who belonged

to the poorest quartile. In addition, when comparing the region with OECD countries, a significant gap becomes apparent: the best ratings in Latin America —those of individuals in the richest quartile— are comparable to the results of the poorest-performing quartile among the OECD countries (the quartile with the lowest income). The study undertaken by Humberto López and Guillermo Perry in 2007 shows that this disparity in education contributes to perpetuating inter-generational income inequality, and also results in lower levels of human capital, and therefore in lower economic growth.

Another way in which growth inequality is transmitted is through investment when there are problems of access to financing. The World Bank shows that in 2008, businesses in Latin America, especially micro, small and medium enterprises, reported that one of

the major restrictions on investment was the lack of access to credit and its high cost. Very high levels of inequality and poverty, together with underdeveloped capital markets, are in fact associated with lower levels of growth as demonstrated in the studies undertaken by several economists.

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**A POSITIVE CORRELATION IS FOUND BETWEEN HIGH LEVELS OF INEQUALITY AND HIGH RATES OF THEFT AND HOMICIDE.**

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When social variables are analyzed for Latin America, a positive correlation is found between high levels of inequality and high rates of theft and homicide. In addition, more than 25 per cent of companies in the region consider crime a barrier to growth. This suggests

that inequality not only has effects on social variables related to crime, as shown, for example, in an article by Pablo Fajnzylber *et al* in 2002, but that it also has repercussions on growth itself and on job creation.

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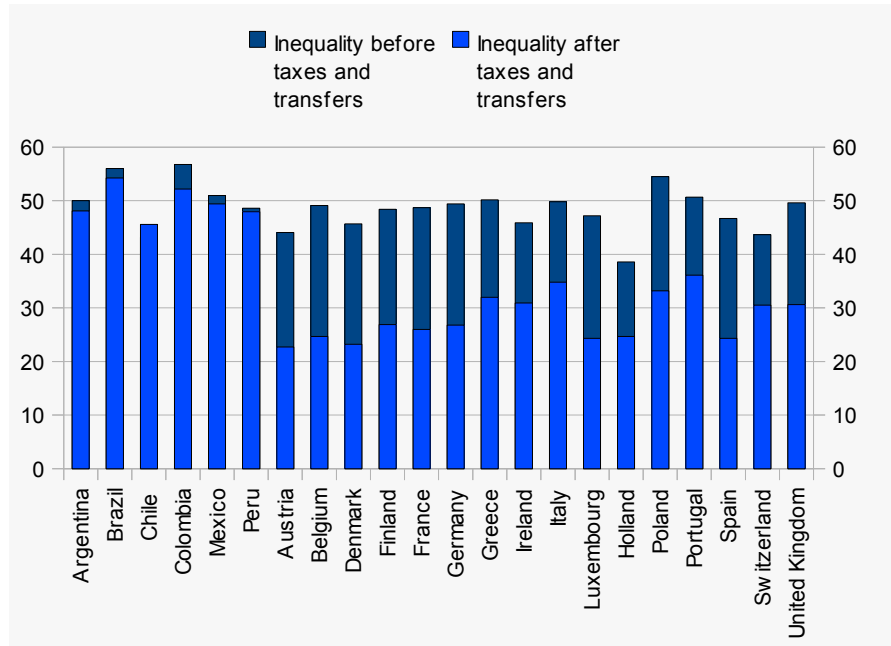
**IN SOME EUROPEAN COUNTRIES, THE GINI COEFFICIENT PRIOR TO REDISTRIBUTION THROUGH FISCAL POLICY IS AS HIGH AS IT IS IN SOME LATIN AMERICAN ONES.**

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It is important to highlight the deficient role of fiscal policy with respect to income redistribution in the region. The Gini coefficients for Latin America and various European countries are quite similar if evaluated before taking fiscal policies into consideration (Figure 2). In fact, in some European countries, the Gini coefficient prior to redistribution through fiscal policy is as high as it is in some Latin American ones. Nevertheless, the Gini coefficients of all European countries are significantly lower once the effect of taxes and transfers are included.

The discouraging results of fiscal policy are related, in part, to taxation systems that collect very little

**Figure 2**  
**Income inequality before and after taxes and transfers**



Source: Organization for Economic Co-operation and Development, *Latin American Economic Outlook 2009*, Paris, 2008.

personal or property income taxes, which are particularly progressive taxes. Instead, the taxation system concentrates its collection efforts on corporate income taxes or duties, which can have negative effects on business and the competitiveness of companies and no positive effect on the distribution of income or on other indirect taxes such as the Value Added Tax (VAT).

Another perspective, shown in a 2008 study by Edwin Goñi, Humberto López and Luis Servén, is that for each progressive public

expense, there is another highly regressive one in the region. A good example of this are the conditional cash transfer programs, which have been widespread during the last decade. They have produced good results with respect to social indicators, and expenditure is concentrated in the lowest income quintile. Yet these programs, which do not require many resources, exist alongside extremely costly pension systems that benefit mainly the richest 20 per cent of the population. Something similar occurs in the case of public education: while

the majority of expenditures on primary education are focused on the poorest 25 per cent of the population, the majority of spending on postsecondary education is aimed at the wealthiest 25 per cent of the population.

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**AS THE LEVEL OF  
EDUCATION AND WEALTH  
INCREASES IN A COUNTRY,  
SUPPORT FOR POPULISM  
TENDS TO DECREASE.**

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Finally, there is evidence of a relationship between inequality and support for populism. According to an academic article by Mitchell Seligson published in 2007, as the level of education and wealth increases in a country, support for populism tends to decrease. It is worth mentioning that populist redistribution—which uses mechanisms such as the arbitrary expropriation of land and wealth as well as excessive increases in taxes and transfers—has been shown to have negative effects on growth in the short and medium term, while the equalization of opportunity—which can bring with it costs with respect to growth in the short term due to an increase in taxes—is without a doubt very beneficial in the medium and long term. In this regard, the

equalization of opportunity can be supported by everyone, regardless of political affiliation or ideology.

## Conclusion

In spite of the acceptable results recently observed in several countries in the region, there is a long way to go in reducing levels of inequality and increasing social mobility. To achieve such progress it is necessary to take concrete steps to reduce inequality of opportunity, in particular in the areas of education, health care, access to public infrastructure and to the financial system, and security.

Redistribution policy must be aimed at greater taxation of individuals with respect to income and property, which would allow for a much more progressive taxation system. In addition, spending must be focused on the equalization of opportunity. To do so, the universalization of health-care services and education is essential, as are significant improvements in the provision of public infrastructure assets. At the same time, it is essential to eliminate or redesign those subsidies focused on high-income individuals—such as pensions, energy subsidies and protectionist policies aimed at the agricultural sectors—while continuing to strengthen poverty

reduction programs that, for the most part, include conditional transfers.

In spite of the fact that inequality levels differ within the region, it is important to reach regional political and economic agreements that can help focus efforts and generate synergies between governments in order to reduce the high indices of inequality throughout the region; in this regard, the next Summit of the Americas may provide a favourable opportunity for discussions on regional public policies in this area.

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## FURTHER READINGS

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