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Income Inequality and the Role of Government: The Case of Mexico

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ABSTRACT

Disparities in income distribution are generally explained by economic, political and social factors. However, income inequality can be aggravated by government actions that promote privileges for some groups. Obstacles to free competition, including a low degree of development, also explain inequality. When a country tries to increase economic openness but this is accompanied by privileges granted and the use of power, the accumulation of wealth is concentrated in fewer hands. Mexico's income inequality can be explained by all these factors.

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Keywords: Income distribution, income inequality, wealth concentration, capitalism, government, politics, poverty, reforms, Mexico.

I. THE RICH AND THE REST

Income inequality is a remarkable feature of Mexico.[1] On the one hand there is a small group of businessmen and a well-paid bureaucracy. On the other hand there is the rest of the population, those who pull the economy with daily work but with restricted opportunities. Mexico's income disparity is not because the rich are much more productive than the others. It is because of a political system with a few privileged groups and the political class.

Among economic factors, the wage differential is most often cited to explain income inequality. In Mexico, most workers are paid according to their training and physical abilities, while the privileged class receives wages based on factors such as level of education and friendship with capital owners, and also because of political recommendation.

The arrival of a political party to power has always been accompanied by the emergence of a new political class with privileges. The education system, which produces mainly low-quality workers, helps maintain low wages and accommodates social pressures. In fact, the excess supply of low-skilled professionals generated massively by education institutions is an important factor to consider in the study of inequality in Mexico.[2] The lack of job opportunities and limited access to education in rural and ethnic communities make those less privileged groups more vulnerable to the ups and downs of the business cycle. Another important factor related to education and correlated with the accumulation of wealth is the culture of savings in low-income people. However, we have to consider that the problem is not only that there is a lack of saving behavior or absence of financial education, but also the restriction to save faced by the poor as a result of his low income and high propensity to consume[3].

In general total income is distributed among production factors—labor and capital mainly—and another part appropriated by the government through taxes[4]. Given that the largest component of the population is employees and a smaller component is capital owners, a relative increase in the payment to capital implies a relative decrease in the payment to labor. Thus, if the return to capital is greater than the rate of growth5, income distribution changes unfavorably for labor. Hence, an acceleration in the rate of return to capital —relative to the rate of growth— could imply the worsening of income distribution not only among factors but also inside the capital sector if wealth is concentrated in few hands[6].

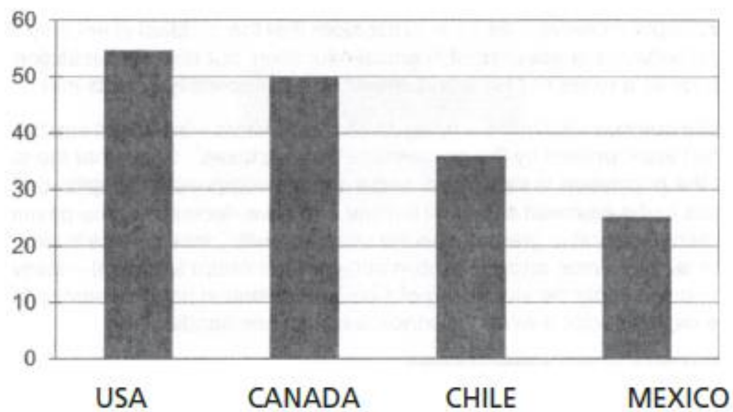
II. CAPITALISM OR LACK OF FAIR COMPETITION?

The core of the problem is not the existence of a capitalist class, but rather the existence of privileges and lack of transparency in a government that assigns contracts to particular groups, accelerating the accumulation of wealth for a few hands and leaving the rest out. As it is also mentioned for the case of the U.S., the problem is not the inherent laws of capitalism but rather "our policies and our politics"[7]. Therefore, a capitalism with weak institutions and biased policies only generates privileges for some and obstacles for others[8].

Some critics argue that capitalism by itself promotes income inequality precisely because of its philosophy of a constant search for wealth and well-being only for particular purpose[9]. However, if competition were fair, with no privileges, with rules enforcing transparency, more competitors could have the opportunity to succeed by their own merits and capacities. Letting markets work as real markets with equal opportunities for everybody should be one of the ultimate goals of public policy.

Empirical evidence shows that income distribution is better in economies with more free and fair competition. Conversely, income inequality is greater in less developed economies with long traditions of protectionism and more government intervention. For example, in the U.S. employee compensation represents a little more than 50% of national income, while in Mexico it represents only around 25% (Chart 1), illustrating an income disparity favoring capital in the less developed country. This is an indication that income inequality can be associated with the lack of competition, particularly in developing economies with some degree of government intervention.

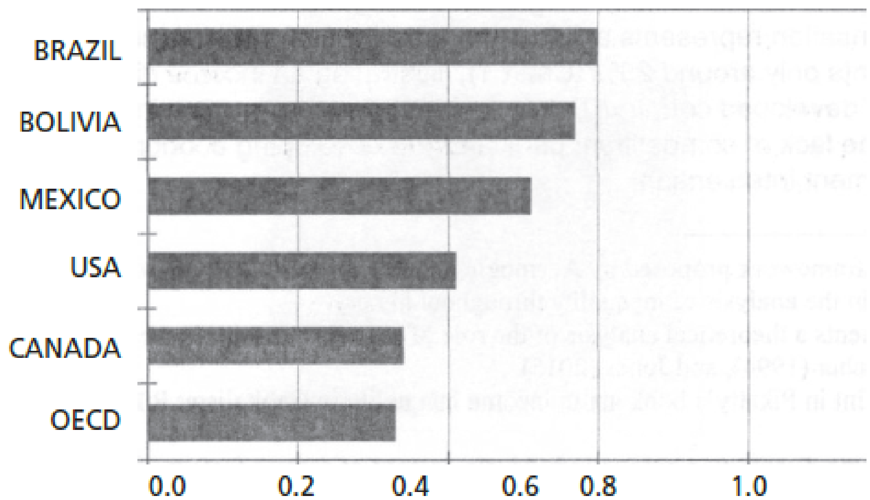
Chart 1
Labor Income Share by Country
Compensation of Employees (2000-2013), % of Nominal GDP



Source: Author with data from National Institutes of Statistics and OECD.

Income disparity and wealth concentration are more remarkable in less developed economies with deficient education and a low-quality labor force. This also promotes labor-intensive production processes and restrains technological progress. In such cases, income inequality is explained by the low productivity of a poorly trained labor force. The Gini coefficient, which indicates higher inequality as the value approaches 1, illustrates how less developed Latin American countries with more government intervention such as Brazil and Bolivia show more income inequality (Chart 2).

Chart 2
Income Inequality by Countries
Gini Coefficient (2000-2012) (1=perfect inequality)



Source: World Bank, ECLAC.

It is also said that globalization and structural reforms aggravate the concentration of wealth because they value the role of capital over labor. However, if competition were fair, more competitors could have access to the benefits of deregulation and openness. But when the government grants privileges and unnecessarily protects some industries, income concentration deteriorates and a monopoly power develops. A monopoly tends to have less incentive to train its labor force because it has no competitors who threaten its market. Prolonged market protection becomes a source of inefficiency for production and distribution processes in an economy. In fact, reforms that produce sufficient structural changes are the ones required to remove obstacles to economic and social progress. Reducing or eliminating the power of monopolies are precisely the changes that help reduce industrial concentration[10].

History also shows that income inequality has been higher in societies with high concentration of political power, particularly in dictatorship regimes. The concentration of political power is usually accompanied by the increase in economic power of small groups or elites around the political leader. In Latin America, income inequality raised during the periods of dictatorships, but also the concentration of wealth aggravated in countries where the political power was concentrated in the President's hands. Mexico is an example of irony, because the period of more industrial concentration in the last quarter of century was precisely when the country implemented important reforms. However, the problem was not reforms, but rather the way reforms were managed by either granting privileges to few groups or by allowing the concentration of activities given the lack of sufficient regulation. In fact, the privatization of the telephone company resulted solely in the change of ownership, from a state monopoly to a private monopoly. The re-privatization of the banking system, few years after the nationalization, also resulted in the concentration of the banking activity, since it only represented the transfer of banks to the private sector without increasing the competition.

III. PRIVILEGES AND NONTRANSPARENCY

A system of competition with unequal opportunities creates the conditions for its self-destruction because the biggest and most privileged players will try to destroy the rest to eliminate competitors. This way, a competitive market can become an imperfect market with the help of a nontransparent government. In this case it is not that the free market is not able to deliver for the society, it is rather the distortions introduced by the government which become the obstacles for the market to act as a genuine market.

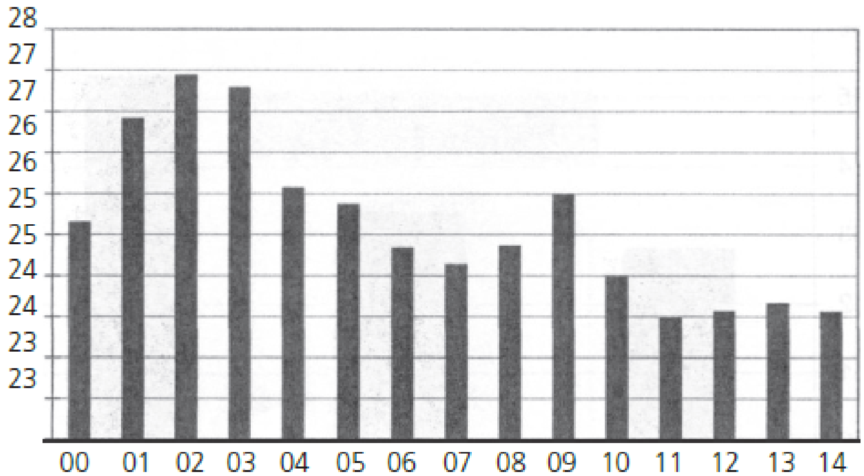
Assigning public contracts to big corporations is not bad by itself, when everybody competes under the same rules, because it can promote access to technology and capital. However, when those contracts are assigned by granting privileges and advantages to a particular firm, it becomes a problem because other qualified competitors are eliminated and inefficiencies are perpetuated. A similar distortion is generated when a government indiscriminately rescues companies or financial institutions in trouble. In this case, the traditional problem of "socializing losses"[11] —after privatizing gains— implies resolving the financial problems of the owners by using the money of the taxpayers.

In this sense, the lack of government transparency is important in explaining income inequality in countries where there is intervention in competition. A privatization process can be successful if authorities avoid the concentration of that industry in few hands. The government must be committed to implementing and enforcing long-term measures to avoid both the concentration of the industry and the increased income inequality potentially caused by that privatization. Mexico has undertaken several privatizations with the intention of promoting more competition and improving income distribution through the redistribution of the resulting proceeds. However, since governments come and governments go, and given the lack of strong institutions and mechanisms to enforce long-term commitments, the good will of one administration falls into obscurity with the next government.

The same way that a tax policy can be used for redistribution purposes[12], It can also produce the opposite results when a government tolerates or grants tax privileges to some, particularly to groups with strong economic power. Mexico's tax system has been one of the poorest systems in Latin America in terms of tax collection, not only because of the inability to capture the informal sector, but also because of the privileges and exceptions granted to some groups. On the one hand, tax forgiveness granted to big corporations, to political leaders at the state and local levels, and to people with close links with government officials promotes unequal accumulation of wealth and makes taxation more unfair. On the other hand, bureaucratic obstacles to start a business generate an unfair environment for small and medium sized companies, also aggravating income inequality.

Economic growth is an important factor that helps explain the conditions of labor income, particularly in countries where the economy is not able to generate sufficient employment ot absorb the extra labor force added to the market every year. The absence of reforms in the last fifteen years has restrained Mexico's production capacity, resulting in a potential growth rate of only 2.4%, compared with the 3.2% rate in the decade of the 90s when main reforms were implemented. This reduction in production capacity was accompanied by a deficit of employments and also by low-quality jobs. As a result, labor income decreased in the past decade and a half, from a ratio of almost 27% of GDP in year 2000 to 24% in 2014 (Chart 3). Since tax collection did not improve as a ratio of GDP, the reduction labor income was accompanied by an increase in capital income.

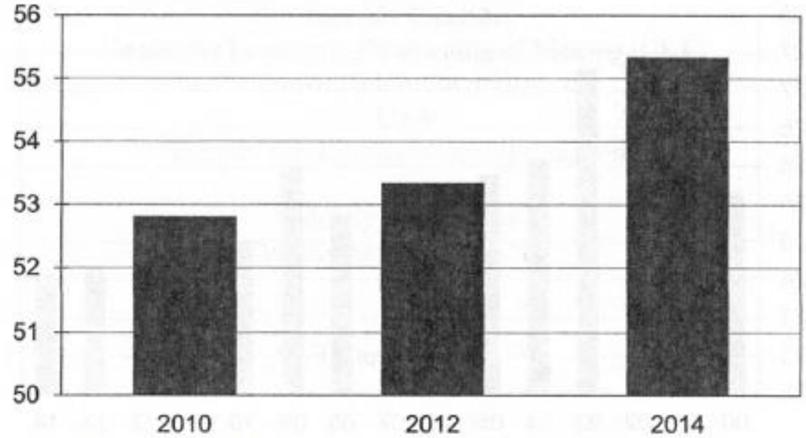
Chart 3
Mexico's Labor Income Share
Compensation of employees, % of Nominal GDP



Source: Author with data from INEGI and OECD.

Poverty is one of the perverse consequences of deteriorating income inequality, and Mexico has not escaped from the increase in the number of poor people. In the past four years alone, the amount of people in poverty increased by 2.5 million to a total of 55.3 million in 2014, representing 46.2% of total population[13] (Chart 4). Thus, Mexico's income inequality —understood as the concentration of wealth in a few hands and consequently the increase in capital income relative to labor compensation— has resulted in increased levels of poverty.

Chart 4
Mexico's Increase in Poverty
Number of People in Poverty, Millions



Source: Coneval.

IV. CONCLUDING REMARKS

All factors mentioned before explain, to a great extent, why Mexicans continue to wait for the largely promised income redistribution. If income inequality aggravated in the past decades, it was not because of the inherent laws of the economic model rather because it was the result of inconsistent regulations and the absence of strong institutions to ensure equal opportunities and fair application of justice for all. Therefore, part of the solution to improve income distribution implies the arrival of political leaders with strong commitment with social wellbeing. Mexico requires both a political system and institutions more transparent and subject to the scrutiny of the society, and also a responsible society open and willing to change for the better.

History shows that economic progress has always been accompanied by structural changes, but changes for the wellbeing of people not for the empowering of politicians and small elites. Reforms should be implemented at all levels, including institutions and also economic policy. The government and society, together, should view modernization as a way to access better standards and to adapt themselves to the changing and challenging reality. Otherwise, obsolescence will perpetuate and will obstruct the progress in politics, economics, and society.

Reforms are the best way to strengthen one of the most important fundamental sources of growth: investment. But investment is needed not only in physical but also in human capital. This implies the preparation of high-quality professionals, not a massive education to be used as the escape valve of social pressures. Indeed, the gain in productivity resulting from training the labor force takes years and even decades to materialize, which requires a government with long-term vision. The country needs a government that truly serves the society, not to be served by it.

Finally, income redistribution should not be understood as the expropriation of wealth of the wealthy, rather should be undertaken as the creation of a strong system that ensures fair rules applied to everybody, promotes equal opportunities, and grants access to justice for all.

NOTES

[1]A short essay on the topic can be found in Coutitio (2015).

[2] In the institutional framework proposed by Acemoglu and Robinson (2015), the supply of skills is a crucial determinant in the analysis of inequality throughout history.

[3] Stiglitz (1969) presents a theoretical analysis of the role of savings behavior in wealth disparities.

[4] Dornbusch and Fischer (1994), and Jones (2015).

[5] This is a central point in Piketty's book about income inequality in Capitalism: Piketty (2014) and Piketty (2015).

[6] An analysis of income distribution among individuals, instead of among factors, is presented in Stiglitz (1969).

[7] Stiglitz (2015).

[8] Acemoglu and Robinson (2015) also emphasizes the important role of institutions and politics.

[9] Piketty's book (2014) and Marx's Capital (1867) are remarkable examples about the dynamics and laws of capitalism.

[10] Acemoglu and Robinson (2015) describe how reforms promoted economic advance in the past two centuries.

[11] Also mentioned in Stiglitz (2014).

[12] Stiglitz (1969) analyses theeffects of taxation on income restribution.

[13] Figures from Coneval (2015).

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