

Richard Blundell
Mariano Bosch
Nora Lustig
Marcela Melendez

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Working paper

Income inequality and the role of the state in Latin America: an overview

Income Inequality and the Role of the State in Latin America: an Overview¹

Richard Blundell (University College London and IFS), Mariano Bosch (Inter-American Development Bank), Nora Lustig (Tulane University), and Marcela Melendez (World Bank)

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Abstract

This paper analyzes how the state can take actions to reduce the persistent and multifaceted nature of inequality in Latin America, where inherited factors account for 50-60% of disparities in individual earnings. Despite declines in income, education, and gender inequality, the region maintains the world's highest income inequality levels, with Gini coefficients above 0.45. Latin America continues to be characterized by significant ethnic and racial disparities, gender wage gaps, and fragmented market structures dominated by giant firms with excessive pricing and wage-setting power. The paper argues for comprehensive state intervention through a three-pronged approach: (1) closing earnings potential gaps through improved education, health, and skill development policies; (2) shaping labor and output markets through productivity-enhancing measures, minimum wage regulations, and competition policies; and (3) redistributing income via fiscal instruments including taxes, transfers, and social security systems. The paper emphasizes that effective inequality reduction requires a holistic policy mix integrating both pre-fiscal interventions addressing structural causes and post-fiscal redistribution mechanisms, as purely redistributive approaches cannot adequately address deeper market inefficiencies and intergenerational transmission of disadvantage.

Keywords: income inequality, intergenerational transmission, ethnic and gender disparities, state intervention, fiscal redistribution, education, health, labor markets, product markets, social policy, Latin America

JEL Classification Codes: D31, D63, I24, I38, O54

¹ This is the working paper version of the article entitled 'Income Inequality and the Role of the State in Latin America', prepared for the LACIR project. The Latin American and Caribbean Inequality Review (LACIR) is an independent scholarly endeavor created with the aim of understanding why, despite major structural economic and social change, inequality in Latin America and the Caribbean persists at exceptionally high levels. The review focuses on inequality along various dimensions, including income, wealth, education, health, and political power. Much of the data and analyses presented in this chapter are based on studies published by the review. For more information, go to <https://lacir.lse.ac.uk/>. This working paper includes an expanded discussion of a broad set of mechanisms by which the state impacts income inequality in Latin America. We are deeply grateful to the LACIR panel and conference participants for their valuable comments. Richard Blundell is grateful for financial support from the Economic and Social Research Council (ESRC) (CPP at IFS, ES/M010147/1; ES/W010453/1). Mariano Bosch is grateful for financial support from the Inter-American Development Bank (IADB) (RGT3609) and for research assistance from Paola Rojas and Pablo Tillán.

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1. Introduction

Latin America faces persistent and multifaceted inequality, despite strides in income, education, and gender equality. Factors such as inherited disparities contribute to more than half of the region's inequality,² with early childhood development gaps leaving lasting impacts on opportunities and outcomes.³ Education quality is a significant challenge, lagging behind other regions, with stark differences between schools attended by wealthy and low-income children⁴. The poorest households suffer from limited access to maternal care, higher rates of infant mortality, and stunting. Health systems in most countries are fragmented, linking access to quality care with an individual's income or employment status, which exacerbates inequalities. In all, inequality remains high, despite progress at the start of the century: the Gini coefficient remains above 0.45 in the region. Like poverty, inequality has hardly fallen in the last ten years, and LAC remains the most unequal region in the world⁵

Ethnic and racial disparities are also glaring. Black and Indigenous populations are overrepresented among the poor and absent from middle and upper economic classes. Even when controlling for social origins, darker-skinned individuals experience significant disadvantages in education, income, and employment.⁶ Gender inequality persists in the quality and remuneration of jobs, with women burdened by an unequal division of unpaid and paid labor, leaving them systematically worse off than men. In all, individuals' incomes are largely shaped by inherited traits beyond their control—sex, race, birthplace, and family background—accounting for 50-60% of earnings, with birthplace and parental education being the most influential factors.⁷

The region's economies are uniquely skewed, with giant firms dominating market structures, partly because of the absence of a significant segment of small, medium, and large firms: the most salient feature of LAC markets is the excessive fragmentation of output and labor across a myriad of tiny units.⁸ The largest firms often wield excessive power, with average price markups of 84% over

² Paolo Brunori, Francisco H G Ferreira, and Guido Neidhöfer, "Inequality of Opportunity and Intergenerational Persistence in Latin America," *Oxford Open Economics* 4, no. Supplement_1 (2025): i167–99, <https://doi.org/10.1093/ooec/odae021>.

³ Orazio Attanasio et al., "Inequality in the Early Years in LAC: A Comparative Study of Size, Persistence and Policies," *Oxford Open Economics* 4, no. Supplement_1 (2025): i273–91, <https://doi.org/10.1093/ooec/odae032>.

⁴ Raquel Fernández et al., "Education Inequalities in Latin America and the Caribbean," *Oxford Open Economics* 4, no. Supplement_1 (2025): i55–76, <https://doi.org/10.1093/ooec/odae013>.

⁵ Antonella Bancalari et al., "Health Systems and Health Inequalities in Latin America," *Oxford Open Economics* 4, no. Supplement_1 (January 1, 2025): i122–47, <https://doi.org/10.1093/ooec/odae029>.

⁶ Edward E Telles et al., "Racial Inequality in Latin America," *Oxford Open Economics* 4, no. Supplement_1 (2025): i200–218, <https://doi.org/10.1093/ooec/odae022>.

⁷ Inés Berniell, Raquel Fernández, and Sonya Krutikova, "Gender Inequality in Latin America," *Oxford Open Economics* 4, no. Supplement_1 (2025): i219–72, <https://doi.org/10.1093/ooec/odae035>.

⁸ Marcela Eslava et al., "Businesses and Inequality in Latin America," *Oxford Open Economics* 4, no. Supplement_1 (2025): i334–48, <https://doi.org/10.1093/ooec/odae031>.

marginal costs and wages suppressed by 44% below what workers contribute in value⁹ further entrenching inequality.¹⁰

This inequality landscape demands proactive state intervention. Governments affect inequality through laws, regulations, fiscal redistribution, and efforts to shape societal values. Competition policies and minimum wages are examples of regulations that can reduce income disparities. Access to quality education determines future income and can help mitigate the intergenerational transmission of inequality. Universal healthcare systems can address disparities in health outcomes. Conditional cash transfers can mitigate poverty and the influence of inherited inequality. Affirmative action programs can bridge ethnic gaps in education and employment. Broadly, taxes and transfers remain crucial tools for reducing post-fiscal income and wealth disparities. While some state actions have immediate effects on inequality by altering resource allocations, others are designed to shift long-term equilibria and break the cycle of intergenerational inequality.

From a life-cycle perspective, the state's role in addressing inequality can be grouped into three main areas:¹¹

1. **Closing the earnings potential gap:** Policies that improve education, health, skill development, and social networks to boost income opportunities and close the gap in living standards.
2. **Shaping labor and output markets to reduce inequality:** Productivity-increasing policies that result in better jobs and better labor incomes. Regulations like minimum wage laws and competition policies that influence the division of income between labor and capital. Policies that reduce gender and ethno-racial gaps.
3. **Redistributing income through taxes and transfers:** Fiscal tools such as taxes and transfers to adjust post-production income distribution. Instruments such as pensions to provide economic security over the life cycle.

It is important to note that addressing inequality comprehensively requires a combination of all three approaches. Effective redistribution policies cannot merely patch over deeper structural inefficiencies. Instead, they must complement interventions that address root causes, such as unequal access to education, healthcare, and economic opportunities.

Two data points from the region underscore the need for this holistic approach. Evidence shows that more than 50% of income inequality is explained by “inherited” factors, ranging from 44% in Argentina to over 60% in Guatemala.¹² Among these, parents' education and occupation play the

⁹ T H Gindling and Lucas Ronconi, “Minimum Wage Policy and Inequality in Latin America and the Caribbean,” *Oxford Open Economics* 4, no. Supplement_1 (2025): i400–415, <https://doi.org/10.1093/oeec/odae011>.

¹⁰ Marcela Eslava, Alvaro García-Marín, and Julián Messina, “Inequality and Market Power in Latin America and the Caribbean,” *Oxford Open Economics* 4, no. Supplement_1 (2025): i416–25, <https://doi.org/10.1093/oeec/odae037>.

¹¹ Olivier Blanchard and Dani Rodrik, eds., *Combating Inequality* (The MIT Press, 2021), <https://doi.org/10.7551/mitpress/13469.001.0001>.

¹² Paolo Brunori, Francisco H G Ferreira, and Guido Neidhöfer, “Inequality of Opportunity and Intergenerational Persistence in Latin America,” *Oxford Open Economics* 4, no. Supplement_1 (2025): i167–99, <https://doi.org/10.1093/oeec/odae021>.

most important role, followed by geographic location and ethnic origin. Similarly, according to Acevedo et al. (2013), during the decline in inequality in the early 2000s, about 60% of the reduction was explained by falling labor income inequality, while roughly 17% was due to government transfers.

This paper focuses on the role of the state in affecting inequality broadly understood. We emphasize the importance of a balanced policy mix that integrates pre-fiscal and post-fiscal interventions. Taxes and transfers are among the most powerful instrument to affect post-fiscal income inequality. While essential, must be carefully designed to minimize inefficiencies and maximize equity. They have a more immediate impact income inequality and provide an important balance with pre-fiscal policies aimed at longer-term structural imbalances. However, the role of the state goes beyond redistribution. It also encompasses correcting market distortions, fostering social mobility, reducing gender and racial gaps, and removing barriers to access in finance, education, and healthcare. Some policies—particularly those targeting early-life disparities in health, education, and related areas—may take time to yield results, yet they are essential for addressing the structural roots of inequality. Ultimately, only a holistic policy mix can effectively confront the deep-seated drivers of inequality.

2. Closing the Earnings Potential Gap

2.1 Early Childhood Development¹³

Children experiencing disadvantage in their early years are more likely to face adverse outcomes throughout their lives. A recent study examined inequalities in language, cognitive, and socio-emotional skills among children aged 0–5 in Chile, Colombia, Mexico, Peru, and Uruguay.¹⁴ The findings revealed significant gaps across countries and emphasized the need for large-scale, evidence-based interventions to address these disparities and promote equal opportunities later in life. In some countries the inequalities are very large, with language development gaps between children of mothers with only primary education or less and those whose mothers achieved secondary or higher education widening over time—from less than a two-month delay at age two to a gap of over 16 months by age five. Expanding and improving early childhood development (ECD) services for low-income and vulnerable populations is essential for reducing inequality in Latin America. Investments in ECD are among the most effective long-term strategies to improve outcomes for disadvantaged children. Yet, the available data show that current funding levels in LAC are insufficient to ensure an adequate supply of sustainable, high-quality, and equitable services. While LAC invested, on average, 0.34% of GDP on pre-primary education in 2020/2021, non-LAC OECD countries allocated 0.54% of GDP and Nordic countries 0.90% of GDP. UNESCO (2020)

¹³ The data and analysis presented in this section are based on: Orazio Attanasio et al., “Inequality in the Early Years in LAC: A Comparative Study of Size, Persistence and Policies,” *Oxford Open Economics* 4, no. Supplement_1 (2025): i273–91, <https://doi.org/10.1093/ooec/odae032>.

¹⁴ The Latin American and Caribbean Inequality Review (LACIR) is an independent scholarly endeavor created with the aim of understanding why, despite major structural economic and social change, inequality in Latin America and the Caribbean persists at exceptionally high levels. The review focuses on inequality along various dimensions, including income, wealth, education, health, and political power. Much of the data and analyses presented in this paper are based on studies published by the review. For more information, go to <https://lacir.lse.ac.uk/>

While implementing high-quality ECD programs at scale is vital, this requires overcoming challenges in operations, monitoring, and evaluation. Governments must focus on long-term improvements in program quality, rather than just measuring how many children and families are served. One important step in reducing socio-economic gaps in ECD is alleviating poverty. Conditional cash transfers (CCTs), which provide financial assistance to low-income families contingent on specific actions like school attendance or healthcare visits, have proven effective. In several countries, including Honduras, Ecuador, and Nicaragua, CCTs have led to better cognitive development in children, especially in areas where socio-economic disparities are largest, such as language skills. Importantly, the benefits of these programs often persist over time.

One of the most prominent CCT programs, Mexico's Progresa (later renamed Prospera), was unexpectedly scaled back in recent years. Research has found that this rollback immediately reduced school enrollment, particularly among high-school-aged boys, and increased child labor in affected areas.¹⁵ The findings highlight the critical role such programs play in supporting the education and well-being of vulnerable populations.

Another key policy for improving ECD outcomes is center-based care, which includes childcare for children aged 0–3 and preschool for children aged 3–5. Childcare centers offer a range of services, including nutrition, stimulation, and education, while preschools prepare children for primary school. Studies show that access to preschool positively impacts academic performance, high school progression, and long-term outcomes, such as higher income, greater employment opportunities, and reduced crime rates. However, these benefits are most pronounced when the quality of services is high and when the programs target vulnerable populations.

In remote areas, alternative approaches to ECD are needed to address gaps in access. Wealth disparities in developmental inputs, such as reading, playing, and engaging with children, are evident in Latin America. Home visiting programs, where trained professionals provide support and guidance to families, have shown promise in improving parental practices and child development. For example, the Reach Up and Learn program in Jamaica has demonstrated long-lasting benefits, including better academic performance, reduced depression, and higher earnings—up to 43% higher at age 31. However, large-scale evaluations of similar programs in Latin America have produced mixed results, underscoring the need for further innovation and adaptation.

The cost-effectiveness of ECD programs also varies widely. For example, studies have found benefit-cost ratios for at-scale home visiting programs ranging from 5.4 in Peru to 11.7 in Nicaragua. Center-based childcare programs have shown similar returns, with a ratio of 6.2 in Nicaragua. These ratios are often higher than those for preschool programs, highlighting the importance of carefully considering the potential benefits and costs of different approaches.

In conclusion, investing in high-quality ECD programs is critical for reducing inequality and improving long-term outcomes in Latin America. While challenges remain, evidence shows that these

¹⁵ Fernanda Marquez-Padilla, Susan W. Parker, and Tom S. Vogl, "Rolling Back Progresa: How the Sudden Ending of a Landmark Anti-Poverty Program Affected School and Labor," *Association of Population Centers*, no. Working Paper Series 2407 (September 13, 2024), <https://doi.org/10.31235/osf.io/h9qmc>.

investments yield significant returns for children, families, and society as a whole. Policymakers must prioritize innovative, scalable solutions that ensure all children, regardless of their socio-economic background, have the opportunity to thrive.

2.2 Basic Education¹⁶

Despite significant investments in education over the past few decades, learning outcomes across Latin America remain alarmingly poor. While the average years of schooling have risen across the region—especially in lower middle-income countries that started with lower educational attainment—the quality of education remains a critical concern. International assessments, such as the PISA exams for 15-year-olds, reveal that Latin America consistently underperforms compared to other regions.

The transmission of inter-generational inequality is strong. Parents' education levels strongly influence the quality and quantity of education their children receive. For example, children with at least one parent who has completed tertiary education are far more likely to finish high school and pursue higher education themselves. However, this relationship varies across countries, with some showing an increasing dependence on parental education over time.

A striking issue is the stark difference in academic performance between public and private school students, even after accounting for parents' education levels. Private school students in the region tend to perform significantly better than their peers in public schools, and private schools are among the most socio-economically segregated in the world. Many better-off families have opted out of public education, leaving public schools to struggle with declining quality and limited resources. This means children from affluent families attending private schools primarily interact with peers from similar backgrounds, which reinforces and perpetuates educational inequality.

Education inequality drives inequality in other areas, particularly wages. Returns on education—meaning the financial benefits of obtaining more schooling—are still remarkably high in Latin America compared to other regions, even though they have declined over time. This contributes to wider income gaps, as access to quality education is highly uneven. The ripple effects of this inequality extend to other areas, such as health and wealth, amplifying disparities across society.

The COVID-19 pandemic highlighted and worsened existing inequalities in education. The widespread and prolonged closure of schools shifted the burden of education and childcare almost entirely onto parents and families. While schools in some countries reopened intermittently or for select groups of students, access to consistent quality education was uneven.¹⁷

¹⁶ The data and analysis presented in this section are based on: Raquel Fernández et al., “Education Inequalities in Latin America and the Caribbean,” *Oxford Open Economics* 4, no. Supplement_1 (2025): i55–76, <https://doi.org/10.1093/ooec/odae013>.

¹⁷ The data and analysis presented in this section are based on: Guido Neidhöfer, Nora Lustig, and Mariano Tommasi, “Intergenerational Transmission of Lockdown Consequences: Prognosis of the Longer-Run Persistence of COVID-19 in Latin America,” *The Journal of Economic Inequality* 19, no. 3 (July 31, 2021): 571–98, <https://doi.org/10.1007/s10888-021-09501-x>.

For economically disadvantaged children, the effects were particularly severe. School closures removed the equalizing effect of standardized curriculums and similar learning environments, replacing them with a patchwork of home-based learning that varied widely in quality and support. Children from low-income households, who were already struggling to keep up with their wealthier peers, fell further behind. The pandemic also had a significant impact on students nearing the end of their education and preparing to enter the workforce. This group faced interruptions during a critical period in their lives, potentially affecting their job prospects and long-term economic opportunities.

To improve learning outcomes, the region must prioritize both increased funding (LAC spends 4.6% of GDP vs 5.1% in OECD countries)¹⁸ where needed and more effective spending, particularly for programs aimed at supporting children from low-income households whose already disadvantaged situation worsened during the pandemic. Giving priority to improving educational access and learning outcomes for the disproportionately underprivileged populations is key to reducing inequality of opportunity and outcomes. Tackling the region's education challenges requires not only addressing disparities in access and quality but also ensuring that public schools become a viable and effective option for all families. This is essential for reducing inequality, improving economic opportunities, and ensuring a brighter future for Latin America.

2.3 Health¹⁹

Healthcare access and health outcomes are strikingly unequal in the region. Public health spending in LAC is 4% of GDP, significantly lower than the 7.4% in high-income countries. One key characteristic of Health systems in Latin America is that they are often divided into contributory and non-contributory insurance schemes. Contributory programs, funded through formal employment and social security contributions, tend to offer better services than non-contributory programs, which are usually funded by taxes and targeted at informal workers or low-income populations. This segmentation has led to significant disparities in the prevention and treatment of non-communicable diseases. These differences cannot be fully explained by income or socioeconomic status alone but are partly due to unequal access and quality between the two types of systems. Countries with a universal healthcare system such as Brazil, Costa Rica, and Cuba, generally showed lower levels of inequality in antenatal care, teenage pregnancy, hypertension testing and treatment, mammograms, and cervical cancer screenings.

Beyond healthcare access, health outcomes are shaped by many factors, including household resources, access to information, societal norms, and power dynamics. While expanding healthcare coverage and improving access to medical services are important steps, reducing health inequalities requires addressing these broader influences as well. Policies need to work across sectors to ensure families have the resources, support, and information they need to lead healthier lives.

¹⁸ Elena Arias Ortiz et al., "The State of Education in Latin America and the Caribbean 2023," *IDB Publications*, January 23, 2024, <https://doi.org/10.18235/0005515>.

¹⁹ The data and analysis presented in this section are based on: Antonella Bancalari et al., "Health Systems and Health Inequalities in Latin America," *Oxford Open Economics* 4, no. Supplement_1 (January 1, 2025): i122–47, <https://doi.org/10.1093/ooec/odae029>.

Reducing health inequality in Latin America requires a multifaceted strategy that integrates universal access to affordable, high-quality healthcare with stronger systems for health promotion and disease prevention. This involves blending contributory and non-contributory schemes to guarantee a baseline of benefits for all, while expanding programs that encourage healthy behaviors and prevent chronic illnesses. Investments in infrastructure—such as clean water, sanitation, and other public health projects—are equally critical, provided they are delivered on time and effectively utilized by communities. At the same time, robust safety nets can help families withstand financial shocks, while greater attention to mental health services ensures that this often-neglected dimension of well-being is addressed. Finally, improved data collection and analysis are essential to inform evidence-based policies that tackle the root causes of inequality.

3. Shaping Labor and Output Markets to Reduce Inequality

Labor and output markets amplify existing inequalities in Latin America and the Caribbean (LAC), often reinforcing disparities that begin early in life. Approximately 55 percent of workers in LAC are employed in the informal sector—either as self-employed individuals or in very small firms—earning low wages with minimal or no social protection, such as access to quality healthcare or future pensions. This situation renders traditional policies used in developed countries less effective in addressing inequality. In particular, many of the policies related to taxes and social insurance remain ineffective as governments are unable to tax effectively and target transfers in the way that developed countries do, as a large share of the labor force operates outside the reach of standard payroll-based taxation, which limits governments' ability to finance redistributive social insurance schemes with payroll taxes.

Additionally, there is a significant educational divide between those working in small, unproductive informal firms and those in larger companies. Labor market outcomes are particularly poor for women and Afro-descendants, underscoring the need for targeted policies. Importantly, research shows that the type of business where people work is as critical, if not more so, than individual characteristics in determining earnings. The lack of medium- and large-sized, high-productivity firms—which could absorb a larger portion of the workforce, expand social protection coverage, and help regulate market power—is a major concern for the welfare of the region.

Governments can implement policies to confront how these structural features reinforce patterns of inequality. For example, minimum wages can reduce inequality when well-calibrated and enforced, as shown in Brazil, Mexico, Costa Rica, and Argentina, but overly high levels—as in Honduras—push workers into informality, limiting benefits for the poorest. Market concentration further worsens inequality, as a few powerful firms charge high prices and pay low wages, highlighting the need for stronger, independent competition agencies and policies that foster SME growth. The region's labor market is dominated by microenterprises, which trap workers (particularly low educated workers) in low-productivity, low-wage jobs, making policies that support firm growth, skills development, and access to finance essential for upward mobility. Gender inequality persists, driven by traditional norms, care burdens, and motherhood penalties, though childcare systems and targeted interventions can help. Finally, racial and ethnic discrimination—visible in persistent “pigmentocracies”—and other forms of exclusion, such as against LGBTQ+ groups, remain major

barriers. Tackling these inequities requires not only redistributive policies but also structural reforms that reshape labor markets, firm dynamics, gender roles, and social attitudes.

3.1 Protecting Workers with Minimum Wage Policies²⁰

Minimum wages can protect workers from being underpaid in labor markets dominated by powerful employers. In theory, setting a wage floor can increase both pay and employment where employers would otherwise exploit their market power. However, for minimum wages to reduce inequality effectively, they must be carefully designed and enforced.

In countries like Brazil and Mexico, where minimum wages are enforced, they have significantly reduced income inequality by raising wages for low-income workers. These policies also create spillover effects, increasing wages for workers earning just above the minimum. However, enforcement is key. Countries like Costa Rica and Argentina have successfully reduced inequality by improving compliance with minimum wage laws.

In some cases, minimum wages are set too high relative to the earnings of most workers, leading to non-compliance and higher unemployment. For example, in Honduras, overly ambitious minimum wage levels have increased informal employment and widened income disparities. While minimum wage increases can signal higher wages even for informal workers, their impact on the poorest households—often self-employed or without labor income—is minimal. They tend to have the most substantial positive effects on households in the middle or lower-middle segments of the income distribution.

Economic conditions also influence the effectiveness of minimum wages. During periods of economic growth, raising the minimum wage can help reduce inequality. However, in times of economic slowdown, it may have the opposite effect.

Policies linking minimum wages to business size, such as those in the Dominican Republic, can discourage business growth and inadvertently increase inequality. Governments should set minimum wages at levels that are not too low -ineffective at reducing inequality- or too high –leading to non-compliance and unemployment and also ineffective at reducing inequality. An optimal minimum wage level would consider workers' productivity and labor market conditions, avoiding such extremes. Striking an optimal balance is inherently complex, particularly in countries where markets are dominated by giant players, the average business is tiny, and overall productivity is low.

Effective minimum wage policies also require robust enforcement mechanisms, including regular labor inspections and penalties for non-compliance. Simplifying regulations to make compliance easier can also improve enforcement. Also, because the ability to enforce minimum wages diminishes rapidly as informality increases, regulatory frameworks drawn in a way that facilitates compliance with mandatory taxes and contributions will ease minimum wage enforcement.

²⁰ The data and analysis presented in this section are based on: T H Gindling and Lucas Ronconi, "Minimum Wage Policy and Inequality in Latin America and the Caribbean," *Oxford Open Economics* 4, no. Supplement_1 (2025): i400–415, <https://doi.org/10.1093/ooec/odae011>.

Finally, minimum wages are often tied to other income sources, like pensions, , and used as units of measurement in other policies. For example, in some countries, traffic penalties and social housing prices are expressed in minimum wages. . These linkages should be carefully designed to ensure they contribute to reducing inequality rather than exacerbating it.

3.2 Reducing Market Power²¹

In Latin America, small businesses dominate the economy, but a few large corporations wield immense market power. These corporations can charge higher prices and pay lower wages because they face little competition. This concentration of power affects inequality in several ways. For instance, high prices on essential goods disproportionately burden low-income households. At the same time, large firms often pay workers less than their contribution to the company's revenue, especially in industries where competition is limited.

Studies reveal that firms in Latin American manufacturing charge prices 84% above their production costs and pay wages 44% below what workers contribute to revenue. Larger firms, in particular, pass on a smaller share of their revenue to workers, worsening wage inequality. However, similar patterns of market power are found in countries with comparable incomes but lower inequality, suggesting that other factors also drive inequality in the region.

Addressing market power requires stronger competition policies. Competition agencies in Latin America often lack resources and independence, making it difficult to fight market power abuse effectively. To reduce political interference, the appointment and removal of agency leaders should be insulated from presidential influence. Additionally, these agencies need better funding and staffing to match their counterparts in other regions.

Beyond defending competition, broader structural reforms are necessary to address market concentration and firm dominance in critical sectors. Shaping other regulatory frameworks so they don't grant or protect unwarranted rents is also a priority. . Policies that promote small and medium-sized business growth can also reduce market power by increasing competition. In the labor market, strengthening wage-setting mechanisms and promoting collective bargaining and wage transparency can ensure fairer pay. Despite potential political resistance from powerful corporations, such reforms are essential to address inequality. For example, greater transparency in how wages are set can help narrow disparities within firms. Finally, the political influence of large businesses must be addressed. These firms often resist reforms that could reduce their dominance in markets and labor. Tackling this issue is vital to creating fairer economic opportunities for all.

3.3 Fostering the Growth of Small and Medium-sized Firms²²

In Latin America, most workers are employed in very small businesses: 70% of the workforce is employed in businesses with fewer than ten employees, including 30% in businesses with fewer than

²¹ The data and analysis presented in this section are based on: Marcela Eslava, Alvaro García-Marín, and Julián Messina, "Inequality and Market Power in Latin America and the Caribbean," *Oxford Open Economics* 4, no. Supplement_1 (2025): i416–25, <https://doi.org/10.1093/ooec/odae037>.

²² The data and analysis presented in this section are based on: Marcela Eslava et al., "Businesses and Inequality in Latin America," *Oxford Open Economics* 4, no. Supplement_1 (2025): i334–48, <https://doi.org/10.1093/ooec/odae031>.

five employees and another 30% in one-person enterprises. Only 20% of workers are employed by larger firms with over 50 employees. This is starkly different from more advanced economies, where less than 30% of the workforce is in businesses with fewer than ten employees, and larger firms account for 60% of employment. Even among formal businesses (i.e., those that comply with regulations) small firms dominate. In Brazil, for example, more than 85% of formal businesses have fewer than ten employees. In Mexico, this figure is slightly lower but still significant at 76%.

The uneven distribution of workforce size in Latin America is not simply a reflection of the region's development level. Other factors must explain why so few medium-sized, large, and even small firms (those with 10 to 50 employees) have been able to emerge and thrive. Furthermore, businesses in the region tend to remain small throughout their lifecycle, with limited growth potential. Unlike firms in the United States, which often experience rapid growth after their initial years, Latin American firms show little expansion beyond their fourth year of operation. This stagnation is especially apparent in businesses with fewer than ten employees, which rarely grow into larger, more productive enterprises.

The high concentration of small businesses has significant implications for inequality because earnings are closely tied to the size of the business where an individual works. In Latin America, employees in businesses with fewer than ten workers earn significantly less than their counterparts in larger firms, even when accounting for factors such as education, age, gender, and industry. For example, only 3% of the lowest-earning workers are employed in businesses with more than ten employees, compared to 55% of workers in the top 10% of earners.

Even within the formal sector, this pattern persists. In Brazil, workers in firms with six to ten employees earn 20% more than those in smaller businesses. This earnings' premium rises to 70% for employees in firms with over 100 workers, after accounting for differences in worker characteristics—such as education, experience, and skills—to ensure a fair comparison. Similar patterns are observed in Mexico. The strong correlation between firm size and earnings is more pronounced in Latin America than in advanced economies, where small firms do not dominate the workforce to the same extent. This concentration of workers in tiny, low-productivity businesses contributes to both low labor incomes and high-income inequality across the region.

One of the key challenges in Latin America is fostering the growth of small and medium-sized firms that can absorb a larger share of the workforce. Policies should aim to create an environment where more salaried employment opportunities exist, offering higher-paying jobs and reducing reliance on microbusinesses and self-employment for income.

Steps to achieve this include:

- Simplifying regulations: Streamline regulatory processes and reduce compliance costs, which often discourage business growth.
- Removing distortions: Eliminate policies that effectively tax business growth or subsidize informal labor arrangements.

- Building human capital: Address skills gaps, including deficits in managerial expertise, that hinder business expansion.
- Improving access to financing: Help firms invest in innovation, expand their operations, and hire more workers.

These measures can boost productivity, reduce inequality, and reshape the labor market. Reducing inequality in Latin America requires addressing the unusual distribution of business sizes and labor across these businesses. Policies that enhance productivity will also help narrow income gaps. Importantly, policies that favor smaller firms at the expense of more productive, larger ones may undermine these goals and should be avoided.

3.4 Addressing Gender Gaps²³

In Latin America and the Caribbean, gender gaps persist in education and the labor market, especially in areas like labor force participation and unpaid work. These disparities stem from traditional gender roles that place the burden of domestic chores and caregiving on women, while men are expected to focus on paid work. This dynamic leads to financial dependence, an uneven division of household responsibilities, and limited opportunities for women. For society, it means losing out on a significant portion of its productive workforce and talent.

Although progress has been made in some areas, significant challenges remain. In education, for example, although girls are on average more likely to finish secondary education, adolescent girls often lag behind boys in mathematics achievement and are less likely to pursue careers in science, technology, engineering, and mathematics. Women remain underrepresented in these fields, even though these careers offer higher financial returns compared to fields like education or healthcare, where women are more prevalent. These gaps persist despite widespread societal belief in women's equal capabilities in science and technology.

In the labor market, women are less likely to work for pay and spend significantly more time on unpaid household tasks compared to men. When women do enter the workforce, they often face lower-quality jobs and significant wage gaps. For instance, even when women have similar qualifications and roles as men, their wages are still markedly lower. Motherhood is at the heart of these challenges, leading to dramatic drops in labor force participation and wages that show little recovery over time, and constituting one of the main drivers of gender wage gaps in the region. Women's, but not men's, labor force participation and earnings fall dramatically once they become parents -- by around 20-40% and 20-50%. Cultural norms play a significant role: in poorer countries and among less-educated populations, more conservative attitudes often discourage women's participation in paid work.

Women's labor force participation has increased in wealthier LAC countries but stagnated in poorer ones. However, economic development alone is not enough to drive progress. For instance, while Spain has seen significant increases in female labor force participation, similar progress has stalled

²³ The data and analysis presented in this section are based on: Inés Berniell, Raquel Fernández, and Sonya Krutikova, "Gender Inequality in Latin America," *Oxford Open Economics* 4, no. Supplement_1 (2025): i219–72, <https://doi.org/10.1093/ooec/odae035>.

in the United States. Within LAC, countries like Brazil and Ecuador have made steady gains, while others, such as Colombia, have seen stagnation. Understanding these differing trajectories could provide valuable insights for policymaking.

Research highlights the value of examining gender gaps across different life stages. For example, disparities in math skills only begin to emerge between the ages of 8 and 12, suggesting that interventions targeting “middle childhood” could be particularly effective. Similarly, while boys tend to fall behind girls in secondary and tertiary education completion rates—especially in wealthier countries—understanding the drivers of these trends could inform policies to prevent such gaps from widening as poorer nations develop.

There are reasons for optimism. Gender gaps in mathematics and reading skills among secondary school students have narrowed over the past two decades. Female labor force participation has also increased, particularly among women with lower education levels in poorer countries. However, progress is uneven, with some areas experiencing stagnation or even regression. Governments can help level the playing field by providing accessible childcare and eldercare services, enabling women to engage more fully in paid work. Building a care system in Latin America and the Caribbean requires substantial investments from both private and public sectors, estimated at 1-3 percent of GDP in most countries²⁴. They can also implement initiatives to challenge traditional gender roles within families and workplaces.

3.5 Addressing discrimination²⁵

Research reveals widespread social stratification based on race and ethnicity. The region’s racial composition varies, from predominantly white populations in Argentina to mestizo and Indigenous communities in Guatemala and Bolivia, and Afro-descendant populations in Brazil. Census and survey data consistently show racial hierarchies, with lighter-skinned individuals occupying higher socioeconomic positions and darker-skinned individuals facing greater disadvantages. This “pigmentocracy” persists even after accounting for factors like social class.

While inequality in the region has traditionally been viewed through the lens of social class, recent studies emphasize the independent role of racial and color-based discrimination. This stratification affects education, income, job opportunities, and even geographic mobility. Social surveys further underscore the enduring impact of discrimination on individuals’ lives.

Some countries, notably Brazil, have begun implementing policies to address racial and ethnic disparities. For example, Brazil’s introduction of racial quotas in higher education over the past 20 years has significantly improved access for underrepresented groups. However, more work is needed to achieve broader equity and dismantle systemic discrimination.

Governments have a critical role to play in combating discrimination, including in the labor market. This applies to ethnic minorities and LGBTQ+ individuals. Public policies should also focus on

²⁴ María Caridad Araujo et al., “Expanding Opportunities: Policies for Gender Equality and Inclusion,” ed. María Caridad Araujo et al., *IDB Publications*, November 25, 2024, <https://doi.org/10.18235/0013261>.

²⁵ The data and analysis presented in this section are based on: Edward E Telles et al., “Racial Inequality in Latin America,” *Oxford Open Economics* 4, no. Supplement_1 (2025): i200–218, <https://doi.org/10.1093/ooec/odae022>.

educating society to address unconscious biases, starting from early childhood. Evidence suggests that teaching children to embrace diversity is a cost-effective way to reduce prejudice.

4. Redistributing Income Through Taxes and Transfers ²⁶

Taxation and government spending are among the most powerful tools Latin American governments have to influence the distribution of income. While markets determine wages, returns to capital, and access to jobs, the state can correct or amplify these outcomes through fiscal policy. In a region characterized by high inequality and limited social mobility, the way fiscal policy is designed and implemented becomes crucial for shaping opportunities and living standards.

4.1 The Overall Redistributive Impact of Fiscal Systems

An analysis of the impact of fiscal systems on income distribution in 18 countries across the region, using a comparable framework to similar fiscal incidence analyses worldwide, produced several important insights.²⁷

Fiscal systems reduce inequality, but less than in other regions. All 18 countries studied showed reductions in income inequality through fiscal policy. The extent of this effect varies, with Argentina, Costa Rica, and Uruguay achieving relatively larger declines, while Honduras, Peru, and Colombia show more modest results. On average, the redistributive effect of direct taxes and cash transfers in Latin America reduce inequality by 2.3 Gini points, compared with 3.3 in other upper-middle-income countries and 7.7 in the European Union.²⁸

Poverty outcomes are less encouraging. Despite their equalizing effect on income distribution, fiscal systems do not consistently reduce poverty. In fact, in nine of the 18 countries, poverty increases after fiscal intervention. This paradox arises because poor households pay more in taxes, especially consumption taxes, than they receive in direct transfers. Transfers are often too small, insufficiently targeted, or fail to reach enough households to offset the poverty-increasing impact of taxation.

More, inequality does not drive more redistribution efforts. Unlike other regions, Latin American countries with higher pre-fiscal inequality do not allocate more resources to redistribution. This may reflect the political economy of the region, where entrenched elites are able to limit redistributive efforts. In contrast, in some countries, redistribution went so far as to create strong disincentives and unsustainable macroeconomic conditions.

Mixed results across fiscal instruments in reducing inequality. Regarding the impact of specific fiscal interventions, direct taxes and direct transfers are always equalizing. This result is

²⁶ The data and analysis presented in this section are based on: Nora Lustig, Valentina Martinez-Pabon, and Carola Pessino, “Fiscal Policy, Income Redistribution, and Poverty Reduction in Latin America,” *Oxford Open Economics* 4, no. Supplement_1 (2025): i426–46, <https://doi.org/10.1093/ooec/odae034>.

²⁷ The data and analysis presented in this section are based on: Nora Lustig, Valentina Martinez-Pabon, and Carola Pessino, “Fiscal Policy, Income Redistribution, and Poverty Reduction in Latin America,” *Oxford Open Economics* 4, no. Supplement_1 (2025): i426–46, <https://doi.org/10.1093/ooec/odae034>.

²⁸ The redistributive effect corresponds to the case in which contributory pensions are treated as deferred income rather than as government transfers. In addition, for comparison with advanced countries such as those in the European Union,

unsurprising. Contrary to expectations, however, indirect taxes and subsidies are more frequently equalizing than unequalizing. There is evidence that the equalizing effect of indirect taxes may occur for the wrong reason. Because poor households tend to buy in informal markets more frequently than the nonpoor, they avoid paying some of the consumption taxes. Public spending on education and health are highly progressive. However, this is due in part because wealthier families often opt for private services, leaving public services underfunded and of lower quality.

We now cover in detail the challenges that specific redistributive instruments face in the region and how to advance towards more efficient and equitable fiscal systems.

4.2 The Low Redistributive Impact of Tax Systems²⁹

The region's tax systems by themselves tend to have a low redistributive impact. This is due to various factors. First, in general countries collect relatively little personal income and property taxes, which are often highly progressive taxes. The redistributive impact of a tax is determined by size and progressivity. Compared to other regions in the world, based on statutory rates, LA on average appears to have one of the most progressive income tax systems. Their low redistributive capacity is thus determined primarily by size. Except for Argentina, countries in LA have a significantly lower average tax rate than other regions of the world. This is the case not only when compared with Europe but also with Africa and Asia (except South Asia). Second, there are significant tax expenditures, which tend to be pro-rich and, in the case of direct taxes, reduce their redistributive impact. Third, income tax evasion (estimated by some to be around 50%) has a negative effect on inequality.

4.3 The Limited Poverty Impact of Cash Transfers³⁰

As we saw above, in several countries a portion of the poor are net payers into the fiscal system: that is, people who are poor or near poor pay more in taxes than they receive in transfers (and subsidies). Why are transfers unable to reduce poverty and inequality more significantly in the region? A review of 67 transfer programs that comprehend primarily conditional cash transfers and noncontributory pensions yields the following conclusions. Transfer programs have become quite widespread in the region reaching 166 million people (about 30 percent of the region's population).

There are, however, two key factors that limit the effect of cash transfer programs on poverty and inequality: the small size of their transfers and their sizeable under-coverage of the population living in poverty. While again there is heterogeneity across countries, spending on non-contributory transfers as a percentage of GDP is low compared to high-income countries. This translates into the fact that for the median country transfers represent approximately 33% of the poverty gap, on average. Additionally, only 55% of the population in poverty benefits from these programs. At the

we show the redistributive effect of direct taxes and direct cash transfers only because the available EUROMOD results covered only the latter, while indirect taxes and subsidies were not included.

²⁹ The data and analysis presented in this section are based on: Carola Pessino et al., "Distributional Effects of Taxation in Latin America," *Oxford Open Economics* 4, no. Supplement_1 (2025): i447–80, <https://doi.org/10.1093/ooec/odae038>.

³⁰ The data and analysis presented in this section are based on: Marco Stampini, Nadin Medellín, and Pablo Ibararán, "Cash Transfers, Poverty and Inequality in Latin America and the Caribbean," *Oxford Open Economics* 4, no. Supplement_1 (January 1, 2025): i481–509, <https://doi.org/10.1093/ooec/odae033>.

same time, 41 percent of people living in households that receive at least one non-contributory transfer are above the poverty line. Children and Indigenous people are underrepresented, relative to their poverty rate, in the rosters of beneficiaries.

In addition to their direct impact on income poverty, conditional and unconditional cash transfers are likely to increase school attendance and the use of health services because when households' incomes go up, consumption of all goods tends to increase. Conditional transfers are expected to further increase demand for these services through a substitution effect (by lowering the cost of the services through the delivery of the transfers). The literature shows that conditionalities explain a significant portion of the health and education impacts of cash transfers. In addition, the existing literature unambiguously shows that conditional cash transfers have achieved their primary short-term objective of increasing spending and reducing current poverty. It also shows that the programs have successfully induced the desired behavioral responses (less child labor, more demand for health and education services, and higher food consumption). Evidence is mixed for impacts on learning and long-term employment and poverty. These results are shaped by elements outside the control of the institutions implementing cash transfer programs, in particular the quality of health services and schooling and how well labor markets function.

Noncontributory pensions, which provide benefits to older adults without requiring prior contributions, have become the second-largest transfer program in LAC. Pension coverage in the region has increased substantially over the past two decades, from 46% to 69% of the older population. This growth has been driven mainly by the expansion of non-contributory pensions. Countries have expanded non-contributory programs because most of the population does not have access to contributory benefits, either because they work informally or because their formal employment does not qualify (in terms of duration or continuity) for contributory protection. The rationale for non-contributory pensions is to support people's income and consumption when their ability to work decreases as they age. About 21 percent of the population 65 and older receive non-contributory pensions.

Non-contributory pensions address the historic low coverage of contributory pensions in the region, which reaches only 48% of people over 65, with great variation among countries. This has created a two-tier system in which the average value of contributory pensions is 56% of wages, while the average value of non-contributory pensions is only 11% of wages.³¹ In spite of these lower benefits, non-contributory pensions have reduced poverty among seniors and improved well-being, particularly for women. Primarily due to the expansion of these programs in the region, the percentage of people aged 50 to 80 with no source of income has decreased from 29% in 2000 to 18% in 2019. This reduction in the percentage of people with no income has been most pronounced among women, dropping from 41% to 26% over the same period.³² In terms of impacts on beneficiaries, evaluations of these programs in Latin America and the Caribbean document that non-

³¹ Natalia Aranco, Pablo Ibararán, and Marco Stampini, "Prevalence of Care Dependence among Older Persons in 26 Latin American and Caribbean Countries," *IDB Publications*, May 13, 2022, <https://doi.org/10.18235/0004250>.

³² Natalia Aranco, Pablo Ibararán, and Marco Stampini, "Prevalence of Care Dependence among Older Persons in 26 Latin American and Caribbean Countries," *IDB Publications*, May 13, 2022, <https://doi.org/10.18235/0004250>.

contributory pensions reduce poverty, increase consumption, and decrease geriatric depression indicators and work-force participation.³³

The Covid-19 pandemic reshaped non-contributory cash transfer programs in Latin America and the Caribbean. During the crisis, governments across the region relied heavily on cash transfers to protect households and individuals. Drawing on standardized household survey data from 13 countries, Swarz and Stampini (2025) document changes in program coverage between 2019 and 2022, showing a 7.6 percentage points higher than before the crisis—a relative increase of about 30%. This expansion was driven by broader inclusion of urban residents, targeted efforts to reach older populations, and the adoption of unconditional transfers in place of other program types. Yet despite these gains, important gaps persist: 31.4% of individuals living below US\$3.65 per day remain excluded, even as coverage expanded among higher-income groups.

4.4 Towards More Equitable Fiscal Systems

There are several lessons that emerge from our analysis. We begin with those related to the diagnosis of fiscal redistribution. The fact that specific fiscal interventions can have countervailing effects underscores the importance of taking a coordinated view of both taxation and spending, rather than a piecemeal analysis. When combined with generous, well-targeted transfers, efficient regressive taxes (such as VAT) can reduce inequality by more than a system without a regressive VAT but that collects less revenue. Furthermore, in order to assess the impact of the tax system on people's living standards, it is crucial to measure the impact of taxation and spending combined not only on inequality but also on poverty, because --as in the case of some LAC countries-- the fiscal system can be equalizing but poverty-increasing.

In terms of policy prescriptions, a basic lesson is that governments should design their tax and transfer systems so that the after-tax and after-transfer incomes of the poor are not lower than their pre-tax incomes. The cash portion of the tax system should not impoverish the poor (or make the non-poor poor). If the policy community is seriously committed to eradicating income poverty, governments will need to explore ways to redesign taxation and transfers so that the poor do not end up as net payers.

Specifically on the tax side, recommendations include reducing the evasion of direct taxes and targeting tax expenditures better. In addition, countries could consider eliminating VAT exemptions and refunding the VAT actually paid by low-income households. This measure would eliminate the subsidies that exemptions provide to the non-poor, while reducing the burden of VAT on poor households, thereby reducing the regressivity and impoverishment caused by this tax.

³³ Sebastián Galiani, Paul Gertler, and Rosangela Bando, “Non-Contributory Pensions,” *Labour Economics* 38 (December 2016): 47–58, <https://doi.org/10.1016/j.labeco.2015.11.002>, and Rosangela Bando, Sebastián Galiani, and Paul Gertler, “The Effects of Noncontributory Pensions on Material and Subjective Well-Being,” *Economic Development and Cultural Change* 68, no. 4 (2020): 1233–1255, <https://doi.org/10.1086/702789>

Another measure that could have a high redistributive impact while reducing labor informality is tax credits for labor income of low-income households. These measures could also potentially counteract the significant increase in poverty caused by excessive indirect and payroll taxes on the poor in the face of transfers whose coverage and size are insufficient to make all the poor net beneficiaries of the fiscal system.

In addition, although-- as mentioned above-- income taxes are quite progressive, the progressivity could potentially be higher. For example, the top marginal income tax rate in LA is 30%, while it is over 45% in advanced OECD countries. This contrast is even more striking when compared to Bolivia, Guatemala and Paraguay, where the top marginal income tax rate is below 15%. Top rates on capital gains, inheritance, and gifts are generally low compared with advanced OECD countries (but not necessarily with other upper-middle-income countries).

On the transfer side, cash transfer programs would need to be scaled up to increase their impact on poverty and inequality. The first imperative is to increase efforts to cover the poor, in particular those living in extreme poverty. For this group, undercoverage can be addressed through a combination of modern poverty mapping techniques and active outreach. Importantly, to achieve higher coverage, countries may need to revise eligibility criteria that limit some groups' access to cash transfer programs. For example, the demographic eligibility criteria of the programs in some countries in the region lead to a mismatch between the lists of beneficiaries and the population groups with the highest poverty rates. In particular, in some countries, children and indigenous people are underrepresented among beneficiaries (relative to what would be expected based on their poverty rates).

Achieving higher coverage also requires frequent recertification of the list of beneficiaries to remove those who no longer need support and to make room in the program for those who have recently become eligible. This is particularly important in urban areas, where poverty is more transitory. Rather than relying on periodic socioeconomic censuses, increasing opportunities to make social registry data interoperable with other administrative data creates the possibility of real-time, low-cost recertification.

Frequent recertification is key to preventing temporary income losses from leading to permanent poverty, including the transmission of poverty to the next generation. Job loss, death or illness of the breadwinner, crop failure, and so on, are examples of shocks that the poor or near-poor may not be able to cope with and end up permanently worse off. The transfer system should be designed to help families and individuals cope adequately with temporary shocks. In addition to combat chronic and transient idiosyncratic poverty, the transfer system should be designed to address systemic shocks such as macroeconomic crises, natural disasters, pandemics, and conflict. The COVID-19 pandemic has left some valuable lessons on how large-scale safety nets can be rapidly deployed.

5. Addressing the Regressivity of Contributory Pension Systems³⁴

³⁴ The data and analysis presented in this section are based on: Alvaro Altamirano et al., "Calculating the Redistributive Impact of Pension Systems in Latin America and the Caribbean," *Oxford Open Economics* 4, no. Supplement_1 (2025): i510–33, <https://doi.org/10.1093/ooec/odae030>.

Latin America and the Caribbean is still a relatively young region. Only about 9% of its population is 65 or older, compared to 19% in Europe and 17% in North America. Yet pensions already account for the largest share of social spending in many countries, representing 3.9% of the region's GDP.³⁵ This is significant, especially given that not everyone in the region has access to a pension.

What makes this even more pressing is how quickly the region is aging. While it took Europe 56 years for the proportion of people aged 65+ to rise from 10% to 20%, this transition will happen in just half that time in Latin America and the Caribbean. As the population ages, pension costs will consume an even greater share of public spending, leaving fewer resources for other priorities. Without reforms, pensions could dominate public budgets by 2050, crowding out investments in areas like education and healthcare.

5.1 Challenges of inequities in Pension Systems

Two important facts are worth highlighting when trying to understand fairness and redistribution of pension systems in the region.

First, there's a wide variety of systems and challenges across the region. Most countries operate "defined benefit" systems, where pensions are based on a worker's final salary (or the last few years or salary), but some have shifted to "defined contribution" systems, where pensions depend on how much a person has contributed to the system during her or his working years. Coverage and benefit levels also vary greatly. For example, Brazil and Argentina offer nearly universal coverage, while in Guatemala and Honduras, only 20% of adults receive a pension. Similarly, pension benefits range from full salary replacement to just 30–40% of final earnings.

Second, evaluating the fairness of these systems is complex. Pension systems differ from other taxes because people view their contributions as an investment toward future benefits. Ideally, the benefits someone receives should match the contributions they've made over their lifetime. But in practice, this is rarely the case. For example, workers in defined benefits systems often receive pensions that are far more generous than what their contributions could realistically fund. This gap represents a subsidy provided to the worker through the pension system and financed with general taxes

5.2 Who Benefits Most from Pensions?

A good starting point for understanding who benefits most from pensions is examining the goals of pension systems. In many countries, pension systems are designed to provide higher benefits to low-income workers. For instance, a worker earning 75% of the average wage (this is call replacement rate) may receive a pension worth 69% of their final salary, while someone earning three times the average wage might get only 51%. This progressive design means lower-income workers are supposed to receive a larger share of subsidies. The variation across countries is substantial. In most systems, replacement rates decrease as income rises, but the pace of this decline differs

³⁵ Natalia Aranco et al., "Aging in Latin America and the Caribbean: Social Protection and Quality of Life of Older Persons," *IDB Publications*, June 8, 2022, <https://doi.org/10.18235/0004287>.

significantly across countries. For example, in Brazil, the Dominican Republic, and Peru, replacement rates for workers earning 75% of the average wage are about 40 percentage points higher than for those earning three times the average wage. By contrast, in countries such as Colombia (DB), Ecuador, or Panama (BD), the gap is less than 5 percentage points.

However, the reality is different. In practice, pension systems often benefit higher-income workers more. First and foremost because, many low-income workers fail to qualify for pensions as they don't meet minimum contribution requirements, often due to informal or intermittent work. Only 42% of workers, on average, contribute to pensions. There is a strong correlation between the level of education and the share of workers that contribute to pensions. Highly educated workers are between 20 and 50pp points more likely to contribute to pensions. In some countries, the share of low-educated workers contributing to the system is below 10%. For example, in El Salvador or Colombia less than 5% of workers in the lowest income decile qualify for a contributory pension compared to more than 45% of the highest income decile. Whatever subsidies are built into the pension systems, higher-income workers capture the bulk of them.

For instance, in defined benefit systems like those in Paraguay and Colombia, 70–95% of subsidies go to the wealthiest workers.³⁶ Even in defined contribution systems, where subsidies are smaller, the richest deciles still receive 50–60% of the benefits. Countries like Chile, which provide explicit subsidies for the poorest workers, achieve a more equitable distribution of benefits.

As discussed above non-contributory pensions (i.e., benefits provided to people who haven't paid into the contributory system) paid with general taxes have emerged as a solution and can help offset the inequities in contributory pensions. For example, in Paraguay, without non-contributory pensions, 97% of subsidies go to the wealthiest workers. But when these pensions are extended to the poorest 30% of the population, the share going to the richest workers falls to 82%, and further to 71% if coverage is extended to the poorest 60%.

However, the impact of non-contributory pensions depends on their size and how they're targeted. In countries with lower contributory pensions, these programs only slightly improve the distribution of subsidies.

5.3 Making Pension Systems Fairer

Pension systems in LAC can be redesigned to be more equitable. Here are three potential reforms:

1. **Reduce Barriers to Eligibility:** By lowering or removing the minimum contribution requirements, low-income workers with irregular work histories would have a better chance of receiving pensions.
2. **Strengthen the Link Between Contributions and Benefits:** Countries could adjust benefits to reflect contributions more closely, reducing implicit subsidies for high-income earners.
3. **Target Subsidies to the Poor:** Explicit subsidies, like non-contributory pensions or contribution support for low-income workers, can be directed to those who need them most.

³⁶ Under the current reform, this will no longer be true.

Monitoring how pension systems impact income inequality is crucial. Regular evaluations can help policymakers design reforms that make these systems fairer and more sustainable for future generations.

In all, the region's current relatively generous contributory systems that work for high income workers coupled with relatively low non-contributory pensions that aim at providing benefits to low-income workers, create inequality and limit redistributive potential. Policies should aim for more integrated systems with broader coverage and better-quality benefits.

6. Conclusions

Latin America continues to face deep-rooted income inequality, shaped by historical, structural, and institutional factors. While progress has been made in areas such as education, healthcare, and social protection, disparities remain stark, particularly along socio-economic, ethno-racial, and gender lines. Addressing these challenges requires a comprehensive, multi-faceted approach that combines pre-fiscal policies, labor market interventions, and fiscal redistribution measures.

Pre-fiscal policies aimed at enhancing earning potential, such as investments in early childhood development, quality education, and equitable healthcare, are critical to breaking the cycle of inherited inequality. Strengthening public education and ensuring universal access to healthcare can help level the playing field for disadvantaged populations. Similarly, addressing gender and ethno-racial gaps in the labor market is essential to creating more inclusive economic opportunities.

Labor and output market reforms can play a pivotal role in reducing inequality. Ensuring fair wages through well-calibrated minimum wage policies, strengthening competition policies to limit market power, and supporting the growth of small and medium-sized enterprises can enhance economic mobility. Implementing policies to mitigate existing gender and ethnic and racial disparities is crucial for significantly reducing overall inequality. Additionally, reducing informality in labor markets through regulatory simplifications and improved enforcement mechanisms can increase social protections for vulnerable workers.

Fiscal redistribution remains a crucial tool for mitigating inequality. However, current tax and transfer systems in Latin America have had limited success in substantially reducing poverty and inequality. Enhancing the progressivity of taxation, reducing tax evasion, and expanding well-targeted cash transfer programs can improve the redistributive impact of fiscal policies. Additionally, pension systems require structural reforms to ensure fairness and sustainability, particularly in light of the region's aging population.

Ultimately, a holistic approach that integrates pre-fiscal and post-fiscal interventions is essential for reducing structural inequality. Governments must prioritize policies that not only redistribute income but also address the root causes of disparities. By fostering economic opportunities, strengthening social protections, and ensuring equitable access to education and healthcare, Latin American countries can build a more inclusive and sustainable future for all.

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