LATIN AMERICA and THE CARIBBEAN

Growth in Latin America and the Caribbean was disappointingly weak in 2018, at an estimated 0.6 percent, and notably lower than previously expected. This reflected the impact of Argentina's currency crisis, a truckers' strike and policy uncertainty in Brazil, and worsening conditions in Venezuela. Growth is expected to pick up to 1.7 percent in 2019, as growth accelerates in Brazil and the recession in Argentina begins to fade. Per capita growth in LAC is projected to pick up moderately, and to outpace that in advanced economies starting in 2020, after six years of stalled convergence. Downside risks continue to dominate. Key external risks include further tightening of external financial conditions and additional escalation of international trade policy uncertainty. The region also faces intraregional and domestic risks, such as spillovers from larger-than-expected growth contractions in Argentina and Venezuela and the persistent threat of natural disasters and extreme weather.

Recent developments

Growth in Latin America and the Caribbean (LAC) stalled at a subdued 0.6 percent in 2018, substantially weaker than previously projected. The disappointing growth outcome reflected softening global trade growth and tighter external financing conditions. Developments in Argentina, Brazil, and Venezuela hindered regional growth, despite better performance in several mid-size economies (e.g., Chile, Colombia, Peru). Growth moderated in Central America, reflecting a variety of factors, while it strengthened in almost all Caribbean economies as the subregion began to recover from a severe 2017 hurricane season.

In Brazil, growth bounced back in the second half of 2018, following a strike-induced dip around mid-year, but remains subdued. In Argentina, the currency crisis and associated sharp tightening of monetary and fiscal policies, together with the effect of a severe drought on the agriculture sector, resulted in a contraction in activity. Venezuela's economic collapse has deepened, and there is no indication that the latest redenomination of the currency has had a major impact on ongoing hyperinflationary dynamics.

Note: This section was prepared by Dana Vorisek. Research assistance was provided by Brent Harrison.

Commodity price developments are also affecting LAC economies. The decline in copper prices in the second half of 2018 contributed to slowing growth momentum in Chile and Peru, after a an acceleration in the first half. Rising oil prices underpinned accelerating growth in oil-producing Colombia, while they were one factor that inhibited growth in oil-importing Central America in 2018, despite the decline in prices at the end of the year. The Central American sub-region was also affected by weak confidence in Costa Rica and Panama, political uncertainty in Guatemala, and social unrest in Nicaragua.

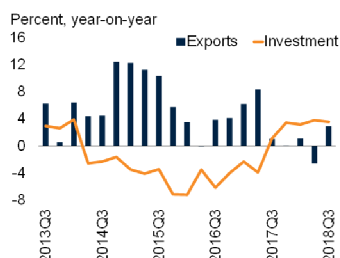
A long-awaited rebound in regional fixed investment that began in 2017 was significantly weaker in 2018 than previously expected, after losing momentum in the first half of the year (Figure 2.3.1). Export growth in the region was also lower than expected, owing to the drought in Argentina and slowing global trade growth.

Nearly all LAC economies with floating exchange rates have experienced nominal depreciation against the U.S. dollar, particularly Argentina, Brazil, Chile, and Uruguay. The adjustment in effective terms has been more modest. In most of these economies, especially Argentina, depreciation is contributing to a rise in inflation. Recent interest-rate hikes (e.g., in Chile) were

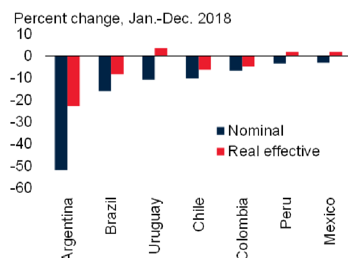
FIGURE 2.3.1 LAC: Recent developments

Investment and export momentum in LAC have slowed. Rising U.S. interest rates and weakening investor sentiment toward EMDEs has translated into diminished capital inflows and rising bond spreads and credit default swap spreads in LAC, while a strengthening U.S. dollar is putting upward pressure on inflation in some countries. Fiscal deficits narrowed in most LAC countries in 2018, mainly reflecting higher revenues, but debt continues to build.

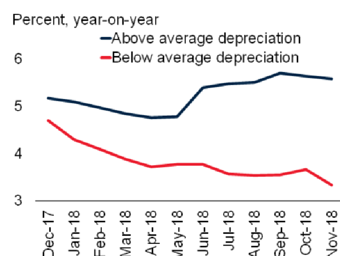
A. Investment and export growth



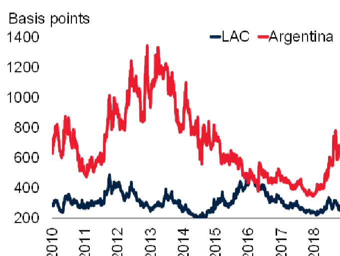
B. Exchange rates against the U.S. dollar



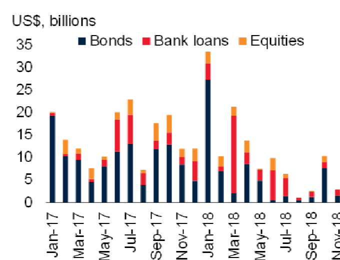
C. Inflation



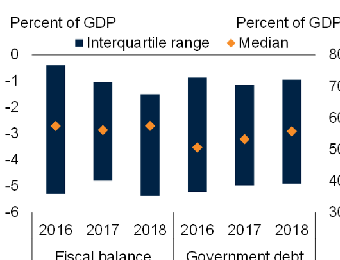
D. Bond spreads



E. Gross capital inflows



F. Fiscal balances and government debt



Sources: Bloomberg, CPB Netherlands Bureau for Economic Policy Analysis, Dealogic, Haver Analytics, International Monetary Fund, World Bank.

A. Investment growth is the GDP-weighted average of 15 economies, excluding Venezuela, that represent 93 percent of regional GDP. Investment for 2018Q3 is estimated using actual data for economies representing 87 percent of regional GDP. Last observation is 2018Q3.

B. Last observation is December 19, 2018.

C. Lines show group averages. Above average and below average groups are delineated according to currency depreciation against the U.S. dollar between January 2, 2018 and November 1, 2018. Sample includes 17 economies, excluding Argentina and Venezuela, and excluding those with conventional currency pegs and currency boards and those using the U.S. dollar as their official currency. Last inflation observation is November 2018.

D. LAC line shows median of 15 economies. Last observation is December 19, 2018.

E. Last observation is November 2018.

F. Sample includes 32 economies.

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made partly in reaction to exchange rate pass-through to domestic inflation, despite falling pass-through ratios observed over the long term (Ha, Stocker, and Yilmazkuday 2019). Central banks in several countries have intervened in foreign exchange markets using derivative instruments to reduce currency volatility (e.g., Brazil, Uruguay) or to build reserves (e.g., Colombia).

External financing conditions have tightened. Against the backdrop of rising U.S. interest rates, U.S. dollar appreciation, and weaker investor sentiment toward EMDEs, the region has experienced a generalized rise in bond and credit default swap spreads and a fall in equity prices. Capital inflows, particularly bond flows, steadily diminished through the third quarter of 2018. Current account deficits have widened in most commodity-exporting and commodity-importing economies. Several Caribbean economies that were not significantly damaged by hurricanes in 2017, however, registered narrowing deficits or widening surpluses as a share of GDP in 2018 on strong tourism inflows and rising oil prices (e.g., The Bahamas, Belize, St. Vincent and the Grenadines, and Trinidad and Tobago).

Fiscal conditions across the region remain fragile, and government debt continues to build. Fiscal deficits narrowed slightly in most countries in 2018, however. The improvement mainly reflected higher revenues, in part stemming from rising prices of key commodities. The fiscal austerity program in Argentina will be challenging to implement but should improve long-term fiscal sustainability, while a recently legislated fiscal reform in Costa Rica will boost revenues and should improve investor sentiment. In Colombia, a proposed tax reform would boost revenues in order to comply with fiscal targets. A proposed tax reform in Chile would integrate and streamline the tax system.

Outlook

Regional growth is projected to advance to a still modest 1.7 percent in 2019, lower than previously projected, and build to 2.5 percent in 2021 (Figure 2.3.2). The acceleration will be supported mainly by a pickup in private consumption. Investment growth will accelerate, though at a slower pace this year than previously expected, in view of tight financing conditions and planned

public spending reductions in a number of countries. Decelerating global trade will limit export growth during the forecast period.

Although the prices of key non-oil commodities such as soybeans and copper are projected to continue rising through the forecast period, copper prices will increase at a much slower pace through 2021 than in 2017 and 2018. Oil prices are projected to be flat, on average, during 2019-21, at $67 per barrel, potentially limiting fiscal and export revenue increases in oil-producing economies.

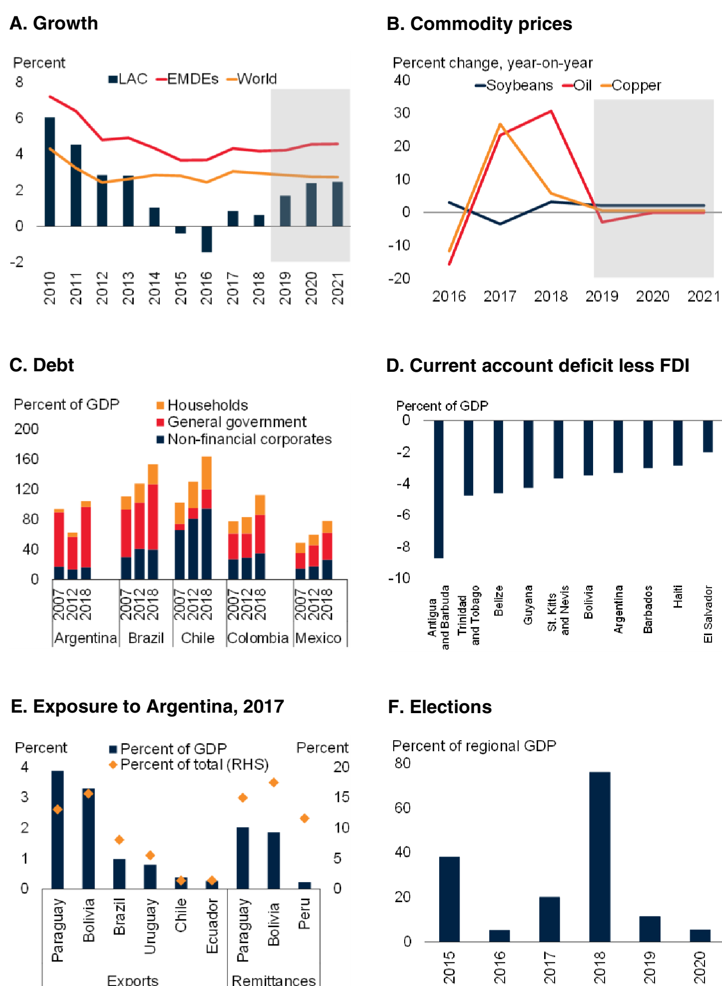
In Brazil, growth is expected to steadily build momentum in 2019, from a weak base. The forecast of 2.2 percent for this year assumes that fiscal reforms are implemented expeditiously under the incoming administration, and that a recovery of consumption and investment, resulting from improving confidence and investor sentiment, will outweigh the negative growth effect of reduced government spending. In Mexico, policy uncertainty and the prospect of still subdued investment is expected to keep growth at a moderate 2.0 percent in 2019, despite the decrease in trade-related uncertainty following the announcement of the United States-Mexico-Canada Agreement. Argentina's economy is expected to continue contracting in 2019 as deep fiscal consolidation results in a loss of employment and reduction in consumption and investment, and as high interest rates place corporate balance sheets under stress and dampen private investment.

By 2020, a strengthening recovery in Brazil, modestly accelerating growth in Mexico, and solid performance in Chile, Colombia, and Peru, are expected to help push regional growth to 2.4 percent, consistent with potential. Per capita GDP growth in the region is also expected to accelerate moderately, and to outpace per capita growth in advanced economies starting in 2020, after six years of stalled convergence.

Achieving sustained improvements in potential growth in the region over the medium term will require implementing reforms in several areas. There is need to improve infrastructure and education attainment, reduce labor market inflexibility, deepen trade integration, and address the negative economic and social outcomes of informality, among other challenges (World Bank 2018l; Chapter 3; Box 2.3).

FIGURE 2.3.2 LAC: Outlook and risks

Growth in LAC is projected to accelerate only moderately through 2021, and at a slower pace than previously expected. Risks to the regional outlook are predominantly to the downside. Further tightening of global financing conditions and escalation of trade tensions among major economies are key external risks. The region also faces intraregional and domestic risks, such as spillovers from a larger-than-expected growth contraction in Argentina or a worsening collapse in Venezuela, and unexpected disruptions from natural disasters and extreme weather.



Sources: Bank for International Settlements, Comtrade, Haver Analytics, International Monetary Fund, World Bank.

B. Lines show change in nominal prices.

C. Bars show data for 2007Q4, 2012Q4, and 2018Q2.

F. Chart shows GDP of LAC countries holding presidential or parliamentary elections in a given year as a share of regional GDP. An economy is counted only once when both types of elections occur in a single year.

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Risks

Risks to the regional outlook remain tilted to the downside. The experience of Argentina in 2018 is a stark reminder of the risk of sudden and widespread shifts in investor sentiment. Tightening global financing conditions are a particular concern for countries with large current account deficits or reliance on volatile capital inflows (e.g., Argentina, Bolivia, and several Caribbean countries), with high external debt loads (e.g., Jamaica, Nicaragua, Venezuela), or with sizable foreign-currency-denominated debt as a share of GDP (e.g., Costa Rica, Honduras, Nicaragua).

Trade tensions are another key external risk. Although trade diversion in response to rising trade restrictions in the United States and Canada may benefit some LAC economies in the short term, continued trade tensions may dampen regional growth in the medium term through export, confidence, and commodity market channels.

LAC economies also face intraregional and domestic sources of risk. Thus far, the recession in Argentina has had limited spillovers on the rest of the region. But a larger-than-expected contraction in Argentina could spill over to the rest of the region through trade and financial flows. Bolivia and Paraguay are most reliant on Argentina as a destination for goods exports and a source of remittance inflows. Although Uruguay has diversified its trading partners in recent years, it remains reliant on Argentina for services export revenues through tourism. Cross-border bank lending data for Latin American economies is patchy but suggests that Panama is most exposed, although with bank claims on Argentina still limited at approximately 0.6 percent of domestic GDP.

Continued outward migration from Venezuela is producing spillovers elsewhere in the region. In Colombia, the cost of providing basic public services to migrants and Colombian returnees at levels similar to those delivered to the local population is an estimated 0.2–0.4 percent of GDP per year in the short term (World Bank 2018m).[1] However, in the medium and long term, inward migration to Colombia could result in a growth boost as a result of a larger labor supply and higher consumption and investment.

Poor fiscal conditions and slow progress in addressing of fiscal imbalances are downside risks, and may have negative repercussions for debt sustainability and market confidence. In Argentina, for instance, adherence to the fiscal consolidation plan is key to a quick emergence from the recent currency crisis. Plans to implement fiscal reform in other countries (e.g., Costa Rica) need to be carried out to retain investor confidence. In Brazil, the new administration needs to urgently make plans to reduce fiscal vulnerabilities arising from an unsustainable pension system.

Election-related risks, which generated considerable uncertainty in countries such as Brazil and Mexico in 2018, are expected to recede, given that the elections scheduled in the next two years are in economies representing a much lower share of regional GDP. However, it will be incumbent on some new governments to implement challenging policy reforms.

Unexpected disruptions related to natural disasters and extreme weather represent a significant ongoing risk. Hurricanes, floods, droughts, and earthquakes have long had detrimental impacts on growth in several economies in the region in recent years. The region remains highly vulnerable to such events, underscoring the need to use risk instruments such as catastrophe bonds and domestic and multi-country catastrophe risk insurance funds (Végh et al. 2018).

[1] Calculations of the cost of public services are made using the number of migrants and returnees in Colombia as of September 2018.

TABLE 2.3.1 Latin America and the Caribbean forecast summary

(Real GDP growth at market prices in percent, unless indicated otherwise)

	2016	2017	2018e	2019f	2020f	2021f	Percentage point differences from June 2018 projections: 2018e	2019f	2020f
EMDE LAC, GDP[1]	**-1.5**	**0.8**	**0.6**	**1.7**	**2.4**	**2.5**	**-1.1**	**-0.6**	**-0.1**
(Average including countries with full national accounts and balance of payments data only)[2]									
EMDE LAC, GDP[2]	-1.4	0.8	0.6	1.7	2.4	2.5	-1.1	-0.6	-0.1
GDP per capita (U.S. dollars)	-2.5	-0.2	-0.4	0.7	1.4	1.5	-1.1	-0.6	-0.1
PPP GDP	-0.8	1.2	0.9	1.8	2.5	2.6	-1.0	-0.6	-0.1
Private consumption	-1.6	1.6	0.5	1.8	2.7	2.8	-1.6	-0.7	0.0
Public consumption	0.1	-0.7	0.1	-0.1	0.1	0.4	0.3	-0.3	-0.6
Fixed investment	-7.0	-0.6	1.4	2.1	4.8	4.6	-2.3	-1.9	0.2
Exports, GNFS[3]	1.2	2.4	3.3	4.0	3.6	3.6	0.1	0.3	-0.3
Imports, GNFS[3]	-3.1	5.2	2.7	3.7	4.8	4.9	-1.6	-0.4	0.2
Net exports, contribution to growth	0.9	-0.6	0.2	0.1	-0.2	-0.3	0.4	0.2	0.0
Memo items: GDP									
South America[4]	-3.1	0.3	-0.1	1.4	2.3	2.4	-1.4	-0.7	0.0
Central America[5]	3.9	3.8	2.7	3.4	3.5	3.6	-1.0	-0.5	-0.4
Caribbean[6]	4.4	3.4	4.4	4.0	4.0	3.8	0.9	0.5	0.2
Brazil	-3.3	1.1	1.2	2.2	2.4	2.4	-1.2	-0.3	0.0
Mexico	2.9	2.1	2.1	2.0	2.4	2.4	-0.2	-0.5	-0.3
Argentina	-1.8	2.9	-2.8	-1.7	2.7	3.1	-4.5	-3.5	-0.1

Source: World Bank.

Note: e = estimate; f = forecast. EMDE = emerging market and developing economy. World Bank forecasts are frequently updated based on new information and changing (global) circumstances. Consequently, projections presented here may differ from those contained in other Bank documents, even if basic assessments of countries' prospects do not differ at any given moment in time.

1. GDP at market prices and expenditure components are measured in constant 2010 U.S. dollars.

2. Aggregate includes all countries in notes 4, 5, and 6, and Mexico, except those for which data limitations prevent the forecasting of demand-side GDP components: Dominica, Grenada, Guyana, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Suriname, and Trinidad and Tobago.

3. Exports and imports of goods and non-factor services (GNFS).

4. Includes Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Paraguay, Peru, Uruguay, and Venezuela.

5. Includes Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, and Panama.

6. Includes Antigua and Barbuda, The Bahamas, Barbados, Belize, Dominica, Dominican Republic, Grenada, Guyana, Haiti, Jamaica, Suriname, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, and Trinidad and Tobago.

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TABLE 2.3.2 Latin America and the Caribbean country forecasts[1]

(Real GDP growth at market prices in percent, unless indicated otherwise)

	2016	2017	2018e	2019f	2020f	2021f	2018e	2019f	2020f
							Percentage point differences from June 2018 projections		
Argentina	-1.8	2.9	-2.8	-1.7	2.7	3.1	-4.5	-3.5	-0.1
Belize	-0.5	1.2	1.5	1.9	1.7	1.7	-0.5	0.0	0.0
Bolivia	4.3	4.2	4.5	4.3	3.8	3.4	0.6	0.7	0.4
Brazil	-3.3	1.1	1.2	2.2	2.4	2.4	-1.2	-0.3	0.0
Chile	1.3	1.5	3.9	3.5	3.3	3.2	0.6	0.1	-0.2
Colombia	2.0	1.8	2.7	3.3	3.7	3.6	0.0	0.0	0.1
Costa Rica	4.2	3.3	2.7	2.7	2.8	3.0	-0.7	-0.9	-0.8
Dominican Republic	6.6	4.6	5.8	5.1	5.0	4.8	0.8	0.4	0.4
Ecuador	-1.2	2.4	1.0	0.7	0.7	1.2	-1.2	-0.8	-0.2
El Salvador	2.6	2.3	2.8	2.5	2.4	2.4	0.5	0.3	0.2
Grenada	3.7	5.1	5.2	4.2	2.8	2.8	1.9	1.4	0.0
Guatemala	3.1	2.8	2.7	2.9	3.0	3.1	-0.4	-0.4	-0.3
Guyana	2.6	2.1	3.4	4.6	30.0	24.8	-0.4	0.8	1.0
Haiti[2]	1.5	1.2	1.6	2.3	2.4	2.5	-0.2	-0.1	0.0
Honduras	3.8	4.8	3.6	3.8	3.8	3.7	0.1	0.2	0.0
Jamaica	1.4	1.0	1.7	1.8	2.0	2.0	0.0	-0.1	0.0
Mexico	2.9	2.1	2.1	2.0	2.4	2.4	-0.2	-0.5	-0.3
Nicaragua	4.7	4.9	-3.8	-0.5	2.6	3.6	-8.5	-5.0	-1.8
Panama	5.0	5.3	4.0	6.0	5.4	5.2	-1.6	0.4	-0.2
Paraguay	4.3	5.0	4.0	3.9	4.0	4.0	-0.3	-0.3	-0.2
Peru	4.0	2.5	3.9	3.8	3.8	3.7	0.4	0.0	0.0
St. Lucia	3.4	3.8	1.5	2.7	2.8	2.3	-1.3	0.4	0.5
St. Vincent and the Grenadines	1.3	0.5	1.2	1.6	1.6	2.0	-0.9	-0.9	-1.1
Suriname	-5.6	1.7	1.4	1.6	1.8	1.9	0.3	-0.1	-0.3
Trinidad and Tobago	-6.1	-2.6	1.0	0.9	1.2	1.2	-0.6	-1.0	0.0
Uruguay	1.7	2.7	2.1	2.1	2.3	2.5	-1.2	-1.0	-0.6
Venezuela	-16.5	-14.5	-18.0	-8.0	-5.0	-4.0	-3.7	-1.0	-1.0

Source: World Bank.

Note: e = estimate; f = forecast. World Bank forecasts are frequently updated based on new information and changing (global) circumstances. Consequently, projections presented here may differ from those contained in other Bank documents, even if basic assessments of countries' prospects do not significantly differ at any given moment in time.

1. GDP at market prices and expenditure components are measured in constant 2010 U.S. dollars.

2. GDP is based on fiscal year, which runs from October to September of next year.

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BOX 2.3.1 Informality in Latin America and the Caribbean

Informal sector output in Latin America and the Caribbean, equivalent to about one-third of GDP, is slightly higher than in the median emerging market and developing economy, despite a steady decline during recent decades. Roughly six out of ten of those employed in the region are employed informally. Informality has been associated with lower growth, weaker productivity, and higher levels of inequality. Policies to reduce payroll taxes and increase labor inspections have been found to reduce informality.

Introduction

Informality in Latin America and the Caribbean (LAC) during the past decade was slightly higher than in the median emerging market and developing economy (EMDE), whether measured in terms of informal output or the share of self-employment (Figure 2.3.1.1; Box 3.2). Yet there is substantial heterogeneity in the incidence of informality within the region. Informality tends to be higher in countries with poorer institutional environments.

Against this backdrop, this box addresses the following questions:

- How has informality evolved in Latin America and the Caribbean?
- What have been the macroeconomic and social correlates of informality?
- What policy options are available to address challenges associated with informality?

Evolution and drivers of informality

Moderate informality. On average, the informal economy in LAC was equivalent to 34 percent of official GDP in 2016, slightly above the median EMDE.[1] Informal employment averaged 62 percent of total employment in 2016 (slightly below the EMDE median), while 38 percent of those employed were self-employed. Within the region, informality varies considerably.

Regional heterogeneity. The amount of output generated by the informal sector (output informality) ranged from 16 percent of GDP in Chile, in line with rates observed in advanced economies, to 56 percent in Bolivia. Haiti also has very high informality, at 61 percent of GDP.[2] Survey-based measures of labor informality show a similarly wide range. For Caribbean countries with available data, self-employment as a share of formal employment tends to be very low: 12 percent in Suriname (2014), 14 percent in The Bahamas (2011), and 17 percent in Barbados (2013). Again, Bolivia appears at the top end of the spectrum, with self-employment equivalent to 64 percent of formal employment in 2015. In most countries, labor informality is higher than output informality, although Brazil, Guatemala, and several Caribbean countries are exceptions.

Trend decline in output informality. Output informality in the region has steadily declined since the early 2000s (Figure 2.3.1.2). Several of the countries with the highest incidence of output informality (e.g., Bolivia, Panama, Peru) have also experienced some of the largest declines during the past two decades, in part due to rapid formal job creation in the context of strong output growth. Yet even where labor informality has fallen, the decline did not necessarily affect all workers equally. In Argentina and Brazil, two of the largest economies in LAC, middle-aged men, the highly skilled, and those working full time were the most likely to shift from informal to formal employment during the 2000s (Maurizio 2015). Moreover, the decline in output informality has not always been accompanied by a similar decline in labor informality, which has been persistently high in countries such as Bolivia, Colombia, Honduras, Jamaica, Nicaragua, and Peru.

Correlates of informality

Informality has been associated with weak institutions and business climates as well as poor macroeconomic, microeconomic, and social outcomes in LAC. These include lower output and productivity growth, weaker financial resilience of households, and greater poverty.

Weak governance and business climates. Most of the institutional factors associated with informality are at or slightly above the EMDE average in LAC. However, LAC economies with below-average institutional quality have also tended to be those with high informality. For instance, Peru's higher labor informality compared to

Note: This box was prepared by Dana Vorisek. Research assistance was provided by Brent Harrison and Jinxin Wu.

[1] Output informality based on DGE estimates of Elgin and Oztunali (2014), unless otherwise specified.

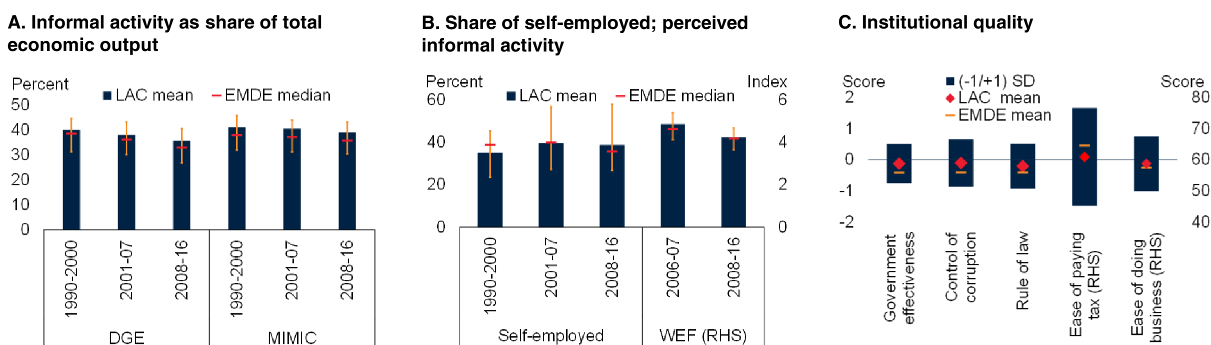
[2] For lack of data on DGE estimates, this figure refers to MIMIC estimates (Chapter 3). DGE and MIMIC estimates are similar at the country level.

[3] Dougherty and Escobar (2013); Estevão and de Carvalho Filho (2012); Loayza (1997); Loayza, Servén, and Sugawara (2010); Vuletin (2008).

BOX 2.3.1 Informality in Latin America and the Caribbean (*continued*)

FIGURE 2.3.1.1 Informality in Latin America and the Caribbean

Output-based informality in LAC has fallen since the 1990s, on average, yet remains above the median in EMDEs. Employment-based informality in the region has risen slightly, to about the EMDE median. The key institutional factors that are often associated with informality, other than the difficulty of paying taxes, are slightly better in LAC than in all EMDEs.



Sources: Elgin et al. (forthcoming), Eurostat; Haver Analytics, Inter-American Development Bank, national statistical bureaus and offices, Organisation for Economic Co-operation and Development, World Bank (Doing Business, World Development Indicators, and World Governance Indicators).

A.-C. Blue bars show simple averages of economies in the region. Red markers show the median of all EMDEs. Vertical lines denote interquartile range of all EMDEs.

A. DGE = dynamic general equilibrium model. MIMIC = multiple indicators multiple causes model. The DGE model estimates the size of the informal sector as a percent of official GDP (see Elgin and Oztunali 2012). The MIMIC model is a structural equations model that considers multiple causes of informal activity and captures multiple outcome indicators of informal activity (see Schneider, Buehn, and Montenegro 2010). It also estimates the informal output as a percent of official GDP. DGE sample includes 26 LAC economies and 122 EMDEs; MIMIC sample includes 25 LAC economies and 124 EMDEs.

B. Self-employed is the presented as the share of self-employment in total employment. WEF = World Economic Forum. WEF index is the average response at the country-year level to the question: "In your country, how much economic activity do you estimate to be undeclared or unregistered? (1 = Most economic activity is undeclared or unregistered; 7 = Most economic activity is declared or registered)." WEF index is inverted; a higher average at the country level indicates a larger informal economy. The index does not use data for 2004–05 due to inconsistency in survey methods. The WVS asks whether respondents can justify cheating on taxes (1 = never justifiable; 10 = always justifiable). The average responses at the country-year level are used as a measure of attitude toward informality (or tax morality; Oviedo, Thomas, and Karakurum-Ozdemir 2009). Self-employed sample includes 32 LAC economies and 134 EMDEs; WEF sample includes 25 LAC economies and 114 EMDEs.

C. All measures are taken from the latest year available. The first three institutional measures are taken from World Bank's World Governance Indicators (2017), with a higher value indicating better institutional quality in 2016. The "ease of doing business" and "ease of paying taxes" are taken from World Bank's Doing Business database and measured as distance to frontier, with a higher value indicating a more favorable business environment. Sample includes 32 LAC economies and 149 EMDEs.

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Chile has been mostly attributed to poor governance (Loayza and Wada 2010a). One of the most common explanations for informality in LAC countries has been restrictive business and labor regulations, which discourage firms from entering the formal sector.[3]

High tax burdens. High tax rates or burdensome tax regulations have also encouraged informality in the region (Loayza 1997; Ordóñez 2014; Vuletin 2008). Both corporate and personal income tax rates tend to be higher in LAC than in the average EMDE—indeed, LAC is the only EMDE region where the average personal income tax rate has risen since the early 2000s.

Trade liberalization amid inflexible labor markets. Some instances of trade liberalization have also been associated with rising informality in LAC. The reduction of trade barriers in the 1980s and 1990s led to fears that domestic firms in the formal sector would be rendered uncompetitive and shift to the informal sector. In Brazil, the association between trade liberalization and informality was ambiguous in the early literature (Bosch, Goñi-Pacchioni, and Maloney 2012; Goldberg and Pavcnik 2003; Menezes-Filho and Muendler 2011). However, recent research has established that trade liberalization was followed by increased informality in Brazil, though only in the long run (Dix-Carneiro and Kovak 2017; Dix-Carneiro et al. 2018). In Colombia, trade liberalization was associated with slightly higher informality, yet only prior to a subsequent reform that increased labor market flexibility (Goldberg and Pavcnik 2003).

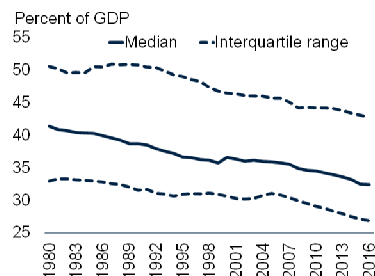
Sectoral and worker characteristics. Informality has been shown to be higher in the presence of large agricultural sectors. Other structural factors, such as poor education and skills, have also been identified as underlying reasons for labor informality (Fernandez and Villar 2016). In some LAC countries, a considerable share of people working informally entered the informal sector voluntarily. Switching between the formal and informal sectors has

BOX 2.3.1 Informality in Latin America and the Caribbean (*continued*)

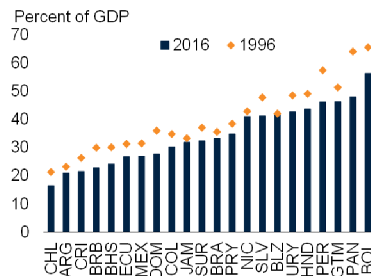
FIGURE 2.3.1.2 Evolution and correlates of informality in Latin America and the Caribbean

Although output-based informality in LAC has fallen, the incidence of informality still varies considerably within the region. In LAC economies where corruption and the burden of paying taxes is high, output-based informality tends to be high. Self-employment tends to be high where labor market efficiency is low. Both corporate and personal income tax rates are higher in LAC than in all EMDEs.

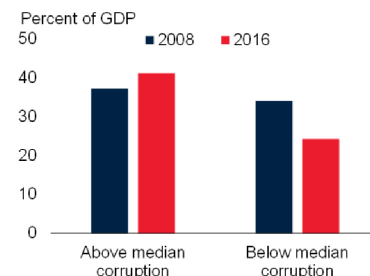
A. DGE-based informal activity



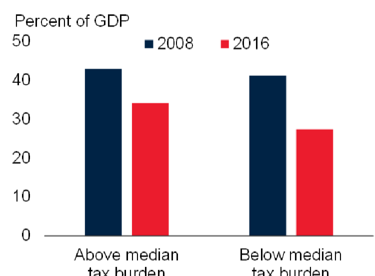
B. DGE-based informal activity, by country



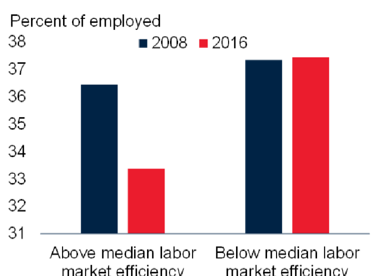
C. DGE-based informal activity



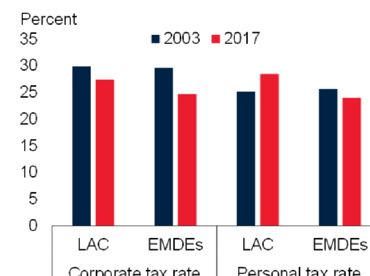
D. DGE-based informal activity



E. Self-employment



F. Average tax rates



Source: Elgin et al. (forthcoming), Haver Analytics, Inter-American Development Bank, national statistical bureaus and offices, Organisation for Economic Co-operation and Development, Végh and Vuletin (2015), World Bank (Doing Business, World Development Indicators, and World Governance Indicators), World Economic Forum (Global Competitiveness Index).

A. Sample includes 23 economies. The median of the MIMIC-based estimate of informality shows a similar downward trend.

B. CHL = Chile, ARG= Argentina, CRI= Costa Rica, BRB = Barbados, BHS = The Bahamas, ECU = Ecuador, MEX = Mexico, DOM = Dominican Republic, COL = Colombia, JAM = Jamaica, SUR = Suriname, BRA = Brazil, PRY = Paraguay, NIC = Nicaragua, SLV = El Salvador, BLZ = Belize, URY = Uruguay, HND = Honduras, PER = Peru, GTM = Guatemala, PAN = Panama, BOL = Bolivia.

C. Bars show medians. Sample includes 21 LAC economies.

D. Bars show medians. Sample includes 20 LAC economies. Tax burden is measured as the ease of paying taxes in the World Bank's Doing Business indicators.

E. Bars show medians. Sample includes 16 LAC economies.

F. Corporate tax rate sample includes 17 LAC economies and 49 EMDEs; personal tax rate sample includes 17 LAC economies and 47 EMDEs.

Click here to download data and charts.

been common in the largest economies in the region (Bosch and Maloney 2010; Fiess, Fugazza, and Maloney 2008; Perry et al. 2007). This may reflect a higher regard for self-employment in LAC relative to other regions, or a response to adverse employment and income shocks in the formal sector.

Lower output growth. In studies of a large number of LAC economies, informality has been negatively associated with growth, even after controlling for country characteristics (Loayza 1997; Loayza, Servén, and Sugawara 2010). However, studies at the country level are less conclusive. In Mexico, for instance, informality has been accompanied by slowing growth, yet in Brazil, falling informality may not be associated with higher GDP (Levy 2008; Ulyssea 2018).

Lower productivity growth. The informality literature on LAC has established a link between informality and aggregate productivity (Loayza, Servén, and Sugawara 2010). Linkages between informality and productivity have also been identified at the firm level. Informal firms in Brazil, for instance, have been less productive than formal firms (de Paula and Scheinkman 2011). In

BOX 2.3.1 Informality in Latin America and the Caribbean (*continued*)

Paraguay, not only are informal firms less productive, but their low productivity has had negative spillovers to formal firms (Vargas 2015).

Lower savings and access to finance for households and firms. For workers and firms, there are negative financial implications of informality. Informal workers in Chile, for instance, have not been able to save as much as formal workers, and have had less access to finance than formal firms (Schlcarek and Caggia 2015). In Brazil, poor access to finance was the key reason for informal firms being small and unproductive: their cost of capital was at least 1.3 times that of formal firms (de Paula and Scheinkman 2011). Similarly, in Ecuador, lower productivity and profitability in informal firms was due in part to worse access to credit (Medvedev and Oviedo 2013). Across the region, rising informality has been associated with lower pension contributions (Vuletin 2008).

Higher poverty and inequality. Informality in LAC has also been associated with inequality and poverty, in part reflecting the wage gap between the informal and formal sectors. In Argentina, past poverty has been associated with current informal employment, and past informality has been associated with current poverty (Devicienti, Groisman, and Poggi 2015). The process of increasing formal-sector employment contributed significantly to the decline in inequality in Argentina and Uruguay during the 2000s (Aramante, Arim, and Yapor 2016; Beccaria, Maurizio, and Vazquez 2015). In Colombia, informal workers received lower wages than formal workers due not only to lower returns to their education, but also to educational mismatches (Herrera-Idárraga, López-Bazo, and Motellón 2015).

Policy options

Designing policies to address informality requires an understanding of its causes and characteristics. These vary considerably, even within individual countries in LAC (Fernandez and Villar 2016; Perry et al. 2007).

Tax system. Making tax policy less restrictive, by lowering tax rates or simplifying tax systems, could incentivize firms to become formal and increase demand for formal workers. Indeed, a large reduction in payroll tax rates in Colombia in 2012 reduced labor informality in the main metropolitan areas by about 7 percentages points (Fernandez and Villar 2016). The results of Brazil's reduction and simplification of business taxes in 1996 have been more ambiguous. Early studies found that the reform was associated with a significant increase in the incidence of formal firms, and that newly formalized firms achieved higher revenue and profits than those operating informally, although the impact of the reform on informality varied across economic sectors (Fajnzylber, Maloney, and Montes -Rojas 2011; Monteiro and Assuncão 2012). Recent studies have found no evidence of increased formalization as a result of the reform (e.g., Piza 2016).

Labor market regulation. Tighter labor inspections have been effective in reducing informality in the region, through a variety of mechanisms. In Brazil, tighter enforcement of labor market regulations raised wages and output by improving the allocation of workers between the formal and informal sectors (Meghir, Narita, and Robin 2015). More frequent labor inspections in Brazil also induced some informal workers to become formal, albeit due to wage rigidity in the formal sector (Almeida and Carneiro 2012). Inspections were also more effective than incentives in convincing firms in Brazil to operate in the formal sector (de Andrade, Bruhn, and McKenzie 2013).

Other regulations. Policy reforms intended to ease barriers to entering the formal sector have had diverse outcomes. A reform that simplified the process of opening a business in Mexico was successful in increasing the number of registered businesses (Bruhn 2011; Kaplan, Piedra, and Seira 2011). However, the reform had no impact on informality: the owners of the new businesses were former employees of formal firms, rather than informal workers. Financial deepening contributed to a reduction in informality in Uruguay, particularly for women and older workers (Gandelman and Rasteletti 2016). Finally, the emerging "gig" economy presents unique policy challenges that may require regulatory changes to smooth economic risks for "gig" workers (World Bank 2014b, 2016c, and 2018n).

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