

# Market Inequality and Redistribution in Latin America and the Caribbean

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*This article analyzes how politics influences Latin American and Caribbean income inequality. Most studies view the distributional process in two phases with inequality shaped first by markets and then by state redistribution. Typically, cross-national analyses of inequality limit the influence of politics to the redistributive phase. But we argue that a full understanding of how government affects inequality must also consider how politics shapes the market. While redistribution is undoubtedly an important mechanism employed by government to influence distributional outcomes, we find that inequality produced by the market is more responsive to politics than is redistribution. Left partisan power and public investment in human capital significantly reduce inequality in the market phase. In addition, social spending on human capital conditions the effect of economic growth. As human capital investment increases, growth becomes more equality enhancing, providing further evidence of the market conditioning effect of policy.*

The distribution of income is one of the most important outcomes produced by contestation over the allocation of resources and power in society, and a substantial body of evidence suggests that politics and policy shape income inequality (Bradley et al. 2003; Huber and Stephens 2001; Huber et al. 2006; Kelly and Witko 2012; Moller et al. 2003; Pontusson 2005).<sup>1</sup> However, we have an incomplete understanding of the broad pathways through which politics and policy influence distributional outcomes. Most studies focus on redistribution through taxes and transfers. We argue that redistribution is only part of the story. It is also possible that governments influence inequality by shaping the behavior of private actors in the market, a mechanism we call “market conditioning.”

This article builds on recent work that demonstrates how decisions in specific policy areas shape market inequality. Previous studies show that investment in public schooling has reduced the skills premium (the divergence between wages of high- and low-skill workers) in some countries, thereby reducing inequality (Barros et al. 2010; Kahhat 2010). Other research demonstrates that capital accounts regulation has minimized inequality-inducing economic volatility

(de Ferranti et al. 2004; Ocampo and Palma 2008). In addition, the development of basic infrastructure expands earning opportunities for the poor (Calderón and Chong 2004; Escobal and Ponce 2002). Investments in basic health care have generated increased productivity and reduced inequality in several countries (Esquivel, Lustig, and Scott 2010; Jaramillo and Saavedra 2010; Kahhat 2010). These are just a few of the countless ways that existing (frequently case study) research traces how individual policy decisions within specific countries shape market conditions in ways that influence distributional outcomes. However, we know very little about the extent to which policy decisions aggregate across domains to produce systematic shifts in inequality that can be explained by political variables such as partisan control of government. Here we explore the distributional consequences of market conditioning at a higher level of aggregation across policy domains and ask whether politics and policy produce cross-nationally generalizable effects on inequality by shaping markets.

Assessing the state’s influence via market conditioning is particularly important in the context of the developing world. While in some emerging markets

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transfer spending has become more progressive, the inequality-reducing effect of redistribution in such contexts remains relatively low. Countries outside the developed world typically have very narrow tax bases, which limits redistributive capacity, and where states do exert explicit redistributive effort via transfer programs, resources frequently benefit only formal sector workers in the middle and upper portions of the income distribution, thereby replicating existing inequalities (Barros et al. 2010; Esquivel, Lustig, and Scott 2010; Goñi, López, and Servén 2005; Robinson 2010). The relative lack of explicit redistribution in this context, as opposed to advanced economies where redistribution is much more significant (Esquivel, Lustig, and Scott 2010; Solt 2008), suggests that market conditioning may carry considerable weight as a strategy for developing world politicians to shape distributional outcomes. Given the potential importance of market conditioning as an avenue for influencing inequality, it is imperative to assess the extent to which political variables systematically shape market outcomes, particularly in contexts where redistribution is so limited. However, previous work exploring cross-temporal and cross-national variation in inequality outside the developed world has been limited (Bogliaccini 2013; Huber et al. 2006; Morley 2001). Moreover, to our knowledge none of this scholarship has examined how politics influence market inequality separately from redistribution as we do here. To assess whether politicians systematically use policy to shape markets and thereby influence inequality, we employ data on market inequality and redistribution from Latin America and the Caribbean (LAC) for a 20-year period.<sup>2</sup> Ideally we would analyze these dynamics across the entire developing world. However, the cross-nationally comparable data needed to capture the political variables in our theoretical model are only available for LAC countries, and the inequality data are also much sparser for Africa and Asia than for Latin America. As a result, we focus on LAC here, but in the conclusions we return to a discussion of how the theory and findings in this article might be expected to translate to other developing-world contexts.

The evidence we will present suggests that political factors, including partisan power resources and social spending, affect income inequality not only via redistribution but also through market conditioning. In the remaining sections of the article, we develop

a model of income inequality focusing on the role of politics in influencing both the market distribution of income and the redistributive impact of the state. Then we detail the analytical approach used to test these theoretical arguments. Finally, we report the results of our analysis and conclude with a discussion of the implications of our work.

## **State Influence on Inequality: Redistributive and Market-Conditioning Mechanisms**

Implicit in most studies of inequality is a two-stage conceptualization of the distributional process. Typically, the initial distribution of income is viewed as emerging from private economic decisions that generate wage, investment, and other forms of income that produce a particular level of market inequality, while the second phase of the distributional process is driven by government redistribution using taxes and transfers to reallocate resources. Cross-national statistical analyses generally relegate the influence of politics only to the redistributive stage. This is understandable since there can be no doubt that the state is involved in this stage, and politics matters because disagreements over taxes and transfer programs are at the heart of political contestation. The state of the literature on Latin American inequality is similar, with redistribution taking center stage in discussions of government's influence on inequality and a particular emphasis on the growth of conditional cash-transfer programs in many LAC countries (Barros et al. 2010; Esquivel, Lustig, and Scott 2010; Huber et al. 2006).

Redistribution is important, but we argue that there is also a role for politics in the market stage of the process (Hacker and Pierson 2010; Iversen and Stephens 2008; Kelly 2005, 2009). The linkages between politics and market outcomes are not always as apparent as linkages between politics and redistribution, but many scholars would acknowledge that "markets never really operate independently" (de Ferranti et al. 2004, 23). However, little research employs cross-national statistical analyses to assess whether political dynamics affect the overall distributional process, taking account of both redistribution and market conditioning. Comparative analysis of how aggregate political processes shape market inequality is one of the contributions of our analysis.

Our argument builds on an emerging body of scholarship that points to the role of the state in shaping the market distribution of income (Barros

<sup>2</sup>We take a distribution-wide view of income inequality operationalized with the Gini coefficient as opposed to other concepts related to inequality such as poverty and high-to-low income ratios.

et al. 2010; Calderón and Chong 2004; Estevez-Abe 2008; Hacker and Pierson 2010; Hicks and Kenworthy 1998; Iversen and Stephens 2008; Volscho and Kelly 2012). Existing work shows that government affects market inequality through a variety of specific policy tools. For example, studies examining capital accounts regulations in Chile and Colombia demonstrate how these policies have mitigated some of the volatility associated with neoliberal economic reforms, thereby minimizing the sharp financial cycles that have frequently exacerbated inequality in other contexts (de Ferranti et al. 2004; Ocampo and Palma 2008). Analyses of Peru and El Salvador indicate that policies designed to improve the reach and quality of basic infrastructure have significant equalizing effects by enhancing the ability of the poor to secure decent employment (Calderón and Chong 2004; Escobal and Ponce 2002; World Bank 2005). The expansion of public funding for primary education has been identified as a primary cause of declining inequality in Brazil (Barros et al. 2010). Similarly, investments in basic health care and nutrition have increased worker productivity and reduced wage inequality in several Latin American countries (Esquivel, Lustig, and Scott 2010; Jaramillo and Saavedra 2010; Kahhat 2010). Studies such as these have made major strides in identifying specific avenues through which the state employs market-conditioning mechanisms to influence the distribution of income. However, previous research stops short of cross-national analysis assessing whether politics and policy affect market inequality in generalizable, theoretically expected ways.

We make two important advances along these lines. First, we assess whether broad political dynamics such as partisan control and levels of social spending affect the overall distributional process, at once considering both redistributive and market-conditioning actions by the state. If politics and policy affect distributional outcomes through the market-conditioning mechanism we have identified, variables related to partisan power and government spending should be associated with the distribution of income produced by the market. Second, existing studies in this literature rarely employ cross-national statistical analysis to test the effect of politics on market inequality (for a notable exception, see Bradley et al. 2003). Cross-national time-series analysis is the norm in studies of politics and income inequality in Latin America and elsewhere (Huber et al. 2006; Pontusson 2005), but this technique has not been extensively used to assess the effect of politics on distributional outcomes via markets. In the following discussion, we detail several hypotheses

concerning the influence of politics on both stages of the distributional process. We also outline the potential impact of economics, institutions, and demographics.

### Politics, Policy, and the Distributional Process

Scholarship examining the effect of politics on income inequality emphasizes the influence exerted by the partisan distribution of power in government. Power resources theory, which has found empirical support in Europe as well as Latin America (Bradley et al. 2003; Hicks 1999; Huber et al. 2006; Korpi 1989; Segura-Ubiera 2007; Swank 2002), argues that competing parties possess divergent distributional goals and have different views concerning the role of government in pursuing egalitarian outcomes. As a result, changes in partisan power produce systematic variations in redistribution. Left parties tend to represent the lower classes and favor redistributive policies designed to enhance the welfare of their core supporters. Alternatively, parties of the right are manifestations of upper-class power, typically opposing redistributive policies. In Latin America, new programs such as Mexico's conditional cash transfers for poor families (*Progres y Oportunidades*) and Brazil's unconditional transfers for the elderly and disabled (*Benefício de Prestação Continuada*) have produced important increases in equality (Barros et al. 2010; Robinson 2010). Frequently the development and expansion of these programs have been tied to increased power for the left in national politics. This points to the prediction that redistribution increases as the partisan balance of power shifts left.

Political actors might also employ market-conditioning strategies to accomplish their distributional goals. If politicians use market-conditioning mechanisms, then the logic of power-resources theory developed to explain differences in redistribution is likely to extend to the distribution of market income (Kelly 2009). The same power-resources variables expected to increase redistribution should likewise decrease market income inequality. In the case of partisan power, left party control is expected to reduce inequality.<sup>3</sup>

We also consider the effects of social spending. Including social spending is important because it allows us to assess potentially significant policy effects

<sup>3</sup>Our strategy of analyzing the effect of party control and general categories of spending is preferred to an examination of individual policies because assessing individual policies would undoubtedly miss many potential market-conditioning effects.

that might occur outside or alongside party-based efforts. We consider two categories of social investment: transfer spending and human capital spending. In developed countries, transfer spending, which includes social security and welfare programs, tends to reduce overall inequality through redistribution. But in developing countries, this relationship is not so obvious. Frequently, the benefits of pension and other welfare programs in Latin America are reserved for the relatively privileged formal sector, as opposed to more vulnerable informal workers (de Ferranti et al. 2004; Morgan 2011; Sáinz 2005). Research on social security and welfare benefits in Latin America suggests that some programs within these categories are regressive, while others redistribute progressively (de Ferranti et al. 2004; Huber et al. 2006). Thus, we are cautious in developing expectations concerning the distributional effects of transfer spending. Given that previous analyses slightly favor the conclusion that programs in this category distribute benefits more equitably than incomes, we tentatively posit a positive relationship between transfer spending and redistribution. We do not anticipate much influence for this sort of spending on market inequality because the programs are more redistributive than market conditioning in nature.

Human capital spending tends to be more clearly equalizing. Investments in health care and education have the capacity to increase the lower classes' absolute and relative levels of skills and productivity, shaping the labor market in ways that especially benefit the poor by enhancing their income-earning opportunities (Psacharopoulos 1995; World Bank 1993). Furthermore, single-country studies have pointed to investments in primary education as a key ingredient in reducing the skills premium, which reduces inequality (Barros et al. 2010; Jaramillo and Saavedra 2010). Spending in this category tends to funnel most resources toward in-kind benefits such as access to public schools. Therefore, its distributional effects are most likely to be felt via the market-conditioning mechanism, rather than redistribution.<sup>4</sup> We expect larger human capital investments to generate lower levels of market inequality and thereby reduce overall inequality (Inter-American Development Bank 1998).

Moreover, we expect human capital spending to condition how economic growth influences inequality.

<sup>4</sup>Cross-nationally comparable measures of redistributive impact do not account for public goods and in-kind benefits. If included, redistribution would be higher and health and education spending would be more likely to have effects on both market inequality and redistribution (Barros et al. 2010; ECLAC 2005).

We theorize that investments in human capital affect how the benefits of growth are distributed. The benefits from economic growth may be more egalitarian if social investment strengthens the capacity of the poor to effectively take advantage of good economic times (Hicks 1999; Huber and Stephens 2001; Swank 2002). Alternatively, where governments do not channel increased revenues from growth toward social investment, the wealthy and educated are more advantageously positioned to enhance their status during times of prosperity, while the poor are ill-equipped to make such strides (de Ferranti et al. 2004). Previous research provides evidence of the causal mechanisms underlying this interaction between growth and human capital spending, demonstrating for example that “public investment in education . . . has a major influence on the distribution of the benefits of growth” (de Ferranti et al. 2004, 116). Even small gains in education translate into productivity improvements and increased technology use, enhancing poor households' income prospects and promoting more egalitarian outcomes (Brown and Hunter 2004; Hunter and Brown 2000; Psacharopoulos 1995). Brazil, for example, has focused considerable resources on expanding access to education, an emphasis that scholars credit with playing a significant role in the country's steady declines in inequality during periods of economic growth over the past decade (Barros et al. 2010). Thus, we hypothesize that social spending restructures how markets function, such that the role of growth in the distributional process can be recast depending on the level of human capital spending. When such spending is low, benefits from growth are likely to accrue disproportionately to those who already possess economic advantages. But when human capital investments are more significant, economic gains are more equally shared, thus increasing the relative well-being of the lower classes.

## **Economics, Institutions, Demographics, and the Distributional Process**

We also account for economics, institutions, and demographics, focusing on the explanations most consistently identified as important in previous scholarship. The economic factors are inflation (de Ferranti et al. 2004; Huber et al. 2006; Morley 2001), unemployment (Bradley et al. 2003; Pontusson, Rueda, and Way 2002), and foreign direct investment (Evans and Timberlake 1980; Huber et al. 2006; Lee 2005;

Reuveny and Li 2003). Based on previous scholarship, we expect each of these to increase inequality.

Regime institutions likely shape inequality by structuring policy decisions. Democratic leaders typically need widespread support to achieve and sustain power, which requires them to move beyond the narrow set of interests that have power in authoritarian regimes and instead consider more general interests (Ames 1990; Robinson 2010; Rodrik 1999). Furthermore, democracy opens up the possibility for the poor to gain influence through political parties, elections, and social mobilization (Rueschemeyer, Stephens, and Stephens 1992). Countries with more extensive democratic experiences are, thus, likely to have institutions and norms in place that enable subordinate sectors to affect politics in their favor (de Ferranti et al. 2004, 3). Studies analyzing social policy in Latin America support this argument, suggesting that democracies are more likely to engage in propoor spending (Brown and Hunter 1999, 2004; Kaufman and Segura-Ubiergo 2001). Similarly, we expect countries with longer democratic traditions to manifest lower levels of inequality (Lee 2005; Muller 1988; though see Timmons 2010).

The main regime alternative to democracy is authoritarianism, but authoritarian regimes do not all hold uniformly pro-elite, anti-egalitarian stances. Some authoritarian regimes, such as the Velasco government in Peru (1968–75), actively supported downward redistribution, while others, like Chile under Pinochet (1973–90), pursued policies that concentrated resources in the hands of elites. Thus, we distinguish between left and right authoritarianism, with the expectation that right-wing authoritarian regimes are most likely to reduce (downward) redistribution (Huber et al. 2006; Schamis 1991).

Among demographic factors, we consider educational attainment, age structure, and ethnic composition. Rising educational attainment is generally associated with more equality in educational achievement (Thomas, Wang, and Fan 2001). This helps to reduce the wage gap between those with high and low education (Barros et al. 2010). However, some research suggests that educational attainment has the potential to promote inequality in Latin America because of limited access to tertiary and even secondary education combined with significant returns to higher education (de Ferranti et al. 2004). Thus, our expectations concerning educational attainment are mixed. Concerning age structure, younger populations generate an oversupply of new workers and drive down wages at the bottom of the distribution, producing more inequality (Alderson and Nielsen

1999; Bollen and Jackman 1985). We also anticipate higher inequality in ethnically diverse societies because indigenous and Afro-descendant peoples in Latin America and the Caribbean often have fewer educational opportunities and lower wages (Bello and Ponce 2000; Hall and Patrinos 2005).

## Data and Measurement

To test the ideas developed above, we analyze data from 19 LAC countries over 20 years.<sup>5</sup> As with any time series cross-national study of income inequality, a primary concern is data comparability both over time and across countries. Income concepts and income sources measured vary between household surveys administered in different countries and at different times, so harmonizing measurement across time and space is an important task in analyses like ours. The Luxembourg Income Study (LIS) and the UNU-WIDER databases are by far the most commonly used sources of inequality data in cross-national studies. LIS data are considered the gold standard for comparability. LIS takes great pains to insure that income variables collected in each country's household survey are combined using a consistent methodology to produce very similar income concepts. The main weakness of the LIS is that it is only available at approximately five-year intervals, and it has very limited coverage of developing world countries, particularly in the early waves of the study. The UNU-WIDER data have much greater coverage than the LIS, but these data suffer more from comparability issues because they combine multiple income concepts based on divergent data-collection procedures.<sup>6</sup>

We use a data source that builds on the strengths of LIS and UNU-WIDER and minimizes their weaknesses—the Standardized World Income Inequality Database (SWIID) (Solt 2008, 2009). SWIID combines information from LIS and UNU-WIDER to create an improved dataset with greater coverage than LIS and greater comparability than UNU. While Solt (2008) provides a more detailed explanation of

<sup>5</sup>The countries included in the analysis are Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Jamaica, Mexico, Panama, Paraguay, Peru, Trinidad and Tobago, Uruguay, and Venezuela. The time period spans 1980 to 2000. The precise number of country-years varies based on data availability for the variables included in each analysis.

<sup>6</sup>Organizations like SEDLAC and CEPAL are working to harmonize income data across Latin America, but currently these sources place substantial constraints on the countries and time periods that can be analyzed.

the methodology underlying SWIID, the logic is as follows. The SWIID synchronization process treats inequality as a latent variable, with data from LIS and UNU-WIDER acting as imperfect indicators of the underlying concept. With knowledge from country years in which the two datasets overlap, SWIID uses inequality estimates from the strongly comparable LIS dataset along with inequality estimates and information about the income concept represented in the UNU-WIDER to adjust the more plentiful UNU data such that it mimics the comparability of the LIS data. This yields data for LAC with greater comparability and more coverage than any other dataset available.

Since we examine the distributional process in two stages, we analyze separate measures for each stage, both of which are available in SWIID. Our first dependent variable is based on “gross” adult-equivalent income. This income definition approximates market income—pre-transfer household income adjusted for household composition.<sup>7</sup> Based on this income definition, we use Gini coefficients to summarize gross inequality. Gini scores can range from 0 to 100, with higher scores indicating greater inequality. We refer to this variable as Market Inequality. The second dependent variable of interest is net household income inequality. The main difference between gross income and net income is that net income includes transfers. Essentially, this measure captures a household’s income after the second, redistributive stage of the income-allocation process. As with gross income inequality, inequality in net income is summarized by the Gini coefficient. We refer to this measure as Post-Redistribution Inequality. We also make use of the measure of redistribution included in SWIID. Redistribution is simply the percentage difference between net and gross income—the percentage by which taxes and transfers reduce inequality. Higher scores indicate more redistribution.<sup>8</sup>

<sup>7</sup>In many LAC countries, this measure is net of direct and indirect taxes. This means that the income concept potentially reflects some redistributive effort rather than being purely market income. However, this is not a major issue given that tax systems in LAC are not very redistributive.

<sup>8</sup>We are somewhat less confident in the measure of post-government inequality than in the measure of market inequality because the household surveys underlying inequality statistics often did not explicitly ask respondents about transfer income until the mid to late 1990s. However, SWIID provides some ability to adjust post-tax post-transfer inequality to capture this concept more accurately. Also, SWIID does not generate an estimate of redistribution where the data are too scant to generate a reasonable estimate; thus, where the data are poor, that country-year is excluded.

## Independent Variables

**Legislative partisan balance of power.** This variable is defined as legislative seat share weighted  $-1$  for right parties,  $-0.5$  for center-right parties,  $0$  for center parties (or for nondemocratic years),  $0.5$  for center-left parties, and  $1$  for left parties. Following what has become fairly standard practice, this annual measure is accumulated over the current and previous 15 years to account for the idea that the history of legislative balance of power is important for understanding the current and future structure of inequality. We expect market inequality to decline and redistribution to increase as the legacy of partisan balance of power shifts to the left. In constructing this measure, our coding of political party ideology relies on Coppedge’s (1997) classification of parties on the left-right dimension, as updated in Huber et al. (2008a).<sup>9</sup>

**Human capital spending.** Human capital spending is measured by national and subnational health and education spending as a percentage of GDP. Like Huber et al. (2008b), we use a 15-year average in order to account for the fact that the effect of human capital expenditures can build up over time.<sup>10</sup> We expect human capital spending to decrease market inequality but to have little influence on redistribution.

**Transfer spending.** Transfer spending is operationalized as the percentage of GDP dedicated to national and subnational social security and welfare spending, using data from Huber et al. (2008b). We expect transfer spending to have no effect on market inequality but to increase the redistributive impact of government.

**Economic growth.** We measure economic growth with real per capita GDP in chained 1,000s of purchasing power parity \$US. The data are from the Penn World Table (Heston, Summers, and Aten 2001). We have hypothesized above that human capital spending will condition the effect of economic growth, making growth more equalizing as human capital expenditures increase. By enhancing employment opportunities and productivity for poor households, human capital investment enables the poor to

<sup>9</sup>Our coding differs from Coppedge (1997) only with regard to the Peronists in Argentina. He coded Peronists as “other” due to their dramatic ideological shift over time. Our data code the Peronists as a centrist party in the 1980s and a center-right party in the 1990s.

<sup>10</sup>The most obvious example of this dynamic is that the income effects of current primary education spending are unlikely to be felt until the children benefiting from that spending enter the labor force.

take advantage of good economic times, thereby promoting a more egalitarian distribution of economic growth (Brown and Hunter 2004; de Ferranti et al. 2004; Psacharopoulos 1995). We also expect economic growth to increase redistribution by making it possible to spend more on redistributive programs.

**Other variables.** The SI file discusses the measurement of other factors included in our analysis: inflation, unemployment, foreign direct investment, democracy, right-wing authoritarianism, educational attainment, age structure, and ethnic composition. Descriptive statistics for each variable are in the SI file.

## Analysis and Results

To estimate the relationships hypothesized above, we utilize time-series cross-sectional error correction models (ECMs) estimated with OLS and Rogers' robust-cluster variance estimator. This variance estimator is similar to the familiar Huber-White sandwich estimator, but it is designed to produce valid hypothesis tests in the presence of serial correlation (Rogers 1994). As De Boef and Keele (2008) point out, the ECM is a very flexible time-series model that can, under appropriate conditions, be applied to both integrated and stationary data.<sup>11</sup> Much of the variation in a dataset such as ours comes from differences across countries, but over-time variation within a country is also important. ECMs allow us to appropriately capture this temporal variation in addition to cross-national differences.<sup>12</sup>

One way to express a single-equation error correction model is as follows:

$$\Delta Y_t = \alpha_0 + \alpha_1 Y_{t-1} + \beta_1 \Delta X_t + \beta_2 X_{t-1} + \epsilon_t.$$

The key point to understand is that for each independent variable  $X$  we have up to two parameter estimates— $\beta_1$  for the differenced variable and  $\beta_2$  for the lagged level of the variable. If either of these

coefficient estimates indicates a statistically significant relationship, then it is appropriate to conclude that the explanatory variable has a statistically significant relationship with the dependent variable. In this simple bivariate example,  $\beta_1$  provides an estimate of the initial change in the dependent variable produced in the short term by a shock to the independent variable. This is called the “short-term” effect, not meaning that the effect is impermanent but that the effect occurs wholly at a specific point in time.  $\beta_2$  and  $\alpha_1$  provide the information needed to estimate the slightly more complicated “long-term” impact. This is also called the error correction component of the model. The long-term impact is the portion of the connection between  $X$  and  $Y$  that does not occur at one particular point in time but is distributed temporally such that a portion of the impact is felt in each period over a time span. The size of this long-term impact is a function not only of  $\beta_2$  but also of  $\alpha_1$ , which is known as the error correction rate. The total long-term impact of a shock to  $X$  on  $Y$  via the error correction component is computed by dividing  $\beta_2$  by  $\alpha_1$ . Estimating ECMs allows us to capture not only the immediate effects of explanatory variables on dependent variables but also any effects that are spread over time. Since it is possible, even likely, that political and policy factors generate effects that are distributed over many years, utilizing ECMs is a useful strategy in the context of our analysis.

## Results

The heart of our analysis is presented in Table 1, which displays the analysis of the first stage of the distributional process with market inequality as the dependent variable. We begin with a full model that includes all the variables discussed above except the interaction term between growth and human capital investment. Of the theoretically central variables, only human capital spending has a statistically significant effect in Model 1. The legislative partisan balance of power barely misses statistical significance but has a coefficient signed in the expected direction. However, the number of parameters estimated in Model 1 demands a lot of this moderately sized data set. Therefore, we next estimate a more parsimonious model. Model 2 retains the significant economic, institutional, and demographic controls as well as human capital spending and legislative partisan balance, which are the two political variables hypothesized to influence market inequality. We drop insignificant controls and transfer spending, which we

<sup>11</sup>See the SI file for a more detailed discussion of the appropriateness of ECMs in our analysis.

<sup>12</sup>In the results below, we find a null effect for democracy on inequality and redistribution while Huber et al. (2006) find that democracy reduces inequality using very similar data to ours. This is likely due to the fact that ECMs are very similar in some respects to fixed-effects models (Plümper, Troeger, and Manow 2005). For those concerned with potential unit effects in our analysis, this should provide additional reassurance about the robustness of the results. We also estimated the models below using a random effects GLS model. The results using this alternative estimator are substantively quite similar to those reported.

TABLE 1 Models of Market Inequality

Variables	Model 1	Model 2	Model 3
Market Gini <sub>t-1</sub>	-0.09** (0.03)	-0.06*** (0.02)	-0.07*** (0.02)
Δ Legislative Partisan Balance <sub>t</sub>	-1.27 (0.75)	-1.34*** (0.42)	-1.40*** (0.44)
Legislative Partisan Balance <sub>t-1</sub>	-0.05 (0.06)		
Δ Human Capital Spending <sub>t</sub>	1.76 (1.56)	0.89 (1.25)	0.74 (1.28)
Human Capital Spending <sub>t-1</sub>	-0.14*** (0.05)	-0.16** (0.06)	-0.16** (0.06)
Δ Transfer Spending <sub>t</sub>	0.07 (0.06)		
Transfer Spending <sub>t-1</sub>	0.03 (0.04)		
Δ GDP per Capita <sub>t</sub>	0.26 (0.21)	0.03 (0.18)	-0.04 (0.15)
GDP per Capita <sub>t-1</sub>	-0.03 (0.07)		
Δ GDP <sub>t</sub> *Human Capital <sub>t-1</sub>			-0.24** (0.11)
Δ Inflation <sub>t</sub>	0.02** (0.01)	0.01 (0.01)	0.02 (0.01)
Inflation <sub>t-1</sub>	-0.03*** (0.01)	-0.05*** (0.01)	-0.04*** (0.01)
Δ Unemployment <sub>t</sub>	0.07 (0.04)	0.04* (0.02)	0.03 (0.02)
Unemployment <sub>t-1</sub>	0.02 (0.02)		
Δ FDI <sub>t</sub>	0.74 (3.92)	-1.02 (2.59)	-0.64 (2.85)
FDI <sub>t-1</sub>	2.10** (0.80)	2.33* (1.14)	2.45** (1.14)
Δ Democracy <sub>t</sub>	-0.10 (0.35)		
Democracy <sub>t-1</sub>	0.01 (0.01)		
Δ Right Authoritarianism <sub>t</sub>	0.23 (0.17)		
Right Authoritarianism <sub>t-1</sub>	0.03 (0.04)		
Δ Education <sub>t</sub>	2.63*** (0.79)	2.56*** (0.74)	2.26*** (0.75)
Education <sub>t-1</sub>	0.12 (0.15)		
Δ Youth Population <sub>t</sub>	-0.29 (0.82)		
Youth Population <sub>t-1</sub>	0.08 (0.08)		
Ethnic Heterogeneity <sub>t-1</sub>	0.28 (0.22)		

TABLE 1 (Continued)

Variables	Model 1	Model 2	Model 3
Constant	-0.39 (4.13)	2.75** (1.02)	2.89*** (1.00)
Observations	197	197	197
R <sup>2</sup>	0.29	0.23	0.25

Note: Ordinary Least Squares (OLS) estimates, robust-cluster standard errors in parentheses. Two-tailed significance levels \**p* < 0.10, \*\**p* < 0.05, \*\*\**p* < 0.01.

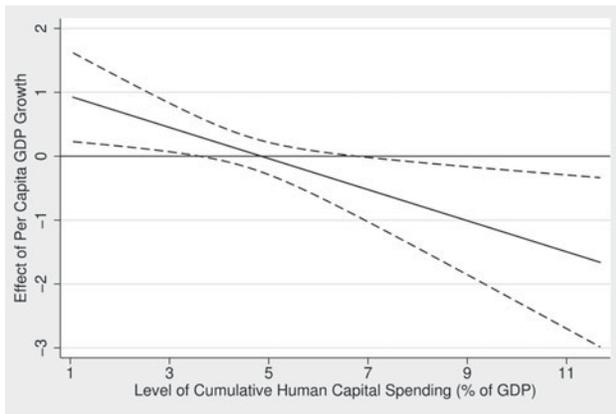
did not expect to influence market inequality and did not approach statistical significance in Model 1.<sup>13</sup> The short-term coefficient for per capita GDP is also included in Model 2 because we have hypothesized an interactive effect with human capital spending, which we will test in the final model.

In Model 2, we find that leftward shifts in the legislative partisan balance of power are associated with significant decreases in market inequality. This is a short-term effect, meaning that it is fully realized at a single point in time. However, since we use a cumulative measure of legislative power, this does not mean that the effects of politics occur all at once. It simply means that the cumulated history of party power in the legislature has an immediate effect on outcomes. As in the first model, higher levels of human capital expenditure are also associated with lower levels of market inequality. This is a long-term effect, meaning the effect is distributed over time and is not fully realized for approximately 15 to 20 years based on the error correction rate of 0.06. Given that human capital expenditure is measured as the average of the current and 15 previous years, this suggests that the effect of human capital expenditures builds up very slowly over time, and even this cumulative measure of spending has an effect that takes many years to be fully felt.

Model 3 adds the interaction between GDP and human capital spending. The level of human capital spending is interacted with the first difference of GDP because we have hypothesized that the *level* of investment in human capital will condition the effect of economic *growth*, or the change in GDP. The evidence from Model 3 supports this hypothesis. The significant and negatively signed interaction term indicates that the effect of GDP growth becomes more negative as human capital investment increases. That is, GDP becomes more equality-inducing as human capital expenditures rise. Figure 1 charts the marginal effect of change in GDP for the observed values of human capital spending

<sup>13</sup>Both short-term and long-term coefficients are included for any variable with a statistically significant long-term effect in Model 1.

**FIGURE 1 Conditional Effect of Growth across Range of Human Capital Spending**



Note: Solid line is point estimate; dotted lines represent the 90% confidence interval. Calculations by authors from estimates in Table 1, Model 3.

in our data. This chart shows that at very low levels of human capital investment, GDP growth actually increases market inequality. However, that effect declines and eventually reverses near the mean value (5.4) of human capital spending. Once spending becomes relatively high, the effect of GDP growth on inequality is negative and statistically significant. Other results in Model 3 remain essentially identical to the results from Model 2 when the interaction term was not included.<sup>14</sup>

To provide some idea of the substantive and relative size of the effects of the core variables, Figure 2 displays the estimated effect of a standard deviation shift in each statistically significant variable from Model 3. We present the short-term coefficient for variables with only a short-term effect and the long-term impact for variables with an effect via the error correction mechanism. Dark bars represent positive effects and light bars represent negative effects. The primary message of this chart is that political variables have important effects on market inequality both substantively and relative to other explanatory factors. Human capital spending has the largest effect of any single variable, and the legislative partisan balance of power is not far behind. These two variables have some of the strongest effects of any variables included in our models, outpacing inflation, FDI, unemployment, and several others. Given that the standard deviation of market inequality is about 6.9, the effect of politics can be described as fairly large. A

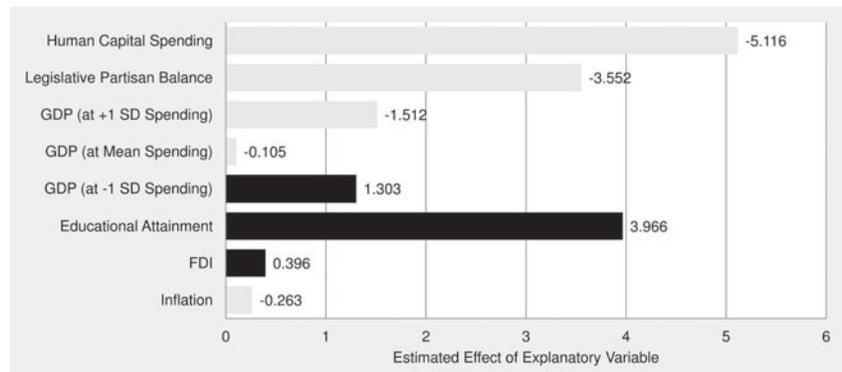
<sup>14</sup>Results from the analyses in Tables 1 and 2 concerning findings for our politics and policy variables as well as the interaction term are robust to various specifications of the control variables and to the removal of individual countries from the analysis using a modified jackknife procedure. See the SI file for more details.

standard deviation shift in either the legislative partisan balance or human capital spending reduces inequality by over half its standard deviation.

In Table 2 we report models with redistribution as the dependent variable in the first two columns of results. The key point in these models is that the only political or policy variable that attains statistical significance is transfer spending, with greater transfer spending associated with more redistribution. Partisan balance of power in the legislature does not approach statistical significance for this dependent variable. To ensure that this nonsignificant result was not due merely to indirect effects of partisan power on spending, we estimated an unreported model excluding the spending variables. In this analysis, left partisan power still has no positive effect on redistribution. This result suggests that in the LAC context, the effect of partisan power on distributional outcomes occurs primarily via market conditioning. Despite this finding, we are reluctant to rule out completely the possibility of an effect for left party power on redistribution. As we mentioned before, there is almost certainly more measurement error in the redistribution measure than in the market inequality measure due to the difficulty of accurately capturing transfer income from government benefits. This measurement error could be masking an effect for partisan power via redistribution. Our main point is simply that market conditioning is an important mechanism through which political factors shape distributional outcomes, and the analysis supports this primary conclusion.

In Models 3 and 4 of Table 2, we check to see whether the effects seen in each stage of the distributional process translate into post-redistribution inequality. In column 3, we estimate a model that includes only partisan power distribution as well as the economic, institutional, and demographic factors. The long-term coefficient for left partisan power is properly signed and barely misses statistical significance with a two-tailed test. (The coefficient is significant with a one-tailed test which is not an inappropriate standard given the directional hypothesis and the relatively small sample size). With the spending variables included in Model 4, we again observe a substantial effect for human capital spending on distributional outcomes, an effect that manifested completely through the market-conditioning mechanism. We also again see a negative coefficient for the interaction between GDP and human capital spending, additional evidence for the conclusion that human capital expenditures condition the market by shaping the effect of economic growth on distributional outcomes.

FIGURE 2 Effect of 1 Standard Deviation Shift in Explanatory Variable on Market Inequality



Note: Dark bars, positive; Light bars, negative. Figure depicts the shift in Market Inequality predicted by a 1 standard deviation shift of the explanatory variable. Calculated by the authors based on estimates in Model 3, Table 1.

## Discussion and Conclusions

This article supports the conclusion that the decisions made by voters and policy makers have important implications for distributional outcomes in Latin America and the Caribbean, aligning with evidence from previous analyses of income inequality conducted in a variety of contexts. Economic, institutional, and demographic factors certainly matter, but politics is part of the story. Unlike previous models that focus on redistribution, we have presented evidence that market inequality is responsive to the partisan balance of power and to human capital investment. In our analysis, market inequality actually seems *more* responsive to political variation than redistribution. Given the difficulty of comprehensively measuring cash and in-kind transfers across countries in Latin America, we present this finding as suggestive rather than conclusive. But as better data on redistribution become available, future research should focus on providing more definitive evidence on the relative importance of redistribution and market conditioning.

The importance of the market-conditioning mechanism may be driven in part by constraints that are routinely faced by policy makers in the developing world (e.g., difficulty in enforcing tax policies, high public debt burdens, and constraints imposed by international financial institutions) that make it particularly difficult to reduce inequality via taxes and transfers. Comparing the redistributive effort of Europe versus Latin America is illustrative of this point. In advanced economies, government transfers reduce inequality by 30 to 50%, while in many LAC countries transfers reduce inequality by less than 10%

(Esquivel, Lustig, and Scott 2010, 199). Thus, market conditioning emerges as a particularly important mechanism for political influence on distributional outcomes in Latin America and the Caribbean perhaps because explicit redistribution is too narrow or too constrained to effect substantial reductions in inequality. While analysis of market inequality in Western Europe has found no significant effects for politics (Bradley et al. 2003), our findings here and the comparative distinctives of the LAC context—namely the international, administrative, and policy constraints limiting the redistributive reach of LAC states—suggest that restricting analysis of how politics shapes inequality to the redistributive phase is likely to miss many important dynamics in developing countries.

We also want to draw attention to our finding that the effect of economic growth on inequality is shaped by human capital spending. When governments reduce investments in human capital, rising GDP per capita produces more inequality. But when governments spend more on health and education, the effect of growth reverses, leading to lower inequality. Chile and the Dominican Republic, the LAC countries with the highest growth rates during the 1990s, fit this pattern. Chile invested heavily in social spending; the Dominican Republic did not (de Ferranti et al. 2004; Ondetti 2012, 135–37). By the mid-2000s, Chilean inequality dropped below its 1990 level, while Dominican inequality increased over the same period. This interactive effect between human capital spending and growth shows that protecting public investments in this sector should be a high priority for those seeking to fight inequality. Not only do social investments have a direct impact on inequality, but they also have multiplicative effects

TABLE 2 Models of Redistribution and Post-Redistribution Inequality

Variables	$\Delta$ Redistribution		$\Delta$ Post-Redistribution Gini	
	(1)	(2)	(3)	(4)
<i>Redistribution</i> <sub><i>t</i>-1</sub>	-0.23*** (0.05)	-0.19*** (0.03)		
<i>Post-redistribution Gini</i> <sub><i>t</i>-1</sub>			-0.13*** (0.04)	-0.11** (0.04)
$\Delta$ <i>Legislative Partisan Balance</i> <sub><i>t</i></sub>	-0.36 (0.55)		0.20 (0.81)	-0.07 (0.79)
<i>Legislative Partisan Balance</i> <sub><i>t</i>-1</sub>	-0.03 (0.06)		-0.08 (0.05)	-0.05 (0.05)
$\Delta$ <i>Human Capital Spending</i> <sub><i>t</i></sub>	2.23 (2.23)			2.02 (1.59)
<i>Human Capital Spending</i> <sub><i>t</i>-1</sub>	-0.05 (0.09)			-0.13** (0.06)
$\Delta$ <i>Transfer Spending</i> <sub><i>t</i></sub>	0.39** (0.18)	0.23 (0.19)		-0.08 (0.08)
<i>Transfer Spending</i> <sub><i>t</i>-1</sub>	0.13* (0.06)	0.15** (0.06)		0.03 (0.04)
$\Delta$ <i>GDP per Capita</i> <sub><i>t</i></sub>	0.25 (0.25)	0.04 (0.22)	0.13 (0.15)	0.21 (0.22)
<i>GDP per Capita</i> <sub><i>t</i>-1</sub>	0.19** (0.07)	0.19* (0.10)	-0.10 (0.07)	-0.16* (0.09)
$\Delta$ <i>GDP<sub>t</sub>*Human Capital</i> <sub><i>t</i>-1</sub>				-0.22** (0.09)
$\Delta$ <i>Inflation</i> <sub><i>t</i></sub>	0.02 (0.02)		0.02 (0.02)	0.04* (0.02)
<i>Inflation</i> <sub><i>t</i>-1</sub>	-0.03 (0.02)		-0.01 (0.02)	-0.00 (0.01)
$\Delta$ <i>Unemployment</i> <sub><i>t</i></sub>	0.05 (0.04)	0.02 (0.05)	0.06 (0.04)	0.06 (0.04)
<i>Unemployment</i> <sub><i>t</i>-1</sub>	0.06** (0.02)	0.05*** (0.02)		
$\Delta$ <i>FDI</i> <sub><i>t</i></sub>	-0.29 (3.47)	0.34 (3.31)	6.13 (4.74)	7.38 (4.78)
<i>FDI</i> <sub><i>t</i>-1</sub>	2.48* (1.24)	1.59 (1.20)	0.88 (0.69)	1.70* (0.91)
$\Delta$ <i>Democracy</i> <sub><i>t</i></sub>	0.57 (0.57)		-0.55 (0.40)	-0.82 (0.48)
<i>Democracy</i> <sub><i>t</i>-1</sub>	-0.02 (0.02)		0.01 (0.01)	0.02 (0.01)
$\Delta$ <i>Right Authoritarianism</i> <sub><i>t</i></sub>	0.61** (0.23)	-0.01 (0.11)	-0.15 (0.24)	-0.08 (0.23)
<i>Right Authoritarianism</i> <sub><i>t</i>-1</sub>	0.02 (0.06)		0.04 (0.04)	0.02 (0.03)
$\Delta$ <i>Education</i> <sub><i>t</i></sub>	-3.45 (2.11)	-3.96 (2.36)	2.45 (1.54)	1.97 (1.43)
<i>Education</i> <sub><i>t</i>-1</sub>	-0.84** (0.33)	-0.60*** (0.18)	0.33** (0.15)	0.31** (0.12)
$\Delta$ <i>Youth Population</i> <sub><i>t</i></sub>	0.37 (1.06)		-0.19 (0.57)	-0.16 (0.51)
<i>Youth Population</i> <sub><i>t</i>-1</sub>	-0.06 (0.09)		0.10* (0.05)	0.10 (0.07)
<i>Ethnic Heterogeneity</i> <sub><i>t</i>-1</sub>	-0.49 (0.41)		0.55* (0.29)	0.09 (0.31)

TABLE 2 (Continued)

Variables	$\Delta$ Redistribution		$\Delta$ Post-Redistribution Gini	
	(1)	(2)	(3)	(4)
Constant	7.00 (5.70)	3.39*** (0.99)	0.70 (2.72)	0.07 (2.97)
Observations	146	156	197	197
R <sup>2</sup>	0.43	0.31	0.24	0.28

Note: Ordinary Least Squares (OLS) estimates, robust-cluster standard errors in parentheses. Two-tailed significance levels  
 $*p < 0.10$ ,  $**p < 0.05$ ,  $***p < 0.01$ .

by conditioning the market itself. This finding implies that international financial institutions concerned with combating poverty and inequality make a grave mistake if they require reduced investments in social spending before permitting access to financial aid.

We have focused our analysis on Latin American and the Caribbean in order to better understand how politics influences markets and shapes inequality in the developing world. Data limitations currently prevent a similar analysis of Africa or Asia, but our findings here may also shed light on the factors that shape inequality in other less-developed regions. As in Latin America, many African and Asian states face a variety of constraints, including international demands, domestic conflict, weak state capacity, and poor economic conditions, which make the implementation of effective, downwardly redistributive tax and transfer policies particularly challenging (Akyüz 2008; Gough and Wood 2004; Segura-Ubierga 2007; Wood and Gough 2006). Given these constraints, it is not surprising that all three regions manifest low state redistributive impact when compared to more advanced economies (Esquivel, Lustig, and Scott 2010; Solt 2008). Therefore, our finding that Latin American policy makers rely more heavily on market conditioning than redistribution to shape the allocation of income is likely to translate to developing countries in Asia and particularly Africa where states face mountainous challenges (Wood and Gough 2006).

We would also expect politics and policy to shape distributional outcomes in other less-developed regions, but the particular causal patterns are likely to vary depending on the economic and political context. In general, Africa poses the most stringent test of the argument that domestic politics shapes the distributional process because many African states lack autonomy and have been forced to surrender much social policy decision making to external actors (Wood and Gough 2006); in Asian countries where

states and economies face fewer foundational challenges, theories concerning domestic politics, policy, and political institutions are likely to have greater purchase, but not necessarily in the exact same ways that we have observed in Latin America (Haggard and Kaufman 2008). For instance, while previous scholars have argued that power resources theory has application across the developing world (e.g., Rudra 2002), and we find support for the theory in Latin America, the weakness of parties, particularly left parties, in both Africa and Asia (Haggard and Kaufman 2008; Kuenzi and Lambright 2001) makes these contexts difficult ones for the argument that left partisan power promotes equality. On the other hand, in Asia public human capital investment may be an especially influential policy tool for shaping distributional outcomes because welfare states there tend to emphasize the delivery of primary education and basic health care to a greater extent than in Latin America (Fields 1994; Haggard and Kaufman 2008). Additionally, regime type may be particularly salient in both Africa and Asia where regime legacies are quite important and where this factor varies considerably both historically and across countries. In fact, previous research by Haggard and Kaufman (2008) suggests that democratic openings played a significant role in permitting the expansion of equality-promoting welfare state policies in emerging Asian democracies.

There is, of course, much work remaining to fully understand the factors that shape inequality, but we have learned a great deal in this study. Electoral choices and policy decisions matter for the distributional process in Latin America and the Caribbean. More importantly, these factors have effects that go far beyond straightforward redistribution—they are intimately tied together with the market. Inequality is not simply a hand that is dealt by the impersonal forces of a market economy; the market itself can be systematically altered through collective political action.

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