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The Achilles' Heel of Latin America The State of the Debate on Inequality

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SUMMARY

Increasingly, Latin Americans no longer believe that democracy is able to improve their lives in a region where 40% live in poverty, and the richest one-tenth owns almost half of the wealth. The growing understanding of the tight links between gaps in income and opportunity, prosperity and political stability is changing the debate on inequality in Latin America. This paper seeks to assess the state of the debate and policies to reduce inequality, among the region's academics, non-governmental organizations, governments, and multilateral institutions participating in hemispheric processes. It draws upon discussions on tackling inequality in Latin America held in 2003 and early 2004 at multiple fora across the Hemisphere. What emerged is a growing consensus that Latin America's high inequality has constrained economic growth and underlies much of today's social and political instability. Moreover, the need to devise specific policies to reduce the equity gap within and between societies consistently appears in hemispheric discussions as a prominent, if not primary concern, irrespective of ideological preferences or geography. Considerable attention is thus allocated in this paper to tested and untested strategies to redress the equity gap. The paper discusses various aspects of education and tax policy, which are widely considered prime avenues to increase levels of equity. It will also examine the heated debate on how to liberalize trade and integrate economies to collectively elevate the wealth of the region's population, and how to ensure that gains are shared broadly. Finally, it considers the implications for Canadian policy.

Ideas presented in this paper are largely based on a series of major events concerned with Latin America's development that took place in 2003-2004, namely: Conference of Montreal: Innovative Thinking and Change in Latin America (2003), FOCAL Forum of Hemispheric Experts: A New Agenda for Latin America? (2003, Ottawa), Université du Québec à Montréal: Building the Americas Conference (2003), Americas Trade and Sustainable Development Forum (Miami, 2003), Canada's Department of Foreign Affairs and International Trade pre-Special Summit of the Americas Stakeholders Meeting (2003, Ottawa), Special Summit of the Americas and associated Future of the Americas Conference and Academic Roundtable on Integration and Inequality (Monterrey, 2004).



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RÉSUMÉ

En Amérique latine près la moitié des gens ne croient plus que la démocratie peut améliorer leur vie et plus de 40% vivent dans la pauvreté dans une région où les plus riches, qui représentent un dixième de la population, détiennent presque la moitié des richesses. Il devient de plus en plus évident qu'il existe des liens étroits entre revenus et possibilités, entre prospérité et stabilité politique, ce qui change le débat sur l'inégalité en Amérique latine. Ce document évalue où en sont les débats et les politiques visant à réduire les inégalités, entre les universitaires, les organismes non gouvernementaux et les institutions multilatérales de la région qui participent aux processus hémisphériques. Il se fonde sur des discussions sur la manière d'aborder les inégalités en Amérique latine qui se sont tenues en 2003 et au début de 2004 lors de nombreux forums qui ont eu lieu dans tout l'hémisphère. Ce qui en ressort est un consensus grandissant que les inégalités de plus en plus criantes en Amérique latine ont entravé la croissance économique et sont en grande partie responsables de l'instabilité politique et sociale actuelle. De plus, le besoin d'élaborer des politiques spécifiques pour réduire les écarts de richesses à l'intérieur des sociétés et entre elles apparaît dans les discussions hémisphériques comme un enjeu important sinon prioritaire, peu importe les préférences idéologiques ou la géographie. Le document accorde donc une importance considérable aux stratégies éprouvées ou non pour alléger le fardeau des inégalités. Il aborde les divers aspects de l'éducation et de la politique fiscale qui sont considérées par beaucoup comme des outils privilégiés pour augmenter les richesses. Il examine également le débat sur la manière de libéraliser le commerce et d'intégrer les économies pour augmenter collectivement la richesse de la population de la région et s'assurer que les gains sont partagés entre le plus grand nombre. Enfin, il évalue les implications pour la politique canadienne.

RESUMEN

Cada vez más latinoamericanos no creen que la democracia pueda mejorar su calidad de vida, en una región donde más del 40% de la población vive en la pobreza y el 10% más rico es dueño de casi la mitad de la riqueza. La creciente concientización del estrecho vínculo existente entre la profunda desigualdad de ingresos y oportunidades, la prosperidad económica y la estabilidad política está cambiando el debate sobre la inequidad en América Latina. El presente trabajo examina el actual debate sobre el tema en el que participan gobiernos, académicos, ONGs, y organismos multilaterales del hemisferio y se basa en una multiplicidad de conferencias y encuentros abocados a la cuestión de la inequidad y políticas tendientes a reducirla, que tuvieron lugar en varios puntos del hemisferio durante 2003 y 2004. Del análisis surge un creciente consenso en que los altos niveles de inequidad existentes en América Latina han restringido el crecimiento económico, y que éstos subyacen a gran parte de la inestabilidad política y social que aqueja a la región. Por otra parte, la necesidad de diseñar e implementar políticas con el objetivo de reducir la brecha de equidad dentro y entre sociedades aparece como una preocupación central en los debates hemisféricos, independientemente de las preferencias ideológicas o la geografía. Por consiguiente, este análisis otorga considerable atención a distintas estrategias destinadas a reparar la profunda brecha de inequidad, que han sido implementadas en la región así como estrategias innovadoras todavía no puestas a prueba. El trabajo también trata varios aspectos de política educativa e impositiva, consideradas avenidas clave para aumentar los niveles de equidad. También examinará el candente debate sobre cómo liberalizar el comercio e integrar las economías de modo de elevar colectivamente el bienestar de la población del hemisferio, y cómo lograr que las ganancias provenientes del comercio sean distribuidas equitativamente. Finalmente, se ofrecen conclusiones y consideran consecuencias para Canadá.

1. INTRODUCTION

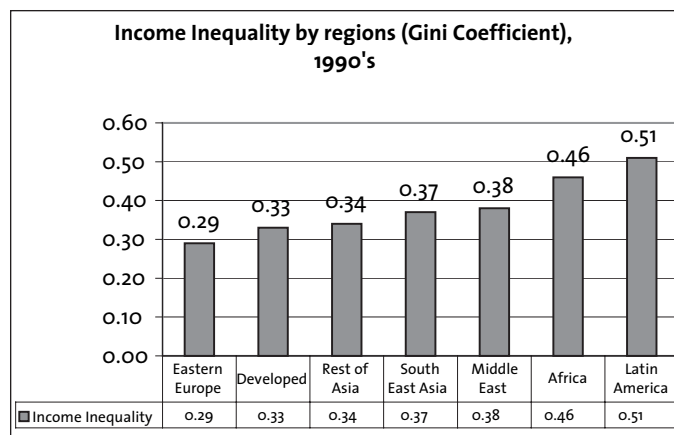
“...The main obstacle to the success of poverty reduction efforts in Latin America and the Caribbean is that the medicine which is most effective in treating the poverty that afflicts the region – inequality reduction – is one that the region seems to find very difficult to dispense...”

[UN Economic Commission for Latin American and the Caribbean (ECLAC), United Nations Development Programme (UNDP) and Brazil’s Institute of Applied Economic Research (IPEA), “Meeting the Millennium Poverty Reduction Targets in Latin America and the Caribbean”, 2002]

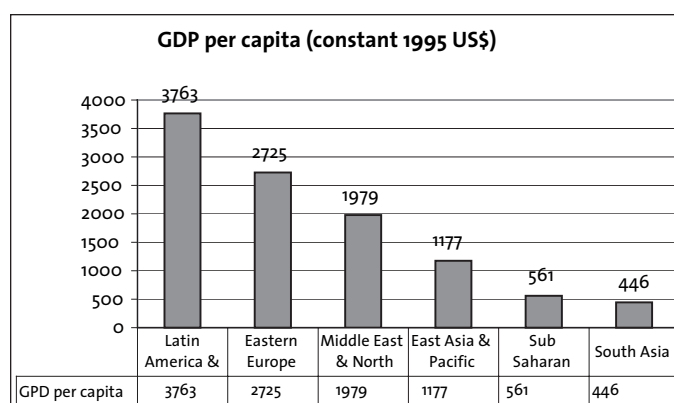
It is estimated that even very small improvements in equity (one or two point decrease in the Gini index) would achieve the same reduction in the incidence of poverty as many years of positive economic growth. According to the joint ECLAC, UNDP and IPEA report, nearly all countries in Latin America would be able to meet the Millennium Development Goal of halving poverty by 2015 if inequality were reduced by less than 4% with annual growth in GDP per capita of no more than 3%. Absent decrease in income concentration and with growth continuing at the same pace of the 1990s, only a handful of countries would be able to reach this goal. The balance of the evidence also suggests that the region’s high inequality levels hinder more rapid growth, which is fuelling attention to the question of inequality, as distinct from poverty, among policy and research communities.

Shift to a focus on inequality

This thinking represents a major departure from what came to be known as the Washington Consensus reforms of the 1990s. These ten policy prescriptions focused on increasing growth with little explicit consideration of equity, with the underlying assumption that the benefits of growth do eventually trickle down to the poor, even if nothing is consciously done to make growth pro-poor.¹ A decade later, in “*Washington Contentious: Economic Policies for Social Equity in Latin America*” Birdsall and de la Torre (2001) put forth ten policies that went beyond the original ten of the Consensus, integrating social and equity concerns with economic growth. The ten “reforms of the reforms” to enable Latin American countries to improve equity without reducing growth are: rule-based fiscal discipline; smoothing booms and busts; social safety nets that trigger automatically; schools that are accessible to the people; taxing the rich and spending more on the rest; giving small business a chance; protecting worker’s



Source: “Inequality, Exclusion and Poverty in Latin America: Implications for Development,” Inter-American Development Bank, 2003.



Source: “Inequality, Exclusion and Poverty in Latin America: Implications for Development,” Inter-American Development Bank, 2003.

rights; dealing openly with discrimination; repairing land markets; and consumer-driven public services.

Despite criticism from one side for not questioning prevailing neoliberal orthodoxy more deeply or addressing root causes of inequality, and doubts expressed by the other side about the compatibility of “contentious” reforms with growth, the *Washington Contentious* marks a new focus in the literature about growth and equity in Latin America.² As the authors state “times have changed. Policy makers in Washington and Latin America no longer hold equity in contempt.” In recent years, the question of inequality has come to the fore among governments of the region (embodied in the successive Summit of the Americas’ declarations and action plans), academic and multilateral communities. By 2003 and 2004 many of the major publications on the region, whether from the UN Economic Commission for Latin America, the Inter-American Development Bank or the World Bank, centered on this issue.

Costs of Inequality

Inequality is both a cause and consequence of underdevelopment in Latin America, and has been found to be an independently significant barrier to achieving prosperity. High levels of inequality in Latin America have reduced growth rates and the benefits of growth on development by restricting education and labour market opportunities, which in turn affect productivity. Also, inequality engenders social and political instability by creating elite ‘winners’ and majority ‘losers,’ fuelling disenchantment with democratic governance and economic reforms, leading to polarization and instability which in turn constrains investment, growth and development.

These socio-political costs of inequality have been brought to the fore by recent Latinobarómetro polls that track the escalating disillusionment with democracy and concomitant economic reforms. The recently released UNDP Report: *Democracy in Latin America: Towards a Citizens’ Democracy* (2004) not only identifies inequality and poverty as the main weaknesses of democracy in Latin America, but finds that support for democracy is higher in countries with lower levels of inequality. The report also revealed that just 43% of Latin Americans are fully supportive of democracy, and that more than half (54.7%) would support an authoritarian regime over a democratic government if it could resolve their economic problems, a considerable decline in support for democracy in Latin America.³

The links between inequality and political-economic development are also drawn in “Inequality Does Cause Underdevelopment,” by William Easterly (2002), who concludes that commodity endowments predict middle class share of income, which in turn predict development and growth.⁴ He also confirms the mechanisms—institutions and schooling—by which middle class share enables consensus around a social contract that entails democratic institutions, income generation and redistribution.

Tackling inequality: An explicit focus on institutions

The key to reducing inequality in Latin America is institutional reform, argued Guillermo Perry, the World Bank’s Chief Economist for Latin America and the Caribbean, and co-author of the Bank’s major study on “Inequality in Latin America and the Caribbean: Breaking with History?” (2004). “To over-

come the inequality that undermines the efforts to get out of poverty people must gain influence within political and social institutions, including education and public services institutions. To enable them to achieve such influence, the institutions must be truly open, transparent, democratic, participatory and strong.”

This focus on better institutions and broader participation or ‘buy-in’ is echoed by Nancy Birdsall, president of the Center for Global Development, who specifically emphasizes the importance of going beyond the standard, poverty-targeted focus to devise a social contract that includes the near-poor middle class. The rationale is two-fold. First, that middle income households in Latin America do not share the equivalent level of income or security of middle classes in advanced economies, and are persistently vulnerable to being or becoming poor; and second, that it makes “political sense” to address the needs of this hidden majority to maintain support for reforms and stable, employment-based growth.⁵

Today there is little disagreement within the policy community, if any, on the pre-eminence of efficient and transparent institutions in addressing Latin America’s underdevelopment, including the gross divergences in income distribution and opportunities within and between societies. In “The Primacy of Institutions” (Finance and Development, June 2003) Dani Rodrik and Arvind Subramanian concluded that the quality of institutions, in particular the role of property rights and rule of law, overrides other factors driving inequality such as geography and international trade.⁶ (Finding that, controlling for institutions, geography has at best weak direct effects on incomes, although it has a strong indirect effect through institutions by influencing their quality. Similarly, trade has a significant effect on institutional quality, but it has no direct positive effect on income).

As key elements of the institutional reforms advocated, the sections that follow deal primarily with the question of inequality within countries in the specific areas of education and tax policy, reflecting current hemispheric debates and research. Disparities across countries of the Americas surface in specific discussions related particularly to trade and integration.

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2. EDUCATION: BALANCING THE MIX

There is broad consensus that education is not only a main driver of development but also a pivotal factor affecting inequality in Latin America. Yet debate continues about the best ways to improve the quality, access and relevance of education. As Jeffrey Puryear, Director of the Partnership for Educational Revitalization in the Americas (PREAL), put it at a FOCAL roundtable in June 2004, education in the region is in “bad shape,” in every aspect except quantity. While budgets for education and coverage have increased in recent years, equity and quality remain poor. He noted that entrenched interests such as teachers unions, bureaucracies and lobbies for public funding only — which tend to benefit the higher and middle classes — continue to resist reform. Education remains a highly political issue.

The pendulum swings?

In the 1980s and 1990s, many Latin American countries increased their spending on education, favouring primary and secondary levels. These investments often extended beyond formal education, for example, successful programs such as *Progresar/Oportunidades* in Mexico, *Bolsa Escola* in Brazil, and *Chile Joven* in Chile, were designed not only to address basic needs, but as investments in human capital.⁷ Despite gains made, increases in public expenditure at basic levels have not necessarily translated into long-term improvements in quality. Moreover, they have come at the expense of higher levels, with secondary and tertiary seen as ‘the forgotten levels’ of reform.⁸

More recently, focus has turned to improving the links between higher education, labour markets and the larger ‘knowledge economy.’ This integration of education with broader development agendas for countries and regions as a whole, has become common currency not only in Latin America but also globally, from New Zealand to South Korea. The importance of trisectoral cooperation (state-academia-business) was central in discussions at the academic conference preceding the 2004 Monterrey Special Summit: Latin America is one of the most poorly linked, academically and economically, regions in the world (certainly third to Europe and Asia). To revert this reality, participants at the Summit’s academic forum, including Michael Crow,

President of Arizona State University, called for a new type of university for the Americas that is inclusive, socially embedded, transnational and linked with the private sector.

New Priorities: Higher Education and the Knowledge Economy

The high rates of return from tertiary education, as compared to secondary or primary, make this level central to addressing inequality. Rates of return to tertiary education in Argentina, Chile and Colombia for example, are twice as high as secondary education. In Brazil, it is estimated that the returns to tertiary education between 1982-1998 increased by 23% whilst returns to primary and secondary levels decreased over the same period.⁹

The profile of tertiary education has changed in Latin America. Enrolment in the region has more than doubled since the mid-1980s, and the public and private number of university and non-university institutions in many countries has grown significantly.¹⁰ (Although with 27% as the average number of 18-24 year olds enrolled, this is still well below the OECD average of 55%). However, expanded enrolment, in and of itself, does not necessarily translate into gains in equity. If higher income sectors are over-represented, not only are distribution patterns largely unaltered, but inequality potentially increases. This remains the case for many of the countries that have increased tertiary enrolment—for

example in Brazil, more than 70% of students in tertiary institutions come from the wealthiest 20% of the population. These discrepancies, combined with the relative high rate of return to tertiary education exacerbate inequality.

Domestic and international institutions are also increasingly looking to tertiary-level reforms not only to reflect labour markets, but to meet demands for knowledge, research and ‘innovation-based’ development. Latin America lags behind in public and private partnerships and investments in R&D, not just in terms of resources but also in feedback systems for tracking students, employers and skills that are required for a responsive relationship. Unlike OECD countries, investment in R&D is primarily public, and makes up a significantly lower percentage of GDP (0.5% vs. 2.4%).¹¹

Despite gains made, increases in public expenditure at basic levels have not necessarily translated into long-term improvements in quality

Colombia and South Korea stand out as having innovatively brought private sector into the educational process, particularly in the areas of curriculum design, teacher training and job placement. Colombia is considered one of the most progressive cases of private sector involvement in education in Latin America and is currently being looked to as a model by business leaders in El Salvador, Nicaragua and the Dominican Republic. For its part, South Korea implemented comprehensive reforms by focusing first on basic education and then increasing investment in higher education in conjunction with technological innovation (the sequencing of education reforms over four decades, focusing first on basic levels through the 1970s and 80s before secondary and tertiary in the 1990s is considered to have worked well in Korea). South Korea remains the prime destination for investment in the Asia Pacific, largely as a result of reforms in the 1990s that created a foundation for knowledge-based economic growth.

Daniel Morales-Gómez, at FOCAL's Forum of Hemispheric Experts (2003) emphasized the importance of systematic monitoring and evaluation of reforms underway, and also underscored that educational reforms need to be better integrated with national development agendas. Developing a political strategy to achieve the right balance in reform and resource allocation among primary, secondary, and tertiary levels, to harness the potential of all sectors remains a challenge with long-term social and economic consequences.

3. TAXATION

The call for better institutions, expanded social services and protection brings in a central imperative: strengthening the capacity of the state. In this regard, it is not surprising that fiscal policy, particularly taxation, is taking center-stage in debates on inequality and redistribution in Latin America. Improving efficiency of tax collection, closing loopholes and eliminating exceptions, are widely recognized as desirable measures that are not growth inhibiting (as increasing the marginal tax rate on earned income). The development of property taxation as a major revenue source also figures prominently in these debates. Moreover, progressive taxation is a key mechanism to redistribute income but only a handful of countries in Latin America have somewhat redistributive policy provisions, notably Uruguay and to a lesser extent Chile and Costa Rica.

Brain Korea 21

In 1995, a Presidential commission was created to generate national education reform proposals (ERPs), to invest in human capital to ensure that Korea was prepared for the future 'knowledge-based economy'. Policy recommendations included deregulation with increased accountability; curriculum reform for diversification; and integration of ICTs. To finance these measures, the ERP proposed that up to 5% of GNP be allocated to education. The result of these reforms was 'Brain Korea 21,' which became the mechanism for proposed investments in higher education, with the aim of creating world-class universities, and to generate knowledge in the sectors that were most important to Korean economy. US\$1.2 billion over seven years was earmarked for this project. Curriculum reforms included linking universities and vocation school training with labour market demands including hi-tech, and creating opportunities for in-situ company training; ensuring a high level of ICT literacy—in fact Korea is considered to have one of the world's most comprehensive internet networks. Most of the BK21 objectives including enhanced R&D capability, high quality universities and human resources, and cooperation between academia, industry and government have largely been met.

Source: "Education Policies and Reform in South Korea", Gwang-Jo Kim, World Bank, 2002

The taxation picture in Latin America

- *Low tax revenues and collection rates:* Tax revenues average about 18% of GDP, compared with 30-50% in OECD economies (Brazil is an exception where revenues are about 30% of GDP, but the potentially beneficial effect is offset by highly unequal public spending).
- *Low effective taxation of high-income individuals:* the richest 10% of Latin Americans face effective tax rates of only 8% of their income (compared to about 30% in the US), even though the statutory marginal rates earned on income can be as high as 40%. The gap is often due to very high minimum personal exemption levels, which are as high as 10 times the average income in Ecuador, Nicaragua, and Guatemala, 5.9 times in Honduras and 3.5 in Brazil.¹² Another example is offered by Argentina where judges are exempted from paying income taxes. In addition to exemptions, numerous loopholes and more or less sophisticated ways to evade paying taxes tend to benefit the rich.
- *Consumption taxes make up the lion's share of revenue:* consumption taxes, particularly the value-

added-tax (VAT), account for about 60% of total revenues in the region, compared to 30% in Europe.

- *Low land and property tax revenues:* coverage of tax is not comprehensive and both assessments and collection rates are often low in most Latin American countries. Compounding this situation is the very unequal distribution of land.

There is widespread consensus that improving the efficiency of tax collection is the first step. The expectation is that by enhancing enforcement, simplifying regulations and eliminating some exemptions much additional revenue can be generated, without adding to the tax burden of the working and middle-income households. The Peruvian experience in eliminating perforations to the tax system and increasing tax enforcement during the 1990s illustrates this point.¹³ Institutional reform and modernization of Ecuador's tax system in the late 1990s also brought about marked improvements in collection efficiency, nearly doubling the amount of taxes collected as a percentage of GDP within the first three years.¹⁴ In some of the most outrageous cases, however, there is room to increase

(...) fiscal policy, particularly taxation, is taking center-stage in debates on inequality and redistribution in Latin America

effective personal income tax rates (PIT). As for taxation on corporate income (CIT), the approach now almost universally adopted in major Latin American countries is to impose a moderate, stable tax on all corporations. While there are distributional gains to be made from integrating the CIT into the PIT, there is no consensus and debate is split on the subject.¹⁵

Easier said than done?

In addition to traditional challenges to tax collection, including a vast informal economy, national tax authorities now have to contend with new challenges derived from increasingly globalized economies. Specifically these include: the growing use of electronic commerce and electronic transactions in general; the increasing importance of off-shores and tax havens as conduits

for financial investments; the growth of new financial instruments and agents for channelling savings such as derivatives and hedge funds; the growing importance of trade within multinationals among their various parts in different locations; the inability of countries to tax financial capital as well as incomes derived by individuals with highly tradable skills.¹⁶

Sources of Tax Revenue in LAC & OECD Countries

	Taxes on income profits and capital gains	Social Security contribution and taxes on payroll workforce	Property tax	Subtotal: taxes on Income and Property	Taxes on Goods and services	Other Taxes	Total
Percent of GDP							
OECD ^a	12.4	9.7	2.4	2.4	24.5	0.3	32.5
Latin America ^b	4.7	3.8	0.3	0.3	8.8	3.4	21.1
Other emerging market countries ^c	6.5	0.8	0.2	0.2	7.5	3.4	19.2
Percent of total tax revenues							
OECD ^a	38.2	29.8	29.8	7.3	75.3	0.9	100
Latin America ^b	22.1	18.1	18.1	1.4	41.5	16.2	100
Other emerging market countries ^c	33.9	4.2	4.2	1	39.1	17.8	100

a. Excludes Mexico
b. Latin America includes Argentina, Brazil, Colombia, Chile, Guatemala, Ecuador, Mexico, Paraguay, Peru, Uruguay and Venezuela
c. Includes India, Indonesia, Malaysia, Russia, Singapore, Thailand and Ukraine

Source: "A Fiscal Policy Agenda", Artana, Lopez Murphy and Navajas, 2003.

Direct Vs. Indirect taxation

Recent experience in tax reform in Latin America has tended to “shift the burden of taxation from income taxes (which are typically at least mildly progressive) to consumption taxes (which are usually at least mildly regressive)” notes John Williamson (2003). While he acknowledges that this has been useful in developing a broader tax base, he recommends reversing the process of shifting from direct to indirect taxation.

There is indeed a tension between direct and indirect taxation. The VAT is today seen as the foundation of revenue in Latin America, leading worldwide trends (OECD countries are trying to move in that direction). Advantages include simplicity, securing collection and possibility to expand the tax base by encompassing more services (especially those consumed disproportionately by the rich). In many countries the VAT functions as a compensating revenue source, following the reduction or almost disappearance of export and import duties as the result of trade liberalization. This is particularly true for the smaller countries of the Caribbean where the share of total revenue coming from this source can be as high as 60% (Bahamas).¹⁷

On the other hand, the main disadvantage of indirect taxation lies in its regressive nature (as a higher percentage are collected from the incomes of poor than the rich, in large part because poor sectors have to spend a larger share of their income than the rich). The regressive effects of consumption taxes, however, can be partially offset by excluding certain items such as food and medicine. This is one way of benefiting from the advantages of indirect taxation while “un-taxing” the poor.

Taxing property

There is agreement that more effective property tax systems should be high on the list of any progressive reformer, given the important links among wealth, income, social development, land use and occupation underlying the nature of the property tax. Moreover, in many countries such as Chile, property taxes are the main method of raising revenues at the local government level. Given the weaknesses of design and enforcement of current property tax systems, the room for improvement is vast. Brazil is a case where inefficient use of the property tax as a source of revenue is widely recognized. A 2001 study

showed that in only a dozen municipalities was the tax evasion rate less than 20%, and in one every five municipalities, the revenue collected represented less than 20% of the properties included in the cadastre.¹⁸ One remarkable feature of property tax is the great diversity found in its administration. For example, the property tax is a purely local tax in Brazil, Colombia and Ecuador, but it is administered at the provincial level in Argentina; El Salvador has never introduced a property tax at all.¹⁹

In order to make inroads in the current state of inequality, progressive taxation needs to be matched by progressive spending. On the expenditure side, the focus of the debate is migrating from one of more social spending²⁰ to one of better spending or with higher redistributive effects. Education, widely considered to be a driver of inequality, is an example that has received singular attention in hemispheric

discussions and in this paper. A comprehensive analysis of government spending exceeds the scope of this paper, but there are clearly other areas, such as health, pensions and social assistance where government action is indispensable in improving overall equity and where innovations are taking place.²¹

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4. TRADE LIBERALIZATION, GROWTH, EMPLOYMENT AND INEQUALITY

“If you had three magic bullets to reduce inequality in Latin America, what would they be?” The question was asked at a major academic conference surrounding the Special Summit of the Americas (2004). “Jobs, jobs, jobs”, replied Nancy Birdsall, president of the Center for Global Development. Indeed, joblessness has been the dark side of reforms in Latin America. According to the International Labour Organization, despite modest economic recovery in 2003, high levels of overall unemployment, a decline in the quality of employment, increases in informal jobs, combined with a fall in real wages and reduction in labour force productivity are pervasive in the region.²² Given these realities, it is very fitting that governments of the Hemisphere have chosen job creation as the central theme for the next Summit of the Americas, to take place in Argentina in November 2005.

Economic growth reduces poverty mainly through its effect on employment and in Latin America growth in the 1990s was not employment-intensive, exacer-

Employment trends in Latin America 1990-2003²³

- The increase in employment informality: out of ten newly generated jobs since 1990, approximately 7 have been informal;
- The tendency towards labour tertiarisation: 9.4 of 10 newly created jobs since 1990 belong to the service sector;
- The persistence of job precariousness: only 4 of 10 new jobs have access to the benefits of social security and only 2 of 10 people occupied in the informal sector have social protection.

bating the problem. Moreover, trade liberalization in itself was not enough to significantly improve and sustain growth and in some cases it may have contributed to unemployment and inequity. Joblessness and a widening of the income gap are some of the painful transition costs of trade opening, given that labour does not automatically migrate from declining to emerging sectors — this reallocation of resources being largely the crux of efficiency gains derived from trade.²⁴ All of these problems can be seen in the liberalizing experiences of Chile, Mexico, Argentina and Brazil. While unemployment has now dropped in Chile and Mexico, income distribution and poverty continue to lag behind in the latter. Joblessness remains persistently high in Brazil and Argentina, and income distribution has sharply widened in the latter in the last ten years.

Poor employment had a negative effect on income distribution largely due to the skill premium or the specific skills required by international competition and technological change. Some skilled workers disproportionately benefited from trade opening, thus contributing to wage gaps. Bolstering the region's weak investment in training, innovation and R&D is central to these discussions.

Trade liberalization may have also contributed to an expanding informal sector. While it is difficult to establish a link between this growth in the so-called shadow economy and trade, it is possible that workers from sectors or industries rendered uncompetitive by trade opening would have found a source of income in the informal sector.

“Trade liberalization raises the growth potential, but translating that potential into reality demands a complementary set of policies” remind Roberto Bouzas and Saul Keifman in “Making trade liberalization work” (2003).²⁵ The kinds of policies and mecha-

The ‘shadow economy,’ property rights and economic growth

“In some developing countries 70 to 90% of economic activity is the shadow economy, meaning it is not recognized by law, and this results in low productivity and a lack of competitiveness” said Hernando de Soto — head of the Institute for Liberty and Democracy of Peru — in a speech at the Inter-American Development Bank on February 17, 2004. In Mexico alone, he said, “this informal economy amounts to \$315 billion (get percent of GDP), resources that can not be mobilized for growth because they have no legal status or framework that would allow them to be converted into loans, mortgages, capital investments or a tradable securities. According to De Soto and the ILD, distributing land titles is not enough. A comprehensive legal property system must also bring personal and business assets inside the formal economy, converting them into capital and thus contributing to government revenue, reduced corruption, and poverty alleviation.

Source: Inter-American Development Bank; Instituto Libertad y Democracia, 2004.

nisms necessary to make trade liberalization and growth sustainable, and to ensure that gains are shared more broadly both within and across countries, is very much at the forefront of hemispheric debates. Topics such as trade adjustment assistance, compensation funds and labour mobility figured prominently in discussions at the Americas Trade and Sustainable Development Forum (ATSDF) that took place simultaneously with 8th Free Trade Area of the Americas (FTAA) Trade Ministerial in Miami (November 2003) and at various academic gatherings leading up to the Special Summit of the Americas in Monterrey (January 2004).

Compensation for the losers of integration

A recurring theme in hemispheric debates among academia, policy institutes and NGOs is the need for trade adjustment assistance from winners to losers of integration. Such adjustment assistance, it is argued, should take place both within and across countries. The importance of adjustment within national boundaries was a subject of lengthy consideration at the Americas Trade and Sustainable Development and included in the final recommendations.

“Trade liberalization does not ensure that these possible gains (from trade) will be long-term or distributed efficiently among the general population...Since comparative advantage is maximized by the mobilization of all factors of production,

exclusion is not only a social cost but also an economic one. While recognizing that a free trade agreement is primarily an economic instrument, it is hoped that with strong enough incentives a FTAA can be used to compel national governments to develop public policies that prioritize inclusion, participation, and economic gains for all people."

Some of the specific measures considered for governments to adopt to assist losers and avoid the creation of a class dislocated by trade opening, include subsidized credits (the positive experience with micro enterprise loan programs since the 1980s in the US was highlighted as a possible model); strengthen job training and placement programs, develop tax incentives for investment in new industries and areas of high unemployment; and provide additional resources for public investment in education, health, and infrastructure.

As growth lagged behind and inequality and poverty rose in the first years of the new millennium, calls for adjustment assistance to deal with asymmetries between countries in the Americas, have become louder and more frequent. Often the European Union's Social Fund (ESF) is invoked to illustrate what could be done in this hemisphere, although there seems to be limited awareness of the complexities of the European experience (See BOX on ESF). To the best of our knowledge, a careful study of the EU model, whether certain aspects of it could be replicated in the Americas, and estimated cost of such fund, is yet to be produced.

The only existing mechanism to date is the *Hemispheric Cooperation Program (HCP)*, established in 2001, which provides technical assistance to countries with a lower level of development in order to allow these countries to fully participate in FTAA negotiations and to implement common disciplines in the future. The HCP envisages cooperation for "adjusting to integration", including the strengthening of the productive capacity, fostering competitiveness, encouraging the development of innovation and the transfer of technology. Such a program, however, has fallen short of meeting the needs and demands of countries because of its limited budget, scope and beneficiaries.

Moreover, the UN Economic Commission for Latin American, one of the three managing institutions of the HCP recently acknowledged that free trade, even

with special provisions to take asymmetries into account (this is at odds with the current practice of "levelling the playing field") will be insufficient to promote income convergence between countries. In "Asymmetries and cooperation in the Free Trade Area of the Americas" (ECLAC 2003) Inés Bustillo and José Antonio Ocampo concluded:

"Two fundamental complements [to free trade in the Americas] are cohesion/integration funds and increased labour mobility. Funds can play a key role in accelerating convergence of income levels within the hemisphere. As the experience of Puerto Rico illustrates²⁶, such funds can play a crucial role in alleviating economic and social adjustment costs in the more disadvantaged areas..."

While virtually nobody questions the desirability of such assistance, some question its political and economic feasibility. A Mexican political scientist participating at the Monterrey Roundtable on Integration and Inequality (January 2004) warned that "it would not be politically viable for the US to agree to transfer funds to the South where the rich don't pay taxes,"²⁷ and in light of Mexico's recent experience in dealing with the US, recommended moving away from proposals resembling the EU model. Unlike the European case, the wealth differential among the thirty-four countries participating in regional trade negotiations is such that the burden of funding would likely fall on only a few countries.

Labour Mobility

Another constant topic in hemispheric debates on integration and inequality is the need to include labour mobility as an equalizing force in any future hemispheric construction. Arguments for it are both political and economic. Politically it could capture the imagination of ordinary Latin Americans and create a pro-integration constituency, in a way that the proposed FTAA has so far failed to do. Labour mobility can also be a major force for a more equitable distribution of FTAA gains, PROVIDED as long as it includes both skilled and low skilled workers.

In "How to Make the Trade Regime Work for Development" (February 2004) Dani Rodrik identified temporary labour mobility as a unique issue in the global economy in terms of potential for raising income levels in poor countries while enhancing the efficiency of global resource allocation. He argued

Two fundamental complements [to free trade in the Americas] are cohesion/integration funds and increased labour mobility

European Structural and Cohesion Funds

The **European Social Fund** (ESF) is the main financial tool through which the European Union (EU) implements its strategic employment policy. Set up by the Treaty of Rome, it is the longest established Structural Fund. The ESF provides the EU funding on a major scale for programs which develop or regenerate people's "employability". The ESF channels its support into strategic long-term programs which help regions across Europe, particularly those lagging behind, to upgrade and modernize workforce skills and to foster entrepreneurial initiative. This encourages domestic and foreign investment into the regions, helping them achieve greater economic competitiveness and prosperity.

Programs are planned by Member States together with the European Commission and then implemented through a wide range of provider organizations both in the public and private sectors. These organizations include national, regional and local authorities, educational and training institutions, and the Social Partners i.e. trade unions and work councils, industry and professional associations, and individual companies.

The **Cohesion Fund** finances projects designed to improve the environment and develop transport infrastructure in Member States whose per capita GDP is below 90% of the Community average. The Member States qualifying for the period 2000-2006 are Ireland, Greece, Spain and Portugal (before May 2004 enlargement). The Cohesion Fund budget for 2000-2006 amounts to approximately US\$22 billion, nearly double Uruguay's annual GDP or more than the combined GDPs of Paraguay and Panama.

Source: European Commission <http://www.europa.eu.int>, 2004.

that a three to five year program designed in a way that includes incentives to return to home countries would far exceed the predictions for all the WTO Doha Round proposal put together. The return home is key to ensure the positive spillovers that returnees would generate such as the experience, entrepreneurship, investment, and work ethic they would bring with them and put to work, which would add considerably to gains from remittances (which are a source of support for families but are unable to spark long-term growth).²⁸

In the Latin American context, arguments against the inclusion of labour mobility are manifold. One is technical and points to the fact that current hemispheric negotiations aim at creating a free trade area and not a common market, which would indeed prescribe free circulation of labour. A second argument points to economic theory that indicates that inflow of low-skilled workers from developing countries

would put downward pressure on wages on unskilled workers in industrial countries. Another argument is concerned with the transfer of skilled workers that would occur towards cities and countries offering better opportunities, virtually draining some countries of their most educated citizens. The demographic concentration in capital cities that is observed in many Latin American countries is often used to illustrate what could happen at a continental scale. While full-scale labour mobility can be easily dismissed, some measure of labour mobility is not too far-fetched. U.S. President Bush's recent proposal for a temporary worker program with Mexico could be a sign that the tide might be turning on this issue.

What kind of Free Trade Area of the Americas?

The new vision for the FTAA as articulated in Miami in November 2003 has added a new wrinkle to hemispheric debates on economic integration. There is a widespread sense among academics and NGOs that the FTAA as it stands will not contribute to achieve the goals of increased growth, opportunities, investment, etc. that it set out to do. Academics gathered for the Special Summit of the Americas on January 10, 2004 in Monterrey issued a communiqué expressing their dissatisfaction with the new vision for the FTAA agreed to in November 2003 in Miami:

"What is needed is an agreement on trade which draws the hemisphere together rather than divides it. A trade agreement under which bilateral preferential agreements proliferate, and which creates a structure under which one country serve as the hub with multiple regional and bilateral spokes, is the antithesis of what is needed to integrate the hemisphere."

It is a broadly held view that a hub-and-spoke pattern of trade agreements that emerged in Miami will not produce a balanced FTAA that takes into account the interests and needs of all parties involved. Not so widespread but increasingly gaining acceptance (lastly among governments of the region) is the belief that civil society involvement in trade consultations and negotiations not only increases transparency and accountability, but is also crucial to make an agreement work. Hearing a diversity of voices ensures agreements better reflect national strengths and opportunities and also helps to anticipate negative impacts and plan for them. A proposal to create a civil society consultative committee within the institutional framework of the FTAA is currently under study by the "Committee on Government Representatives on the Participation of Civil Society", following the Miami Ministerial.

5. CONCLUDING COMMENTS

It makes moral, political and economic sense to focus on inequality. The increasing awareness of the economic, political and social costs of inequality, coupled with limited gains in redressing inequality in the past two decades, make the challenge more pressing. Inequality constrains ‘development basics’ including poverty alleviation and access to health care, as well as the complex priorities of governance, institutional reform, and democratic stability. Escalating disenchantment with democratic governance and economic reforms has its basis in the failure to significantly reduce inequality, preventing consensus around a social contract, a ‘must’ for sustainable transitions to democracy in Latin America. It is not a coincidence that support for democracy among Latin Americans is at its highest in the two countries with the least inequality: Uruguay and Costa Rica, and among the lowest in Brazil and Nicaragua, with possibly the highest levels of inequality in the world, where 65% and 71% of the respective populations surveyed would ‘not mind a non-democratic government’ (Latinobarómetro, 2003). Although inequality has long been recognized as a phenomena pervasive in Latin America, the focused attention that has emerged within mainstream policy and development communities in recent years offers the potential for generating political will and more effective policies to tackle it.

Institutional Reform

There is agreement within the policy community on the primacy of high quality institutions in addressing Latin America’s gross divergences in income distribution and opportunities. As noted in the paper, key avenues for change are via reforms to education, job creation and redistribution through taxation. Despite the ample consensus that education is a main driver of development and a pivotal factor affecting inequality in Latin America, this has not yet resulted in coherent or comprehensive national reforms. Remedying persistently high levels of under and unemployment is also widely considered to be fundamental to increasing equity. In turn, improving tax collection is vital to strengthen the capacity of the state to undertake much of the above changes. This said, institutional reform, sometimes referred to as “second generation reforms”, has proven difficult to materialize because of its political complexity, largely due to its technical intricacy, long-term

impact, and adverse effect on powerful groups of society. Therefore, how to implement institutional reforms remains at the centre of the debate.²⁹

The Collective Dimension

There is much scope for regional cooperation to support national efforts to reduce inequality both in the areas addressed in this paper and beyond. Linking education and innovation, for example, to promote tri-sectoral cooperation among states, universities and business within and across countries is an underdeveloped area, which holds the potential to create a ‘commonwealth’ of knowledge in the Americas.

In the area of tax policy, there is a role for peer pressure from regional partners as well as technical cooperation in tackling tax evasion, particularly given the challenges that increasing globalization poses to collecting taxes owed. In this regard, lessons

from other multilateral bodies, including the OECD Model Tax Convention, could be looked to as a policy resource for Latin America. Ultimately, these are things that can be done and that come down to political will. Serious government action in this area will in turn contribute to changing attitudes towards paying taxes—in itself an indicator of buy-in to a social contract.

Facing some of the highest levels of inequality, it is not surprising that Brazilians and Nicaraguans are most resistant to paying taxes, where only 16% claim to pay value-added taxes, compared to 50% to 70% in the rest of the region (Latinobarómetro, 2003).

With the awareness that trade liberalization alone will not generate the desired effects of growth and social welfare, there is growing momentum to alter the existing structures and policies both within and across countries to ensure that gains are shared more broadly. Calls for more trade adjustment assistance, compensation funds and labour mobility are increasingly reaching the mainstream of the debate, but have not yet produced political conviction on the part of the richest countries of the hemisphere — the United States and Canada. Protracted negotiations for a free trade area of the Americas make introduction of these equalizing elements unlikely in the near future.

Situating Canada within the ‘debate’

At least rhetorically, Canada has recognized the primacy of tackling inequality at the highest political

*It makes moral,
political and
economic sense
to focus on inequality*

level. At the Summit of the Americas in Monterrey, January 2004, Prime Minister Paul Martin, in an address to the Heads of State of the Americas, stated that “...even very small reductions in inequality tied to modest growth can have very large positive effects on poverty reduction.” He went on to identify three equally important elements to ensure that the benefits of growth reach all citizens in an equitable way:

“...First, we undertake fiscal reforms, establish a regulatory framework so that institutions are transparent and effective; we get the sequence right on trade liberalization, and we ensure a strong financial system. Second, at the same time we build a social safety net that includes accessible and high quality health care and education. And finally, we must do all of these things in an inclusive way...”

Translating this political attention into action remains a central challenge; inequality often still comes as a ‘side-order’ in many development programs — assumed to be part and parcel of poverty. Policies to deal with inequality of income and opportunity are often distinct, and need to be an explicit focus of strategies for social, political, and economic development.

Canada is familiar with this situation at home, where First Nations populations continue to suffer from unequal access to income and opportunity. In this domestic context it has long been recognized that generic programs for growth or poverty alleviation have not, in themselves, been sufficient to redress this inequality. It is apt that increasing attention to inequality in the region corresponds with the growing space for indigenous peoples’ issues in the Summit of the Americas Agenda.

Ultimately, education, labour, fiscal and other institutional reforms advocated to deal with inequality are all contingent on social cohesion: a broad-based consensus on governance and how scarce public resources should be generated and allocated. This was recognized in the Academic Communiqué issued by the Roundtable on Integration and Inequality at the Special Summit of the Americas in Monterrey, 2004: “*Social cohesion is an essential precondition for democracy and prosperity...A key barrier to that integration in our view is the severe inequality of income, wealth, power and opportunity which prevails not only between but within the nations of the Americas, between the wealthy elites in many nations and the majority of their citizens.*”

ENDNOTES

¹ John Williamson, An agenda for restarting growth and reform, *After the Washington Consensus*, 2003.

² This said, Moises Naim reminds us that many of these views were first advanced in the 1940s and 1950s in what was then called “development economics.” “Underdevelopment could not be tackled, it was argued without broad based, all-inclusive approach that stressed the importance of institutions, inequality, “structural factors”, cultural specificities, and the constraints imposed by the international environment.” *Washington Consensus or Washington Confusion?* Moises Naim, *Foreign Policy*, Spring 2000.

³ There was some debate between the UNDP and Latinobarómetro about methodology used in the report, but not about the overall findings.

⁴ That is, certain endowments e.g. cash crops and minerals that drew upon slave labour & economies of scale lent themselves to rent-seeking behaviour and appropriation by elites, and thus were associated with high inequality. In contrast, endowments that lent themselves to small-scale production (e.g. wheat, maize in North America) on family-owned farms promoted the growth of a large middle class, see William Easterly, *Inequality Does Cause Underdevelopment*, Working Paper 1, Center for Global Development, January 2002.

⁵ Nancy Birdsall, *From Social Policy to an Open-Economy Social Contract in Latin America*, Working Paper 21, Center for Global Development, December 2002.

⁶ Geography in this case as a key determinant to climate and resource endowment, and that can play a role in disease burden, transportation costs, and extent of diffusion of technology.

⁷ See Nancy Birdsall, *From Social Policy to an Open-Economy Social Contract in Latin America*, 2002.

⁸ See PREAL 2004.

⁹ Lauritz Holm-Nielsen and Kristian Thorn, “Benchmarking Higher Education in Latin America and the Caribbean”, paper presented at the Biennial Congress on Higher Education, Continental Integration and Human Development: Networks, Associations and Strategic Alliances, Mexico, 2003.

¹⁰ Ibid.

¹¹ See World Bank, *Closing the Gap in Education & Technology* (2003) and Organization for Economic Cooperation and Development, *Science, Technology & Industry Scoreboard 2002:7*.

¹² *Washington Contentious: Economic Policies for Social Equity in Latin America*, 2001.

¹³ Rossana Mostajo, “Perspectivas de una reforma tributaria integral con equidad: Hacia un pacto fiscal en el Perú?” paper presented at the XVI Seminario Regional de Política Fiscal, ECLAC, Santiago de Chile, Jan. 2004.

¹⁴ Reforms to Ecuador’s Servicio de Rentas Internas (SRI)

were carried out with approximately US\$15 million in funding from the IDB. The SRI's tax revenue is based on sales, income, excise and vehicle taxes (the petroleum tax which accounts for over 35% of all taxes is administered separately). Reforms included rebuilding the department from the ground up, acquiring qualified personal and current technology, strong leadership and greater institutional autonomy. Between 1998 and 2001 tax collections rose from US\$1.4 billion (7.3% of GDP) to US\$2.3 billion (13% of GDP). IDBAmerica online journal, March 2003.

¹⁵ Richard Bird, Taxation in Latin America: Reflections on Sustainability and Balance between equity and efficiency, ITP Paper 0306, 2003.

¹⁶ Victor Tanzi, Taxation and the future of Social Protection, The Global Third Way Debate, 2001.

¹⁷ Inter-American Development Bank, Fiscal Impact of Trade Liberalization in the Americas, 2004.

¹⁸ Claudia De Cesare, Toward More Effective Property Tax Systems in Latin America, Land Lines, Volume 14, Number 1, January 2002.

¹⁹ Ibid.

²⁰ UN Economic Commission for Latin America & the Caribbean (ECLAC) figures show that social spending in education, health and social assistance rose in 18 countries of the region, an average of 58% in 1990-2001. The ratio of social spending to GDP rose from 12.1% in 1996 to 13.8% in 2001. ECLAC Social Panorama of Latin America & the Caribbean 2002-2003.

²¹ In this regard, the World Bank study "Inequality in Latin America & the Caribbean: Breaking with History?" (2004) concludes: "A particular area of promise is conditional cash transfer, 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 elements can provide the basis for a truly progressive social protection system in LA.C"

²² International Labour Organization, "Labour Overview: Latin American & Caribbean," 2003.

²³ Ibid.

²⁴ David de Ferranti, Daniel Lederman, Guillermo Perry, and Rodrigo Suescún, "Trade for development in Latin America and the Caribbean," 2003, and Roberto Bouzas and Saúl Keifman, "Making Trade Liberalization Work," in After the Washington Consensus, 2003.

²⁵ In After the Washington Consensus, 2003.

²⁶ Puerto Rico's development experience since the 1940s illustrates how factors such as industrial incentives, transfer payments and labour mobility present in conjunction with trade liberalization, can lead to sustained growth and income convergence.

²⁷ This is another context in which the need for fiscal reform comes up in hemispheric debates.

²⁸ L. Alan Winters (2000) had earlier estimated that the effects of increasing temporary workers' permits industri-

al countries by 3% of their current skilled and unskilled force would produce economic benefits exceeding US\$ 150 billion per year, compared with those of US\$ 66 billion for complete goods trade liberalization, shared between developed and developing countries. The research by Winters and Rodrik suggest that global gains from unskilled labour mobility exceed those from skilled labour mobility.

²⁹ See Report on FOCAL IV Forum of Hemispheric Experts (www.focal.ca) and Patricio Navia and Andrés Velasco, The Politics of Second Generation Reform in After the Washington Consensus, 2003.

What kind of Inequality?

In the Latin American context inequality refers to the extreme inequitable or unjust distribution of political, social and economic resources in society. The recent World Bank Report on *Inequality in Latin America and the Caribbean: Breaking with History?* (2004) states:

“Latin America is highly unequal with respect to incomes, also exhibits unequal access to education, health, water and electricity, as well as huge disparities in voice, assets and opportunities. ...In a global economy where “human capital” is critical to competitiveness, inequalities result in a failure to develop people’s skills and knowledge to optimum levels, and can actually slow down the rate of economic growth, and weaken the poverty impact of the growth that does occur.”

Inequality across and within countries:

Different variables are used to measure inequality within and across countries. Inequality within countries in Latin America is contingent upon social structures, progressiveness of tax systems, labour policies, education and ensuing differences in financial wealth, influence and power. Inequality between countries is measured in differences in GDP per capita, questions of macroeconomic stabilization and rapid growth.

Causes of inequality:

The underlying causes of extreme inequality are complex; a result of a range of historical, social, political, and economic factors. The World Bank (2004) study argues that unequal distribution of resources that characterize the region today follow patterns set by European colonization in the region, particularly with regards to education (i.e. low levels of support for basic education contrasted with generous financing for universities, which are only attended by the elite, for example), and weak political institutions susceptible to clientalism and patronage which perpetuated unequal patterns of influence. The report singles out race and ethnicity as consistent determinants of opportunity and welfare in Latin America, finding that indigenous men earn 35-65 % less than white men based on a survey of Brazil, Guyana, Guatemala, Bolivia, Chile, Mexico and Peru. Although social and economic stratification along lines of ethnicity are well known, issues of inequality and ethnicity are often viewed separately through the lens of development, with explicit links only sporadically made in hemispheric discussions. One potential explanation is that the debate has focused on avenues to redress inequality rather than on the root causes.

Latin American inequality in numbers:

The proportion of poverty and indigence grew in 2000-2002, disproportionately affecting children— of whom approximately 59% under the age of twelve live in poverty, according to UNICEF— and most countries show insufficient progress towards Millennium Goal targets. In terms of inequality, the richest one-tenth of the population earns 48% of total income, while the poorest tenth earn only 1.6%. In industrialized countries, by contrast, the top tenth receive 29.1%, while the bottom tenth earn 2.5%. Using the “Gini Index” of income concentration from the 1970s through the 1990s, Latin America and the Caribbean measured nearly 10 points more unequal than Asia, 17.5 points more unequal than the 30 countries in the OECD, and 20.4 points more unequal than Eastern Europe. World Bank Report (2004) data also showed that inequality in the least unequal LAC country – Uruguay – is higher than in the most unequal country in Eastern Europe and the industrialized countries.

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