

## **Inequality and the State in Latin America**

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### *Introduction*

Researchers working for international financial institutions (IFIs) and other international organizations, academics, and politicians agree that Latin America has an extremely unequal income distribution. Most would agree that it has the worst income distribution of any region in the world (IDB 2003). At the same time, Latin America has a higher average GDP per capita than other non-OECD regions. It is also clear that there are significant differences among countries within Latin America, and these differences are not related to the affluence of the societies. The countries with the least inequality are Costa Rica and Uruguay, whereas Brazil, Chile, and Bolivia have the highest degrees of inequality (ECLAC 2002: 227); Chile and Uruguay are second only to Argentina in GDP per capita, whereas Costa Rica ranks markedly lower and Bolivia very low, with \$3,701 and \$952 (in constant 1995 dollars) respectively, compared to Uruguay's \$6,016 (ECLAC 2002: 172).

Of course, income inequality is only one dimension of inequality, but it is an essential one, standing in a mutually reinforcing relationship with larger social and political inequalities. Thus, analyzing the causes of income inequality affords us insights into power constellations in society and into the differential distribution of life chances. Different analyses have emphasized different causes of income inequality and of the variation in inequality, such as historical structural roots in land distribution and natural resource endowments, geography, ethnic divisions, the economic context, demographics, and state action or lack thereof. The emphasis put on these various factor has shifted over time. In particular, the role of the state has not received much systematic attention until rather recently, despite its essential role in the allocation of resources.

There is no general agreement on the need for reducing inequality and on the nature of the remedies. For politicians, inequality per se is not necessarily a problem, depending on their world views and support base. For the political left it is a major problem, and for the center it is a problem at least in so far as it is connected to poverty, whereas the right tends to blame the victims, attributing poverty and inequality to lack of

effort and to promiscuity. Until the 1990s, the IFIs did not regard inequality as a problem either, concentrating on economic growth instead, but two factors moved inequality more towards the center of attention. First, econometric studies have shown that inequality can be an obstacle to growth (e.g. Alesina and Rodrik 1994). Second, public opinion in Latin America has become very critical of structural adjustment, so much so that the IFIs developed a concern with a possible backlash against the economic reforms they have prescribed. Clearly, to the extent that the reforms have been beneficial, the benefits have not reached the poor. Again, studies have shown that the high degrees of inequality reduce the effect of growth on poverty reduction (Bourguignon 2002). Clear signs of the increasing concerns of IFIs with inequality are the studies published by the Inter-American Development Bank (IDB 1998; Birdsall, Graham, and Sabot 1998) and the World Bank (de Ferranti et al. 2004).

International organizations other than the IFIs and academics have emphasized not only that inequality is a major obstacle to reaching the millennium goals of cutting poverty and extreme poverty in half by 2015 (ECLAC 2002) but also that it is undermining democracy (UNDP 2004). ECLAC (2002) states very clearly that poverty will not be effectively reduced without a change in distribution. The UNDP (2004) report on *The State of Democracy in Latin America* argues compellingly that a democracy of full citizenship is not compatible with the degree of inequality existing in many Latin American countries.

It is in the connection to policy and politics where the differences between IFIs and academic analyses remain clearly visible. For the Inter-American Development Bank the “challenge is to find new ways of reducing inequality, not by growth-inhibiting transfers and regulations, but by enhancing efficiency – by eliminating consumption subsidies for the rich, increasing the productivity of the poor, and shifting to a more labor and skill-demanding growth path” (Birdsall, Graham, and Sabot 1998:2). The problem is defined as one of enhancing efficiency, presumably a goal to which most major actors can subscribe and for which there are technical solutions. It is not defined as one of changing the distribution of political power. The contributions to Tokman and O’Donnell’s volume (1998), in contrast, establish clear connections between inequality, poverty, and policy and politics. For O’Donnell, the problem is “the recognition that in redressing poverty and inequality there is a *public* [italics in original] interest that goes well beyond any private interest.” However, this public interest does not assert itself; rather, “it is only through politics, in its dialogues and conflicts, that a persuasive and effective argument about the public interest can be built” (1998: 52). The basic task then is to form political coalitions capable of articulating this public interest, winning elections, and using the democratic process to translate it into redistributive policies.

Indeed, from the point of view of comparative social science, the failure of state action in the area of redistribution in the Latin American countries is central. We know from research on advanced industrial countries that the state can be a very powerful instrument for reduction of both poverty (Moller et al. 2003) and inequality (Bradley et al. 2003). The degree of reduction of poverty and inequality achieved varies with the size of taxes and expenditures and with the structure of expenditures and services, and those in turn vary with the underlying political power distributions (Hicks 1999; Huber and Stephens 2001; Swank 2002). In most Latin American countries, the state is

comparatively small, that is, tax revenue and social expenditures are low, and the resources that are spent are not well allocated. The major transfers are effected through social security programs, and those tend to be regressive. Social services are generally of unequal quality and more difficult to access for poorer groups than for others. However, there are important differences between Latin American countries, so we need to understand what distinguishes Latin America as a whole from other regions of the world as well as what distinguishes the Latin American and Caribbean countries with lower degrees of inequality from those with higher degrees. These differences are in part related to the relative strength of democracy and the political strength of forces representing the interests of the underprivileged, which in turn are related to international power distributions, in ways to be outlined below.

### *Causes of Inequality*

The main factors emphasized in traditional analyses of inequality, going back to Kuznets (1955), are economic and demographic. Kuznets postulated that the relationship between economic development and inequality has the form of an inverted U curve, with inequality rising in the early stages of industrialization, leveling off at intermediate stages, and then declining in advanced stages. Later research has devoted much attention to the mediating mechanisms, such as shifts in the sectoral composition of the labor force, the demographic transition, and the spread of education (e.g. Nielsen and Alderson 1995; 1999). In the specific case of Latin America at the beginning of the 21<sup>st</sup> century, few countries are low enough on the estimated curve that increased income should lead to increased inequality, and several of them are near the peak. However, at any given level of development, inequality in Latin America is about 10 percentage points higher than in the rest of the world (IDB 1998: 89).

The IDB study hypothesizes that geography and natural resource endowments may have something to do with this, as it finds a strong relationship between distance to the equator and income inequality, controlling for other explanatory variables (1998: 97-99).

Tropical conditions hamper the productivity of labor, tropical crops are associated with unequal distributions of land and income, and mineral resources and certain kinds of land require relatively more physical capital and less labor. Further, reliance on mineral and tropical exports entails high vulnerability to external shocks and thus to economic volatility, which heightens inequality of income distribution (IDB 1998: 100). Other analysts agree that the high degree of inequality in land distribution in Latin America and the frequency of macro-economic crises are associated with high inequality (de Ferranti et al. 2004: 157; 227-34).

Looking at recent trends in inequality in Latin America, we can see that it increased in most countries in the 1980s and remained largely constant in the 1990s, as a result of shifts in the sectoral composition of the labor force and changes in returns to education. The economic crisis and subsequent opening of the economies was accompanied by a shrinking of the formal sector, an increase in unemployment, and an expansion of the informal sector. Official unemployment figures vastly underestimate the true dimensions of the problem, because people barely surviving with activities in the informal sector are not counted as unemployed. Within the informal sector, some people are making a good

living, but the majority of people are barely making enough to help their families survive. Workers employed in small enterprises in the informal sector earn less than workers in the formal sector, even controlling for experience and years of schooling. The same is true for self-employed workers, the vast majority of whom are in the informal sector. Moreover, the difference between male and female earnings is larger among workers in the informal than in the formal sector and among the self-employed than formal sector workers (IDB 1998: 40). Thus, the size of the informal sector contributes to high inequality (de Ferranti et al. 2004: 159-61). In the 1980s and 1990s, roughly 8 out of every 10 new jobs created were in the informal sector (Tokman 2002: 161). It is important to keep in mind the magnitude of the phenomenon: Portes and Hoffman (2003) calculate a weighted average for 8 Latin American countries of 46 percent of the labor force belonging to the informal proletariat in the 1990s, that is, non-contractual waged workers, casual vendors, and unpaid family workers. Chile with 35 percent is at the low end and El Salvador with 50 percent at the high end.

Contrary to standard economic wisdom, economic liberalization and growth in the 1990s did not benefit the abundant factor of production, unskilled labor, but rather increased the demand for and the returns to skilled labor. Particularly university graduates saw the return on their education increase, because demand for their skills increased faster than the supply, though supply increased also. The Latin American approach to education policy, which emphasized expansion of primary and of university education, increased education inequality over the past three decades (IDB 1998, Morley 2001). In contrast, the East Asian countries expanded secondary education as well. Educational inequality reproduces itself and income inequality across generations. Latin America exhibits a particularly high degree of marital sorting, that is, correlation between the educational level (years of schooling) of spouses (de Ferranti et al. 2004: 165-6). Parents with low education are more likely to be poor and have more children, the mother has a lower probability of participating in the labor market and finding employment in the formal sector, and the children receive less education. Not only do the children of the poor receive fewer years of education, but they generally also receive lower quality public education (IDB 1998: 55-60).

Ethnicity is frequently associated with inequality in discussions of Latin America. It is true that class position and ethnicity are highly correlated. Indigenous groups and people of African descent are underrepresented among middle and higher income earners. They have lower levels of education, and they are more likely to live in rural areas where incomes are lower. It is also true that the countries with the lowest levels of inequality in Latin America, Uruguay and Costa Rica, are among the ethnically most homogeneous. However, there are no studies that have demonstrated a direct causal relationship between ethnic composition and income inequality.<sup>1</sup> The IDB (1998) study does not discuss the issue. De Ferranti et al. (2004) treat it as part of the discussion of the nature of inequality, not its causes. They analyze variation in labor income by decomposing the

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<sup>1</sup> This may well be a function of lack of data. Most Latin American governments have subscribed to a notion of national integration and official denial of racial and ethnic differences, and consequently most censuses did not ask about racial or ethnic characteristics. According to Florez, Medina, and Urrea (2001) censuses in 14 of 35 Latin American and Caribbean countries do not ask about racial or ethnic origin and even fewer labor force or household surveys do.

Theil index for four highly ethnically diverse countries, Bolivia, Brazil, Guatemala, and Guyana, and find that national wage inequality is mostly explained by within-group, not between-group differences (2004: 95-6). The salient within group characteristics are education and sector of employment.

Both the recent IDB and the World Bank studies do discuss the role of politics and policy in perpetuating inequality, but they do not systematically investigate it, relying instead on selective references to various other studies. The IDB study confines the discussion of politics to one box, *Democracy and Distribution* (1998: 104). The emphasis here is on good institutions, and these institutions are assumed to improve social services and economic growth and stability and thus indirectly reduce inequality. Greater accountability is thought to be more likely to lead to effective delivery of essential social services to non-privileged groups. Firm adherence to the rule of law, including civil liberties, increases confidence among investors and thus economic growth, and economic growth is assumed to promote, over time, more equitable distribution of income. Strong institutions of conflict management may also improve adjustment to economic shocks and thus reduce volatility and its detrimental effects on inequality.

In contrast, the World Bank study (de Ferranti et al. 2004: 109-47) provides a very comprehensive overview of the historical social origins of inequality, arguing that the factor endowments that the colonial powers encountered shaped the institutions that they imposed and that these institutions concentrated wealth and power in the hands of a small minority. Concentration of wealth and power, exploitation of indigenous and imported slave labor, and political exclusion of the majority survived into the independence period and entailed a neglect of the expansion of public education. High inequality generated clientelistic politics and thus prevented the emergence of broad-based reformist political coalitions after the advent of mass politics in the 20<sup>th</sup> century. Elites left the state apparatus with a low capacity to provide for macroeconomic stability, property rights, and basic services, which stood in a relationship of mutual reinforcement with unequal social relations. The struggle over economic and political inclusion versus exclusion resulted in political instability and thus erratic economic policy and growth. The study points to a potential for change as a result of political agency, specifically the organization of alliances between poorer groups, middle-income sectors, and progressive elites, in which programmatic parties have a role to play. This is certainly a sketch of major dynamics that most academic social scientists would in general subscribe to, and it is an interesting indication of the widening of thinking about the problem in the IFIs. The crucial question is to what extent this thinking will influence policy prescriptions formulated by these institutions. In the recommendation section, the study concentrates on policy design and abstains from resurrecting the politics of policy-making. It is precisely here that academic political scientists can make their contribution.

### *State (In)Action and Inequality*

The diagnoses of the causes of high inequality suggest a range of state actions that could potentially remedy the situation. Yet, at least so far, most Latin American states have failed to take such action on a large and sustained basis. We will first review state action

(or lack thereof) as it affects distribution and then turn to the causes of state action or inaction.

Historically, highly unequal distribution of land is at the root of economic inequality in Latin America. The struggle for land has spawned numerous revolutionary and reformist movements as well as some redistribution efforts from above, but the effects of land reforms have generally been disappointing from the point of view of reduction of inequality. In most cases, the proportion of land affected was limited and the most productive land exempt; the exceptions here are Bolivia, Cuba, Peru, Chile, and Nicaragua. In virtually no case redistribution of land was accompanied by significant state support in the form of credit and advisory services, which limited the capacity of the recipients to cultivate the land productively; exceptions are e.g. sugar cooperatives in Peru and Jamaica, that is, plantations in important export sectors. In some cases land reforms were deliberately rolled back by successor governments (Guatemala, Chile) or simply allowed to be eroded over the medium and long run (Mexico, Peru). Indeed, land reform efforts were in some cases crucial contributors to the ouster of reformist governments by coups (Guatemala, to a lesser extent Chile). In sum, even in the second half of the 20<sup>th</sup> century, Latin American states failed to implement effective land reform to correct for historic legacies, such that inequality and poverty remained widespread in the rural sector and contributed to massive rural-urban migration.

Lack of assets, both land and capital, has also remained a problem in the urban areas. Huge numbers of migrants became squatters, building housing on public lands to which they never obtained title. Without collateral, they had no access to the credit system and thus no opportunities to build small enterprises. Public administrations were reluctant to issue land titles and they by and large failed to devise credit schemes for small entrepreneurs. Development banks typically catered to large and medium enterprises, leaving the promotion of small or micro enterprises mainly to civil society initiatives.

The import substitution industrialization model (ISI), followed by the more advanced Latin American countries from the 1930s on and by others later, generated economic growth and formal sector jobs but came to depend on massive external borrowing in the 1970s and thus ended with the debt crisis in the 1980s. Even during its height, the formal sector jobs it created were not nearly sufficient to absorb the increase in the labor force resulting from population growth and rural-urban migration. Thus, a dual economy emerged and reinforced income inequality. Government policy favored capital intensive growth and foreign investment in industry and natural resources, not job creation in small enterprises and small farms.

The Achilles heel of the ISI model was the balance of payments deficit. Chronic balance of payments deficits generated period balance of payments crises that were then countered with stabilization policies prescribed by the International Monetary Fund (IMF). The devaluations and wage freezes that were part of these stabilization packages caused prices for basic goods to increase and real wages to decline, thus hurting the poor and the working class disproportionately and reinforcing inequality (Pastor 1987; Vreeland 2003). In addition, macro-economic policy tended to be inflationary in general and social expenditures were pro-cyclical. As noted above, high inflation and high volatility are associated with high inequality.

The economic reforms that dismantled the ISI model in the wake of the debt crisis had very mixed effects. They did succeed in reducing inflation, but liberalization of trade and finance increased exposure to external shocks and thus volatility. It was particularly the speed of major economic reforms that had negative consequences for growth and inequality (Huber and Solt 2004). Morley (2001: 79-80) finds a statistically positive relationship between an overall reform index and inequality; that is, the reforms increased inequality. Others have emphasized that the timing of the increase in inequality coincided with the implementation of neoliberal economic reforms (Berry 1998: 239). It is also true that countries that proceeded more cautiously with neoliberal economic reforms, Uruguay and Costa Rica, managed to protect lower levels of inequality, whereas the model of radical reformers, Chile under Pinochet, saw a dramatic and lasting increase in inequality.

The key to redress inequality of market income is the system of taxes and transfers. However, the low levels of tax revenue, the structure of the tax system, and the patterns of expenditure have obstructed significant redistribution. Latin American countries as a whole have been undertaxing their populations, with an average tax burden of 14% of GDP in the first half of the 1990s, compared to 17% of GDP in a group of East and Southeast Asian countries (IDB 1996: 128). Direct taxes, generally the most progressive element of taxation, amount to about 25% of tax revenue only, and of this amount some 60-80% typically come from corporate tax payments, while only 10-15% come from private individuals (ECLAC 1998: 72). The situation in the English-speaking Caribbean has been quite different, with an average tax burden in the first half of the 1990s of 27-28% of GDP, essentially double the rate of Latin America, and direct taxation on individuals and corporations accounting for some 40% of tax revenue (ECLAC 1998: 66-72).

Tax reform has been high on the agenda, but the dominant pattern of tax reforms over the past three decades in Latin America and the Caribbean has consisted of reductions of marginal tax rates on corporate and individual incomes and attempts to broaden the tax base (Tanzi 2000). The rationale was that this would reduce tax avoidance and increase revenue. At the same time, revenue from imports and exports and other international transactions declined significantly, mostly due to the lowering of tariff rates and other forms of deregulation. To make up for this decline and to facilitate tax collection, most countries have shifted more weight to value added taxes. These taxes are generally regressive, though exemptions of baskets of basic necessities can reduce the degree of regressivity. On the whole, the tax systems in most Latin America and Caribbean countries in the 1990s have been at best proportional and more commonly slightly regressive (Engel et al. 1998; Gómez Sabaini et al. 2002). Tax evasion and avoidance have remained fundamental problems. Both individuals and corporations continue regularly to engage in both. Despite administrative reforms to upgrade the status, equipment, and quality of personnel of the tax administration agencies, these agencies have fewer human resources and smaller budgets but higher collection costs than their counterparts in the more developed countries (ECLAC 1998:83).

Even a distributionally neutral tax system could be a powerful tool for redistribution if it made a significant share of GDP available for social expenditures, and if these expenditures were allocated in a way that is less unequal than market income. In Latin

America and the Caribbean, this is true for the majority of expenditures on social services but not necessarily for transfers. Studies of different programs show that expenditures on tertiary education and pensions are regressive, whereas basic education and health services provided by the public sector for the uninsured and school nutritional programs have a progressive incidence (e.g. Scott 2003 for Mexico; Wodon et al. 2000). ECLAC data for eight countries in the region show that the most progressive types of expenditures are spending on primary and secondary education, and that public spending on health care and nutrition is the second most progressive category (2002: 26). Within health and education, there are also regressive components, particularly if they involve public subsidies for privately provided services, but in general the progressive components tend to outweigh the regressive ones (de Ferranti et al. 2004: 263-4). Total spending for public education is progressive in Argentina, Chile, Mexico, and Uruguay, but regressive in Brazil (de Ferranti et al. 2004: 264).

The fact that public expenditures on health and education are progressive, of course, does not mean that the poor receive the same quality of services as the better off. The overall amount of expenditures is so low and the quality so poor in many cases that upper income earners simply opt out of the public health and education systems. In other cases, they supplement public with private resources and services. The Chilean education system constructed under Pinochet, for instance, encourages such solutions by providing public subsidies to private schools which then can demand additional fees. In several countries, the social security system as part of public health insurance pays for privately delivered health services, which makes these systems comparatively expensive.

The major reasons why transfers as a whole are regressive are that the bulk of transfers goes to social security pensions, and these pensions are employment-based and segmented and have earnings-related benefits. Typically, social security pension schemes were first established for privileged groups who then kept their privileged schemes even when pensions were later extended to other groups (Malloy 1979, Mesa-Lago 1978, Huber 1996). In the great majority of countries social security coverage remained confined to formal sector employees, which means that often 20% to 60% of the economically active population remained excluded. De Ferranti et al. (2004: 268-72), in their review of a range of studies, found that in most countries the regressive components of social security spending outweigh progressive components. ECLAC (2002:28) also shows that social security spending provides greater benefits to middle and upper strata.

There are a number of cash transfer programs that are not employment-based and earnings-related and are progressive, such as non-contributory pensions and conditional cash transfers. Conditional transfers are targeted to poor households and make receipt of benefits conditional on participation in education and health programs. They generally are highly progressive. The conditional cash transfer programs reviewed by Morley and Coady (2003), however, are limited in coverage and financing, reaching a maximum of 0.2% of GDP. Lavinás (n.d.) reviews conditional cash transfer schemes in Brazil, Mexico, Argentina, and Ecuador and finds that they have very low coverage and very small budgets.

Non-contributory, means-tested social assistance pensions are still relatively scarce and poorly funded as well (Muller 2005). The most significant programs exist in Brazil for

the rural sector and in Uruguay, accounting for 1% and .6% of GDP, respectively (Bertranou, van Ginneken, and Solorio 2004: 7). However, these kinds of programs are highly effective in reducing poverty and destitution among their recipients, not only in Brazil and Uruguay, but also in Argentina, Chile, and Costa Rica (ibid.: 13).

In general, universal programs, whether in transfers or services, cover larger sectors of the poor and thus are more redistributive than targeted programs. Targeted programs could certainly be highly redistributive, but in the reality of Latin America and the Caribbean, they tend to reach relatively small proportions of the poor because they are not sufficiently funded (e.g. von Amsberg et al. 2003 for Brazil). Targeted programs are more difficult to sell politically than universal or near universal programs that benefit middle income groups as well as the poor.

As noted, whereas Latin America as a whole has persistent poverty and excess inequality (Londoño and Székely 1997), there are significant differences between Latin American and Caribbean countries in the degree of social inequality and the role of the state in the distribution of income. Two countries that have had comparatively low degrees of poverty and inequality since the 1970s and managed to protect them through the 1990s are Uruguay and Costa Rica. Argentina and Chile were among the less unequal countries in the 1970s but saw a significant increase in inequality thereafter.<sup>2</sup> In Argentina, poverty also increased greatly in the 1990s and in the wake of the economic crisis of 2001, whereas Chile made significant progress in the reduction of poverty in the 1990s, despite continued very high inequality.

What distinguishes state policy in Uruguay and Costa Rica from that of other countries is the consistently high investment in social capital, particularly in education and health services, and the effort to expand coverage of the pension system and integrate all pension schemes. Literacy in Uruguay reached 94 percent in 1976, the same as in Argentina, and Costa Rica, at a much lower level of economic development, reached 91 percent in 1977. By 1980-86 the primary school completion rate in Uruguay was 88 and in Costa Rica 75, the two highest levels in Latin America (Morley 1995: 62). Coverage of the health system was expanded consistently. Infant mortality was comparatively low in 1970-75 already, with 53 per 1,000 live births in Costa Rica and 46 in Uruguay, and it fell to 16 in Costa Rica (the lowest in Latin America) and 24 in Uruguay by 1985-90 (Morley 1995: 67). This is particularly remarkable for Costa Rica, given the comparatively low GDP per capita. As of the early 1970s, Uruguay reached 84 percent of the population with health care through a combination of public services and mutual insurance schemes, the latter linked to social security financed through employer and employee contributions (Gaudiano n.d.). Costa Rica essentially built a unified national health system in the 1970s, comprising both the public and social security parts and marginalizing private provision. Coverage expanded from 38 percent in 1970 to 84 percent in 1979 and 85 percent by 1989 (Mesa-Lago 1994: 96).

Beginning in the 1980s, the health sectors in both countries experienced severe financial pressures. Particularly Uruguay's population became older and the disease profile came to resemble more and more that of advanced industrial countries. For both countries, the costs for medical technology and drugs increased, at the same time as contributions from

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<sup>2</sup> For a compilation of data from different sources see Morley (2001: 166-9).

employers and employees declined and the state experienced severe budget pressures as a result of the debt crisis. In Uruguay, the complexity of the health system with its many stake holders paralyzed significant reforms, and the result was declining quality of services in the public and social security schemes and by default an expansion of various kinds of private insurance and health delivery (Veronelli et al. 1994). In both countries, inequities emerged in so far as people with higher incomes could circumvent long lines for services in the public sector by making additional payments. In Costa Rica, significant progress was made possible with the introduction of basic health teams at the communal level (Clark 2004), as private interests were not as strong as in Uruguay.

As of the early to mid-1970s, Argentina also had a favorable profile of human capital, with an infant mortality rate of 49 and a primary school completion rate of 70. From then on, the country lost ground, with the primary school completion rate falling to 66 from 1980-89 and infant mortality declining to 32 only in 1985-90 (compared to 16 for Costa Rica). These developments must be attributed to a combination of declines in public expenditures and of the number of people receiving health care coverage through the *obras sociales*, the union-run health insurance schemes that are funded by mandatory contributions from employees and employers and had traditionally offered wide coverage. This decline is due to the shrinking of the proportion of the labor force in the formal sector. By 1997, only 58 percent of the population were covered by the *obras sociales*, 6 percent had private insurance, and 35 percent were not insured (Lloyd-Sherlock 2004). With a structure of the health care system similar to that of Uruguay, Argentine governments have seen their efforts at significant health sector reform stymied by the same complexity of stake holders. The difference is that Uruguay built up and has managed to maintain a stronger system of coverage through public schemes, supplementing the mutual insurance schemes.

In Chile, the net primary school enrollment rate in 1970 was 93, close to Argentina with 95 and higher than Costa Rica with 89. However, by 1980-86, under Pinochet, the primary school completion rate was 58 only, lower than Argentina (66) and much lower than Uruguay (88) and Costa Rica (75) (Morley 1995: 62). In contrast, infant mortality was lowered from 70 in 1970-75 to only 18 in 1985-90 (ibid: 67), the second lowest rate in Latin America. This reflects the dictatorship's neglect of public education on the one hand and its concern with internationally prominent statistics and pro-natalist orientation on the other hand, which led it to focus overall lower public health expenditures on poor pregnant women and infants. The Pinochet dictatorship implemented a sweeping health sector reform, promoting private insurance and delivery by introducing the option for employees to direct their mandatory health insurance contributions to private entities that could offer a wide variety of coverage and demand additional contributions. The result was a two-class health system, with higher income earners only being able to afford private coverage, and the lower income earners getting coverage through the public system where expenditures per capita and quality of services were a fraction of those in the private system (Borzutzky 2002). The democratic governments since 1989 have made major efforts to improve the public system and regulate the private system, with modest results due to the strength of the opposition from the private sector and their allies among the political right. The right has been heavily overrepresented in the Senate, as a legacy of the constitutional engineering performed under the dictatorship. The Lagos government launched an ambitious initiative to offer universal protection for a set of

basic services, but it had to make so many concessions that the financial basis of the reform remains precarious.

In the area of pensions, again Uruguay and Costa Rica have remained committed to a more universalistic, solidaristic, and thus redistributive approach. The pension systems of these two countries as of the early 1990s were more unified than most Latin American pension systems, with 87 percent of insured being part of the general scheme in Uruguay (Mesa-Lago 1994) and a law stipulating that all new public sector employees in Costa Rica had to join the general scheme along with all other employees and – on a voluntary basis – the self-employed. They both had non-contributory, means-tested social assistance pensions, amounting to some 37 percent of the minimum pension in the contributory system in Costa Rica in 2003 (Mesa-Lago forthcoming) and some 45 percent of the average pension in Uruguay (Mesa-Lago 1994). In 1996 a reformed pension system took effect in Uruguay and in 2001 in Costa Rica, both retaining a strong public collective first pillar and adding a smaller private individual second pillar. In Uruguay only contributions on earnings above a specified level go to the private system, and in Costa Rica employee contributions are differentiated by skill level.

The Argentine pension system as of the mid-1970s had wide coverage because of the high percentage of the labor force in the formal sector, and it had generous benefits. However, with the shrinking of the formal sector, coverage declined also, and the economic problems brought about a massive decline in the real value of pensions, some 60% between 1981 and 1991 (Mesa-Lago 1994). In 1994 a reformed system took effect, with a choice for the insured between a public system with a lower replacement rate than in the old system and a mixed public/private system with a replacement rate dependent on returns on invested capital. However, coverage under both systems continued to fall; in 1998-99 only 63 percent of the labor force were covered by both systems, and less than half of them made contributions, amounting to some 30 percent of the labor force as active contributors. This compares very unfavorably with Uruguay, where 72 percent of the labor force were covered and 66 percent of the labor force actually contributed (Cruz-Saco and Mesa Lago 1998). There is a minimum pension, but it requires 30 years of contributions. Thus, the social assistance pension for the uninsured destitute will be the only transfer available to a large proportion of the population.

The Chilean pension system as of the early 1970s had reached comparatively high coverage, but the Pinochet dictatorship in 1981 became the first government to radically privatize the pension system. Essentially, the new system is a system of compulsory private savings. Employer contributions were abolished, and employee contributions go into individual accounts that are administered for a fee by a private pension fund company. Fees are high and absorb a significant share of contributions from low income earners. As of 1998, only 23 percent of the labor force had made a contribution in the last month, even lower than in Argentina and way below Uruguay (Mesa-Lago forthcoming). There is no redistribution in this system. The government does guarantee a minimum pension for people with 20 years of contributions, but that pension is financed out of general revenue. In addition, in 1991 it was only 22 percent of the average national wage and insufficient to meet basic needs. The social assistance pension was less than half of that amount in 1992, and the number granted was limited (Mesa-Lago 1994: 121), so in effect there was no safety net to keep people out of poverty in old

age. Subsequently, the center-left governments improved these benefits, but the entire financial burden has to be carried by the general budget, whereas the high income earners can continue to put all of their contributions into their own accounts.

What do these brief sketches of the four traditionally most comprehensive social policy regimes in Latin America suggest regarding the redistributive capacity of different policy designs? In the area of health, the unified and public system of Costa Rica is performing much better in coverage and equity than the Argentine and Chilean systems, and it is also performing better in equity than the Uruguayan system, despite the lower GDP per capita of the country. The greater capacity to reform the system in Costa Rica was due to the fact that there were fewer powerful private interests than in Argentina and Uruguay, where these interests managed to block reforms. In general, including advanced industrial countries, in systems where health insurance and provision are heavily private, total costs, both public and private combined, are high, and there is greater potential for inequality in access than in public systems.

Pension systems for old age and invalidity are supposed to provide a social safety net for all, and particularly those individuals who would not be able to provide for themselves, by pooling risks and contributions. The special schemes for privileged groups in Latin America of course violated the principle of solidarity. But so does the privatized Chilean system, which is nothing else than a forced private savings scheme. Argentina and Uruguay retained a solidaristic and redistributive component in the public first tier. However, the most privileged groups in all four countries managed to resist inclusion in reforms designed to unify the pension system and standardize benefits. It is worth noting that the Pinochet government exempted the military from inclusion in the new scheme. Costa Rica from the beginning had the most unified scheme and has made greatest progress towards incorporating privileged public sector groups into this scheme. A law passed in 2000 also mandates that the self-employed be included on a compulsory basis in the Costa Rican pension scheme, as they are in Uruguay and Argentina, but in practice very little progress has been made. In Chile coverage for the self-employed remains voluntary.

The self-employed and workers in the informal sector are clearly the most problematic groups for Latin American pension systems. They are an increasingly large sector of the labor force and only a fraction of them actually contribute to the pension system, and then based on a proportion of their income only. Contribution rates for the self-employed tend to be high, because they have to make up for the lacking employer contributions, and for the many low-income self-employed these rates are simply too high. For instance, in the first trimester of 2002, less than 10% of the self-employed made (mandatory) contributions to the pension system in Argentina (Clarín, May 23, 2002). The only way to provide an effective safety net for the self-employed, as well as the growing number of employees in the informal sector, is via a non-contributory pension scheme, or a basic citizenship pension. The existing minimum pension schemes do not reach these groups because they require 20 or more years of contributions, and the existing social assistance schemes are much too limited in coverage and in level of benefits to provide an effective safety net. Such non-contributory pensions, if regarded as a citizenship right, can be incorporated into the regular pension schemes and count as part of pension income for

groups who are covered, in order to avoid wasting benefits on those who do not need them.

### *Causes of State (In)Action*

What explains the comparatively successful policies of Uruguay and Costa Rica, as well as the experiences of Argentina and Chile, and to what extent can these causal processes be generalized? Uruguay and Costa Rica have the strongest democratic records in Latin America. Uruguay has been democratic since 1911, with only two interruptions, and Costa Rica has been democratic since the early 1950s. This means that democratic processes are firmly institutionalized and political parties have had time to become major actors. In particular, in both countries parties with a social democratic orientation were able to attract large support bases and leave their imprint on the social policy regimes. Research on advanced industrial democracies has shown that incumbency of social democratic parties is a key predictor of welfare state generosity and of a redistributive welfare state structure (Huber, Ragin and Stephens 1993; Bradley et al. 2003). The PLN in Costa Rica and the Colorados in Uruguay, at least the factions identified with the Battlista legacy, have been promoters of investment in human capital and social safety nets. In addition, in Uruguay parties to the left of the Colorados have grown in strength and as competitors have made it difficult for the traditional parties to steer away from a commitment to maintaining strong social policies.

In Chile, the comparatively long history of restricted democracy and the electoral strength of left parties before 1973 account for the relatively good performance in quality of human capital and inequality at that point in time. The Pinochet dictatorship destroyed not only democratic institutions but also policies that dampened inequality. In Argentina, the Peronist party led by Perón was the protagonist of redistributive policies before 1974. The reversal occurred first under the military governments and then ironically under the same party led by Menem.

Results from our pooled cross section and time series analysis of data for 17 Latin American countries from 1970 to 2000 suggest that these explanations can be generalized to other Latin American and Caribbean countries. We found that strength of the democratic record is a significant determinant of public spending on health and education (Huber, Mustillo, and Stephens 2004). In contrast, strength of the democratic record does not influence social security spending. Kaufman and Segura (2001) found positive effects of democracy on health and education spending also, and even a weak negative effect on social security spending. However, episodes of populist authoritarianism as well as of repressive authoritarianism are associated with higher spending on social security in our analysis, as are popularly based presidents (democratic or authoritarian) in Kaufman and Segura's analysis. This reflects the fact that social security schemes for various occupational groups were originally created in many cases by populist authoritarian rulers, and that later repressive authoritarian rulers protected social security benefits for more privileged groups. When we include the strength of different party blocs in the legislature in the analysis, we find a positive effect of left party strength on health and education expenditures. This effect is fully in line with results for party

effects in advanced industrial countries, though it is substantively weaker than left effects on expenditures in the latter.

In another pooled cross section and time series analysis of the determinants of inequality in Latin America and the Caribbean we found a negative effect of the strength of the democratic record on inequality, as well as a negative effect of strength of left parties in the legislature (Huber et al. 2004). This suggests that extended periods of democracy make it possible for organizations representing the interests of the underprivileged to emerge, consolidate, and form a counterweight to the political influence of privileged groups. Where left parties achieve electoral strength, they use their parliamentary representation to shape policy in a progressive direction, via more progressive allocation of public expenditures, and presumably a host of other policies that affect distribution, such as minimum wage laws.

If we now turn from differences within Latin America and the Caribbean to differences between these countries and advanced industrial democracies, it becomes clear that weakness of democracy and weakness of the left are major factors explaining the higher inequality in the former. Here we can trace a long historical structural causal chain, going right back to landholding patterns. In all countries, including Italy, Spain, and Prussia, where large landholders played an important role in the national economy and depended on a cheap labor force, they were determined and effective enemies of democracy (Moore, 1966; Rueschemeyer et al. 1992). As long as they remained important economic and political actors, which they did in most of Latin America until at least the 1960s, democracy had difficulty surviving. Moreover, hacienda-style agriculture made independent peasant political organization difficult if not impossible. The contrast with countries dominated by smallholder agriculture or family farming, such as the Northern European countries, where agrarian parties received support and allied with parties based on organized labor to bring about democracy (Rueschemeyer et al. 1992), as well as early universalistic social policy programs (Hicks 1999), could not be clearer.

Weakness of parties of the left in turn is a result of the combination of weakness of democracy and weakness of organized labor. In comparative analyses of OECD countries, strength of organized labor is a very strong predictor of strength of left parties (Stephens 1979). When it comes to data on unionization, we have a very serious data problem for Latin America, so much so that we could not include it in our statistical analysis. McGuire (1999) lists estimates for the 1980s for Argentina ranging from 17 to 36% of the economically active population, for Brazil from 12.5 to 37%, for Chile from 8 to 13%, for Mexico from 9 to 35%, Peru 3 to 16%, and Uruguay 17 to 21%.<sup>3</sup> If, for the purposes of comparison, we accept estimates around the average of these ranges, they remain clearly below the degree of organization achieved in advanced industrial countries, with the exception of the United States and France. Moreover, even if we were to accept the upper level estimates, they would remain far below the degree of organization achieved in most countries with strong social democratic parties and generous welfare states.

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<sup>3</sup> Actually, he lists a further source that I am not including because it seems too far out of line with the rest.

Weakness of organized labor is partly a function of economic structure, that is, a relatively small percentage of the labor force employed in industry, as a result of late industrialization based on imported technology. Partly, it is also a function of the weakness of democracy. Both parties of the left and organized labor, rather than enjoying the democratic freedom to organize, suffered severe repression, forcing parties of the left to abandon much of their reformism as the price of being allowed to participate in the political process (e.g. Apra in Peru 1932-62, AD in Venezuela 1948-58). Parallel to repression, state elites made efforts to encapsulate labor in institutions controlled from above. Whereas such efforts could in fact raise the level of labor organization, they thwarted the independent political articulation of labor and thus kept the base for parties of the left weak. Where parties of the left could not achieve governmental power, they did not have the chance to revise labor laws in a way to support labor organization and to solidify their alliance with organized labor.

We also need to connect the weakness of democracy and of the left to international power constellations. Throughout the 20<sup>th</sup> century, U.S. policy in Latin America was highly interventionist and designed to protect U.S. economic and political interests, and despite attempts to legitimize interventions with reference to strengthening of democracy and freedom, these interventions systematically weakened democracy and reformist forces (La Feber 1983). Time and again, overt and covert interventions were directed against reformist political actors and left repressive authoritarian regimes in their wake. Out of the National Guards created under U.S. auspices during military occupations emerged Somoza in Nicaragua and the Duvalier dynasty in Haiti. A CIA-supported coup overthrew the second democratically elected president in Guatemala and stifled democracy there for the following four decades. Easily the best documented case of intervention is the one in Chile, where U.S. actions were aimed at systematically destroying the governing capacity of democratically elected and radically reformist president Allende (Kornbluh 2003). The coup and the following dictatorship of Pinochet were a massive setback for the strength of reformist forces in that country.

Organized labor was a particular target for covert U.S. operations and for overt support for anti-communist forces. In most countries the big push for industrialization occurred in the post-WW II period, during the Cold War, and radical left or communist influence in the labor movements started growing. U.S. interference contributed to weakening labor by enhancing political divisions and by establishing relations of dependency to external patrons, specifically the American Institute for Free Labor Development. The military governments that took power in the 1960s and 1970s shared the same anti-leftist zeal, and physical repression under most of those governments severely debilitated organized labor (Drake 1996). The economic crisis and the neoliberal economic reforms prescribed by the IFIs then further weakened unions by shrinking their potential membership base.

The increase in electoral strength of left parties in the 1990s and early 2000s, precisely when unions were so debilitated, seems to challenge the argument about the connection between strength of organized labor and strength of the left. However, it is worth remembering that the Labor Party (PT) in Brazil grew out of the labor movement there.

Indeed, Madrid (2004) found that the unionization rate was a consistently statistically significant and substantively important determinant of the left's share of the vote in Latin American elections in the period 1978-2002. The recent rapid growth of left electoral support is largely a result of popular disenchantment with the economic performance of incumbent traditional parties, and the presence of a left alternative that has demonstrated governing capacity in subnational units. One should keep in mind that the same disenchantment generated support for the populist authoritarian Fujimori in Peru, where no credible left alternative was available. In other words, the recent expansion of electoral support for the most part does not rest on an ideologically committed and reliable social base, but one that is likely to diminish if incumbent left parties prove unable to modify public policy sufficiently such as to improve popular living standards.

### *Potential Remedies*

It is rather obvious that economic growth per se will not significantly reduce the extremely high levels of inequality prevalent in most Latin American and Caribbean countries. Even the achievement of the Millennium goals of cutting poverty and destitution in half by 2015 is unlikely, because the rate of growth would have to be much higher than what can realistically be expected (ECLAC 2004). Thus, state action in changing the distribution of assets and income is essential for making progress in both the areas of inequality and poverty.

Historically, distribution of land has been at the root of inequality and poverty. Though land has by and large lost its importance as a source of national accumulation, even in the less developed countries of Central America (Segovia 2004), it retains actual and potential significance as a source of livelihood for families. Land reform was a key issue in the civil war of El Salvador and it remains the *raison-d'être* of the Movement of the Landless in Brazil, one of the most dynamic social movements in the region. Land reform is not cheap, of course, because in order to improve productivity of small-scale agriculture it requires provision of credit and investment in infrastructure. Moreover, to the extent that it would involve privately owned lands, it runs completely counter to the emphasis on the sanctity of property rights in the neoliberal policy doctrines. Nevertheless, land reform remains an essential element of a redistributive social policy regime, a fact recognized clearly in the World Bank study (de Ferranti et al. 2004).

The need for a stronger tax base has by now become quite universally accepted among policy experts. This is a change in the policy of the IFIs, whose preferred approach to reducing deficits in the 1980s was through cuts in government expenditures, rather than in tax increases. If investment in human capital as well as transfers are to be increased, and if this is to be done in a fiscally responsible and sustainable manner, tax collection has to be improved. Whether indirect taxes are indeed easier to collect than direct taxes seems to be an empirical question. If the present shift to reliance on indirect taxes is to continue, more exemptions of basic goods and higher rates for luxury consumption items are indicated to reduce the regressive impact of these taxes.

The need to structure transfers in a more progressive direction is also quite obvious, as are the characteristics of policy designs that can meet this need, but the politics of such a change are particularly difficult. In all countries, including the OECD, it is extremely

difficult to lower benefits in established pension systems. In the Latin American context, the beneficiaries of the privileged systems are at the same time among the politically most articulate and influential groups. It is telling that in many countries some of the most privileged groups managed to exempt their schemes from pension privatization. Nevertheless, Latin American countries simply cannot afford pension systems where some categories of high level public servants can retire after 30 or 35 years of service with virtually full pay. As the public awareness of the existence of such schemes grows, and programmatic parties get in a position to shape policy, chances for reforms increase.

It is rather clear by now that the privatization of the pension systems in some Latin American countries has not fulfilled expectations at best (Chile) and been a complete disaster at worst (Argentina). In Chile, with the longest-established of the reformed systems, effective coverage has actually declined, if one considers the share of the economically active population who make regular contributions. Thus, many people will have to fall back on the minimum pension for those with a certain number of years of contributions but insufficient accumulation, and even more people will have to depend on the means-tested social assistance pension. In both cases, the state has to subsidize or fully pay for these schemes. In Argentina, the financial crisis severely damaged private pension funds and greatly reduced the value of more than half a decade of deposits by insured employees, stimulating a discussion about new reforms. Clearly, these experiences teach that financial markets are inadequate providers of old age security, and that the state has to play the central role. Evidence from the early years of the welfare states in Northern Europe as well as from the above noted experience with limited non-contributory, tax-funded pensions in some Latin American countries shows that a shift in emphasis from occupationally based, earnings-related, contribution-financed to universalistic, flat-rate, tax-financed pensions would go a long way towards reducing poverty in old age.

A comparison with Europe is instructive here. For instance, Finland, a late developer in the North- and West-European context, instituted a basic citizenship pension in 1956. In that year, its GDP per capita was \$4,600 in constant dollars adjusted for purchasing power parity. Measured the same way, Chile's GDP per capita in 1992 was \$4,890 (Penn World Tables [www.nber.org/pwt56.html](http://www.nber.org/pwt56.html)). This comparison certainly casts doubt on the assertion that Latin American countries simply cannot afford such schemes. A system of basic citizenship pensions could then be complemented with a mandatory, contribution-based system, be it based on defined benefits, or defined contributions, or notional defined contributions like the Swedish system. Pensions based on collective and publicly managed funds are not only much cheaper to administer than those based on privately managed individual accounts but they also reduce individual and cohort risks (e.g, Orszag and Stiglitz 2001; Huber and Stephens 2000).

Ideally, this system of basic pensions for the elderly would be complemented with universalistic, means-tested social assistance for the working age population, or at least with conditional transfers for the working age population with children. This would not only reduce inequality directly, but it would contribute to a reduction in intergenerational reproduction of inequality. We know from studies of school achievement based on individuals that children from poor households are at a disadvantage. In addition, we now have aggregate data for advanced industrial democracies measuring actual

quantitative and literacy skills in a comparable way (OECD/ Statistics Canada 2000). Achievement levels of the bottom quintile are negatively associated with poverty and inequality (the higher poverty and inequality, the lower achievement levels of the bottom quintile), but they do not show any positive association with total (public and private) expenditures on education. In other words, just investing in education without also addressing poverty and inequality directly is not an effective strategy for improving the quality of human capital at the bottom in advanced industrial societies. We should not expect it to be effective in Latin America and the Caribbean either.

There is an additional strong argument to be made for universalistic pensions and broad social assistance, rather than transfers exclusively focused on the poor. The economic transformations since the 1980s have increased volatility and the size of the economically vulnerable population. This means that relatively large numbers of families live just above the poverty line but are vulnerable to the risk of slipping below with the next economic crisis. A system targeted at the poor will miss those groups until they are in poverty, but a broader system of transfers can protect them from falling into poverty to begin with. To construct this kind of transfer system, a solid income tax system is indispensable. The tax registry will make it possible to screen out the middle and upper income earners who do not need social assistance benefits and pensions, as happens in Australia (Castles 1985), or – in the case of universalistic pensions – it would make it possible to reclaim unnecessary benefits through taxation.

Having emphasized the importance of direct redistribution as a basis for an effective improvement of the human capital base at the bottom, it is also crucial to insist on redistribution of access to quality education and health care services. This means to expand public provision of primary and secondary education, along with an emphasis on quality control, and it means to expand public provision and unification of public and private health care systems. There are three crucial quality differentials in education that have to be overcome; between public and private schools, poor and rich neighborhoods, and rural and urban areas. The trend to decentralization, which has been very strong in the region, is actually an obstacle to overcoming these differentials, unless it entails a strong component of earmarked central financial transfers aimed at equalizing the financial base of school districts.

In most Latin American countries, there are significant quality differentials between the health care provided by the private and social security sectors on the one hand and the public sector on the other hand. The private and the social security sectors are typically closely linked, as health insurance funded by social security contributions frequently pays for health care services from private providers. These sectors have much higher per capita expenditures than the public sector. The public sector is primarily in charge of preventive health measures and of providing care for the uninsured, though in many cases patients with social security insurance coverage also use public hospitals for more complicated treatments. Decapitalization of the public sector during the 1980s had long-lasting consequences in many cases. It opened the way for an increasing role of the private sector, with predictable consequences for growing differentials in access to and quality of health care. Efforts to bridge these gaps then cannot simply concentrate on increasing expenditures but need to work towards a unification of the public and social security sectors, and a reduction of the role of private provision.

Given the intrinsically political nature of social policy, redistribution of resources in the political playing field is a prerequisite for major progress in building redistributive social policy regimes. Strengthening of democratic institutions is necessary but not sufficient. We have seen that strength of the democratic record does depress inequality, but so does political strength of the left. Parties of the left are everywhere at a disadvantage compared to parties of the right in terms of the financial base of their supporters and supportive media coverage. Economically privileged groups support parties that protect these privileges, and privately owned print and electronic media do not tend to favor parties with redistributive programs that might affect the interests of their shareholders negatively. In order to begin to counteract this endemic imbalance, legislation on public financing of parties and of political campaigns is essential. Various countries have successfully used formulas for party financing based in some way on votes received in previous elections. In addition, regulations of election campaigns can restrict the importance of private funds by limiting overall expenditures and providing free and equal media access.

In addition, it is essential to strengthen the infrastructure of democracy by promoting organizations in civil society and strengthening the links between these organizations and political parties. The growth of unions with an encompassing structure and orientation can be favored through labor legislation that encourages union membership and centralized bargaining. Civil society organizations, such as women's, environmental, educational, and community action organizations can be strengthened as legal entities and by frequent inclusion in consultations with public agencies in the course of elaborating and implementing public policies. Various innovative experiments along those lines have been made in cities governed by the PT in Brazil, for instance. It is crucial to link civil society organizations directly to the policy-making process via engagement with political parties. It is more effective to elect representatives with a firm policy commitment than to attempt to work as a pressure group from the outside. Greater attention by social scientists to the identification of possible political strategies to build such alliances and larger dissemination of insights gained from such studies would be one important step towards building the infrastructure for redistributive state action.

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