Competition

The Missing Ingredient for Growth?
Competition: The Missing Ingredient for Growth?
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Overview

Competition: The Missing Ingredient for Growth?
Latin America and the Caribbean (LAC) has made slow but consistent progress addressing the imbalances induced by the pandemic in an international environment that is just now showing signs of stabilizing. However, much remains to be done. LAC, with a few exceptions, has managed to bring inflation down below the levels of member countries of the Organization for Economic Co-operation and Development (OECD). Interest rates are beginning to fall, capping four years of solid macroeconomic management. However, challenges remain to redress fiscal imbalances, recover lost earnings power, and regain the advances in reducing poverty of the previous decade. High interest rates have also created debt distress for households and firms, which needs to be monitored. The region’s central task, however, remains boosting lackluster growth rates. While partly caused by high interest rates, faltering growth reflects long-standing structural issues. These factors also contribute to the less-than-expected gains from “nearshoring” or “friendshoring.” All point to a substantial agenda of reforms that have been put off for decades in infrastructure, education, regulation, and competition policy.

Further, two new features of the region will complicate policy going forward. First, an aging work force poses additional challenges to growth, fiscal stability and households. Second, violence in the region, already the highest in the world by far, has become more severe and widespread, terrorizing the region’s citizens and undermining the gains in investment attractiveness brought by macroeconomic stability.

Chapter 1 of this report lays out the recent social and macroeconomic evolution of the region and the near-term challenges it faces, particularly in the realm of growth and balancing the fiscal accounts. Chapter 2 explores how growth may be enhanced by inducing more competition in the region’s economies, combined with necessary complementary investments in firm and worker capabilities, and improvements in national innovation systems that can support the development, diffusion, and utilization of new ideas, products, and processes.

Chapter 1: Convergence to Inflation Targets but Continued Low Growth

While LAC has shown less dynamism than any other region of the world, it has fully recovered GDP lost during the COVID-19 pandemic, total employment is close to full recovery—although not for all groups—and poverty has fallen below its pre-pandemic level (mainly due to the influence of Brazil and Mexico). Yet, the region confronts a global environment that is still difficult. The US economy has outperformed all expectations and seems poised to achieve the holy grail of a “soft landing,” quashing inflation without inducing a recession, but Europe remains depressed and China, LAC’s largest market, continues its unpredictable but sluggish behavior. Slower progress in decreasing core inflation to targets has delayed interest rate cuts in the Group of Seven (G7) countries. Commodity prices will continue to soften into 2024, reflecting low global demand. LAC forecasts of 2024 growth have been downgraded from 2.3 in September 2023, to 1.6 percent in March 2024, but with substantial variation across countries. Both Brazil and Mexico are expected to slow down compared to 2023.

On the fiscal front, government spending remains elevated. High interest rates, while falling in many countries, keep pressure on debt service. Transitory transfers to vulnerable individuals and businesses during the pandemic are continuing to recede—albeit incompletely, while in many countries, other spending has not fallen or has increased. Overall, progress on debt reduction remains limited: the debt-to-GDP ratio increased considerably in 2023 compared to 2022 and remains above the 2019 level of 59 percent. In classic “twin deficits” fashion, persistent current account deficits largely reflect fiscal imbalances.

On the monetary front, independent central banks in Brazil, Chile, Colombia, and Peru continue to cut rates, and others are following. Regional inflation, excluding Argentina and the República Bolivariana de Venezuela, stands at 3.5 percent, compared to 5.7 percent in the OECD in January 2024. In most LAC countries, inflationary expectations remain anchored and central bank targets are expected to be achieved in 2024. The successful fight against inflation partially reflects external factors—fuel and food prices have fallen—but core inflation has also begun to fall, further signaling deeper rooted progress. On the financial front, higher interest rates have led to debt distress for households and firms, and non-performing loans increased but are subsiding. This debt service shock is taking place against a backdrop of an almost doubling of consumer credit as a percentage of GDP in many countries over the past 20 years;
thus, these risks must continue to be monitored. Despite this evolution, overall levels of non-performing loans are moving only modestly, banking sectors appear relatively sound in the region, and international markets remain calm, with even some decrease in spreads.

Despite solid macroeconomic management in the region, prospects for growth remain low, not only because of global conditions, but also because of long unaddressed structural issues. Regional growth remains constrained by low capital accumulation and low productivity growth over the longer term. Further, despite the enthusiasm for nearshoring, foreign direct investment (FDI) remains below levels of 12 years ago in real terms and greenfield investment announcements continue to fall, including in Mexico. Further, the big investments driving a recent upturn in FDI have occurred mainly in natural resource sectors, while manufacturing investment continues to decrease.

The April 2023 edition of the Latin America and Caribbean Economic Review (LACER) discussed how, despite the fact that wages are now competitive with China and other destinations, other structural factors in LAC—such as taxes, the cost of capital, the weak education level of the workforce, poor infrastructure policy, and social instability—all reduce the attractiveness of the region as a nearshoring destination. Addressing these structural concerns, as well as undertaking necessary fiscal reforms, is urgent.

Two emerging characteristics of the region will add further complications. First, the declining fertility rate is projected to reverse the falling dependency ratio (the share of the non–working-age population relative to the working-age population) in 2027. Given that there has been little growth due to capital accumulation or increased productivity, a declining labor force is expected to lead to even slower growth. The heightened demand for pensions and health care for the elderly, financed by a progressively smaller tax base, will further stress budgets. Finally, care for the elderly will put new burdens on families, particularly for women, who disproportionately take on household caregiving tasks, and will likely reduce their participation in the labor market.

Second, the assassination of Ecuador’s presidential candidate served as only the latest reminder of the tide of violence rising across the region, both in intensity and geographical reach. LAC is the most violent region in the world, and the only one where violence is increasing. Despite the laudable gains in macro management in the region, increased insecurity has become another factor generating citizen dissatisfaction and reducing the attractiveness of the region as a destination for investment.

Chapter 2: Competition—The Missing Ingredient for Growth?

Throughout the region, low competition makes consumers pay higher prices for lower-quality goods and services, reducing overall welfare, and contributes to higher inequality, as monopoly prices on essential goods and services consume relatively more of the budgets of poorer households.

Increasing the competition that LAC firms face has the potential to stimulate growth and improve consumer welfare. Competition from low-cost consumer imports can help raise the standard of living of families across the income spectrum. Competition also has the power to nudge domestic producers into adopting new products and technologies, improving productivity at the firm level. The global integration of markets has contributed to more competitive environments, facilitating the diffusion and adoption of innovations that enhance efficiency. At the same time, competing in dynamic and challenging domestic markets is the best way for firms to prepare for exporting.

Despite these positive impacts, foreign competition often harms local industries and jobs. Therein lies an apparent trade-off in policy-making: whether to protect existing jobs and firms at the cost of foregone growth, or to spur firms to strive for the highest form of technology available and enhance their performance, ensuring that consumers get the best products available at the lowest possible prices.

This is a false dilemma. Greater domestic competition induced by competition authorities yields unambiguously positive results and overall higher welfare. And, while the outcomes from greater external competition are more ambiguous, this is due mainly to the lack of preparedness of firms in LAC to compete with those at the forefront of
global productivity. So, a pressing priority is to help these firms and their workers be better prepared - only that will protect them in the face of global competition forces. Moreover, high market power and business political power too often feed into each other with undesirable outcomes for society. This vicious cycle must be broken. To bring industries closer to the frontier and enable societies to reap the gains from greater competition, competition and pro-competition policies must be paired with efforts to put in place good innovation policies and working national innovation systems - including improved education and skill-training systems - alongside deliberate actions to rebalance power.

A Land of Giants and Micros

Markets in LAC are characterized by a highly polarized business size distribution, in which a few giant firms exist alongside many tiny businesses. This skewed distribution is both a cause and a consequence of low productivity and high inequality. At the bottom, workers in self-employment or tiny businesses commonly engage in activities characterized by low productivity and low levels of technology adoption. They are usually not on the radar of policy initiatives to improve productivity and economic growth. Instead, they often fall under the wing of entrepreneurship programs conceived as a form of social policy. They rarely exert competitive pressure on other businesses. This does not mean that competition does not affect them. At the top, the absence of a large segment of high-productivity small and medium firms translates into highly concentrated markets dominated by giant players and high levels of average market power, resulting in large rents (excess profits possible only through the exercise of market power) in the hands of a few. This high concentration contributes to the stagnant growth experienced by the region over recent decades.

Increasing competition can help stimulate productivity growth through four principal channels. First, it forces less productive firms to exit the market while the more productive firms survive and grow. In its absence, low-productivity firms survive. Second, competition incentivizes innovation. In its absence, firms with a captive consumer base may choose to operate at a higher cost and decide against upgrading to a more efficient technology. Reduced incentives may result in suboptimal managerial choices and effort, and businesses with high market power may see no need to innovate if they can survive and continue to extract rents without upgrading their technology. Third, more competitive markets make technology adoption more affordable and broaden the scope of its diffusion, allowing more firms to benefit from efficiency gains. Fourth, uncontested firms may use their market power to divert resources from productive activities to rent-seeking behaviors.

Import Competition and Productivity in LAC

Despite LAC’s high market concentration and average market power levels, empirical evidence of their effect is scarce because of data availability. An exception is the research examining the effects of import competition on firm productivity and innovation. New evidence discussed in the forthcoming World Bank report, *Competition and Productivity Growth in Latin America and the Caribbean*, underscores the fact that the effects of import competition on productivity and innovation in LAC are the result of varying responses at the firm level that depend on preexisting productivity, markups, and proximity to the technological frontier. The most productive firms are better able to upgrade and survive under increased competition from imports, while the smaller, less productive businesses shrink or exit the market. The economy-wide impact on productivity and growth critically depends on the shape of the underlying distribution of productivity. Because in LAC, this distribution is shifted toward a few top firms, many will suffer, along with the incomes of much of the population, if the forces of external competition are not paired with deliberate government efforts to protect them by helping them become better at what they do. This points to the need for a complementary agenda to help firms improve their performance and approach the technological frontier.

Does Domestic Competition Policy Work?

Countries can use competition policy to promote fairer competition and better-working markets. Its design and enforcement shape the power that firms can exert and determine their ultimate effects on efficiency and equity. Twenty LAC countries have competition laws and agencies. These frameworks are relatively recent compared to those of advanced economies, and the agencies have been outgunned. Throughout the late twentieth century, the concentrated market power ensuing from the privatization of public oligopolies and monopolies was not effectively countered by the expansion of international trade and the entry of multinational corporations contributed to increasing it in several markets.
Recent World Bank research using novel data sets on competition policy interventions provides some of the first evidence on the very positive impacts of competition policy actions. However, because antitrust activity covers only a fraction of the misbehavior in the market, isolated interventions do not always suffice to produce significant changes. There is also evidence that competition policy works together with other regulatory frameworks, and their misalignment can limit its effectiveness. A complete understanding of complementarities across policies is critical to promoting markets that function well.

Despite the transformative potential of sound competition policy, institutions promoting competition continue to be weak, on average, and cartel activity and market concentration continue to be pervasive in LAC. To ensure the effectiveness of competition agencies, their independence and commitment mechanisms limiting their discretion in decision-making are essential. However, in most LAC countries, the competition agency is part of the executive branch, and the president has the authority to replace its head at will. Moreover, LAC competition agencies are understaffed and underfunded compared to peers in other regions, suggesting their relatively weak positioning within governmental policy priorities. Perhaps as a result, LAC competition agencies tend to launch fewer investigations on their own and are less likely to use leniency programs to encourage cartel members to cooperate with investigations. They also conduct fewer unannounced inspections to investigate infringements and impose lower average fines.

Such weaknesses are not independent of the strength of business political power. Powerful corporate actors have been able to dilute or evade government control through de facto interference across all branches of government. Obstructions range from systematic lobbying for favorable legislation to the strategic use of courts and other legal provisions to obtain injunctions against antitrust and other regulatory measures. Similarly, trade protection fixes minimum prices, producing outcomes like those of cartels, and is often the result of intense lobbying.

At least three factors particular to the region, studied by political scientists, contribute to enhanced business political power. Electoral rules resulting in fragmented party systems in which the executive builds support in the legislature through political transactions, allow businesses to finance parties or candidates using negotiations over votes in their favor. Big business and media in all their forms are closely interwoven, and media ownership is highly concentrated throughout LAC. These firms are not likely to use their media programming to argue for stricter market regulation. In addition, a large share of businesses in the region are family owned. Family-owned businesses may oppose taxation and regulation more strenuously than shareholder-owned corporations. They may have longer time horizons, and thus can monitor, support, or punish politicians more effectively. Family members or their proxies may even participate in politics to guarantee trusted representation.

The menace of capital flight and disinvestment also enhances business influence on policy. If the government thinks a regulation or policy intervention will lead businesses to reduce investment, hurting economic growth and employment, it may withdraw the measure.

Such entanglements between firms, government, and elites are found everywhere but are more likely where the economy is dominated by a very small number of giant firms, as in LAC. In the context of transitioning to greener economies in LAC, they present a significant concern.

To move the region forward, critical steps include reviewing regulations to eliminate those that favor private entrenched interests rather than the general welfare and strengthening the power and independence of competition laws and agencies. The path for reform can be paved by taking other measures to rebalance economic and political power, such as regulating campaign financing and lobbying activities and taking the global conversation on taxing the super-rich seriously.

The Complementarity between Competition and Innovation Policy

Because economic activity in the region has historically taken place in an environment highly sheltered from competitive pressures, the LAC productive apparatus is ill-prepared to compete. Firm-level productivity is low, partly because this shelter has historically translated into low incentives for innovation and overall improvement of business capabilities. Higher levels of competition are thus a welcome push for firms to innovate and compete. However, for precisely the same reason, the increased competition from external sources can destroy a large share
of this precarious productive apparatus—and, with it, the source of income of much of the population, leaving LAC countries worse off, even if the most productive firms can survive and grow.

Hence, for LAC, competition, and firm upgrading and national innovation policies are complements: higher competition levels, facilitated by sound competition policy and pro-competition regulatory frameworks, will provide the correct incentives for firms to upgrade technology. Good innovation policy will move more firms closer to the technological frontier, where they can respond to competition by improving their capabilities instead of exiting the market, resulting in improved aggregate productivity dynamics and economic growth.

Why is innovation so low in LAC? Returns to innovation fall with distance from the technological frontier when a broad set of complementarities, such as physical and human capital, are absent. Further, to innovate and manage innovation projects effectively, firms require a range of managerial and organizational capabilities fundamental to productivity and quality upgrading. Firms lacking the capabilities to respond to market conditions, identify new technological opportunities, develop a plan to exploit them, and then cultivate the necessary human resources will find it difficult to innovate.

In addition, government capabilities for designing, implementing, and coordinating effective policy are weak in LAC. First, policy design requires the ability to identify what causes markets to fail, design the appropriate policies to address them, and establish clear metrics for success. Many failed experiments result from importing institutional models and best practices from advanced countries that do not address the actual failures or are not politically viable. Second, effective implementation requires solid public management practices and processes for evaluating, adapting, and modifying or terminating policies when needed. Third, policy must be coherent across ministries and agencies. Fourth, policy consistency and predictability require systems that cultivate innovation policies and institutions over time. Instead, the consensus on the importance of the innovation agenda and high-level political commitment is often limited, so policies are weakly backed and frequently reversed.

The context of scarce government capabilities reinforces the need for complementarity between competition, firm upgrading, and national innovation policies. Rethinking innovation policies will entail broadening the scope of innovation systems to address restrictions to the accumulation of knowledge and human and physical capital; cultivating managerial and organizational capabilities; and selectively balancing government capabilities and feasible actions to avoid importing a complete set of institutions and policies from other country and international contexts.

Unlocking the Potential of Competition as a Driver for Productivity

For competition to work as a driver of productivity in LAC, attention must turn to improving productivity at the firm-level. The evidence in this report reveals just how unprepared LAC countries are to compete. Only a tiny fraction of firms can escape increased competition by increasing investments in innovation and enhancing productivity. This unpreparedness also refers to individuals.

Low firm-level productivity and the resulting lack of preparedness to compete may be traced back to low-quality education, poor access to financing, and inadequate regulatory frameworks for business activity, among other factors. However, a big part of the problem is that businesses emerge and operate in low-competition environments, shielded from the necessary incentives to stay alert about what goes on in the market and prioritize efforts to improve their capabilities and those of their workforce.

Addressing this lack of preparedness to compete by attempting to limit competitive forces will likely backfire, keeping the region stuck in a low-productivity/low-growth/high-inequality equilibrium. Instead, the promotion of fair competition and pro-competition policies must be paired with a deliberate effort to put in place good innovation policies and working national innovation systems—including better education and skill-training systems—aimed at increasing productivity at the firm level and shifting the productivity distribution upward, so the share of firms prepared to compete internationally grows larger.
### Growth Outlook for the Region

#### Real GDP Growth Rates

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<td>2.4</td>
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<td>0.4</td>
<td>3.2</td>
<td>2.6</td>
<td>2.6</td>
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</table>

Source: World Bank staff calculations.

Note: The cut-off date for the data is March 29, 2024. “e” stands for estimate; “f” for forecast.
Chapter 1

The State of the LAC Region
The Latin America and Caribbean region (LAC) has made slow but impressive progress addressing the imbalances induced by the COVID-19 pandemic in an international environment that is just now showing signs of stabilizing. However, much remains to be done. The US economy has outperformed all expectations and seems poised to achieve the holy grail of a “soft landing,” quashing inflation without inducing a recession. The last mile to reaching the target of the US Federal Reserve is proving slow to traverse, but interest rates are expected to decline soon. However, growth remains low in Europe, and the fortunes of the region’s principal trade partner, China, are hard to foresee. In this context, LAC, with a few exceptions, has managed to bring inflation down below the level of the member countries of the Organisation of Economic Co-operation and Development (OECD), capping a four-year episode of exceptionally solid macroeconomic management that is recognized by global markets.

However, challenges remain to redress fiscal imbalances, recover lost jobs, regain the advances in reducing poverty of the previous decade, and most profoundly, find new sources of growth. Further, despite the enthusiasm for “nearshoring” or “friendshoring,” the region is seeing little in terms of gaining segments of value chains. All these factors point to a substantial agenda of reforms that the region has been putting off for decades. In addition, LAC’s already high levels of violence have become more severe and widespread, terrorizing the region’s citizens and undermining the gains in investment attractiveness brought by macroeconomic stability.

Recovery is Continuing, but Growth is Still Disappointing

The economy of the LAC region continues to underperform the economies of other regions in the world. By the end of 2023, gross domestic product (GDP) in Latin America and the Caribbean was 7 percent higher than in 2019, while it was 19 percent higher in East Asia and the Pacific, and 18 percent higher in South Asia (figure 1.1). This trend is expected to continue through 2024, as LAC’s growth rates remain among the lowest in the world.

Figure 1.1.
LAC’s Growth Rates Remain among the Lowest in the World

Real GDP levels by region

Note: The index values are based on projections (as of March 29, 2024). e = estimate; f = forecast.
During 2023, growth in most LAC countries remained subdued, mostly due to a lackluster performance of investment and consumption. While the recovery from the pandemic in most countries relied on a strong rebound of internal demand (figure 1.2), from the third quarter of 2022 to the third quarter of 2023 investment and consumption remained low, partly due to more restrictive monetary policy and slackening labor markets. By the end of the year, an incipient recovery in consumption was underway in some economies due to increasing real wages and falling interest rates. Mexico and Costa Rica are notable exceptions, as they have shown a vigorous expansion of internal demand.

The weakness in internal demand was accompanied by a decrease in the demand for imports. At the same time, the resilience of the US economy as well as that of China (sustained by increases in the consumption of services due to the reopening of the Chinese economy, resilient investment in manufacturing, and public infrastructure stimulus) increased the demand for exports of some countries, such as Brazil and Colombia. Except for Argentina, all major economies in LAC improved their external position (figure 1.3), although some are still running significant current account deficits.

**Figure 1.2.**
**Growth Remains Subdued in Many LAC Countries**

Annual percent change in components of GDP

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**Figure 1.3.**
**Most Major Economies in LAC Have Improved their Current Account Balances**

Current account balance as percent of GDP

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Sources: World Bank Macroeconomics, Trade, and Investment Global Practice—Latin America; Haver Analytics.

Note: Quarterly data for aggregate demand do not include change in inventories. LAC = Latin America and the Caribbean. Each bar in the graph represents the annual percent change. The bar labeled “2023:Q3” compares the percent change between the data in the third quarter of 2022 and the data in the third quarter of 2023.

During 2023, growth in most LAC countries remained subdued, mostly due to a lackluster performance of investment and consumption. While the recovery from the pandemic in most countries relied on a strong rebound of internal demand (figure 1.2), from the third quarter of 2022 to the third quarter of 2023 investment and consumption remained low, partly due to more restrictive monetary policy and slackening labor markets. By the end of the year, an incipient recovery in consumption was underway in some economies due to increasing real wages and falling interest rates. Mexico and Costa Rica are notable exceptions, as they have shown a vigorous expansion of internal demand.

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Following a favorable 2023, the external scenario will be more challenging in 2024 (figure 1.4). After an acceleration in 2023, the economies of China and the United States are expected to grow more slowly, while the US Federal Reserve is expected to cut interest rates later than previously thought, making international financial conditions tighter.

The current trends in commodity prices bring mixed news to the region, depending on the trade basket of each country. Several countries have improved their terms of trade compared to the situation before the COVID-19 pandemic (figure 1.5). Brazil, Chile, and Peru reached levels higher than or comparable to the commodity super cycle of 2010–14. However, others—notably, Colombia—have experienced a sharp decrease in their terms of trade.
Business confidence remains close to its historical average for most countries (figure 1.6, panel a), although with variation across subregions. According to OECD data, business confidence is lower in Chile, Brazil and Colombia than the historical average, while it remains high and is trending upward in Mexico and Costa Rica, countries with stronger internal demand. Most countries have experienced small improvements in consumer confidence over the last year (figure 1.6, panel b).

Along with continued improvements in consumer confidence, the relaxation of monetary policy and the expansion of real wages have provided a boost to consumption that is likely to continue during 2024. On the negative side, a less favorable global economy will provide adverse headwinds. In the aggregate, the three largest economies of the region are expected to perform worse in 2024 compared to 2023. In Brazil, falling investment will drag down aggregate demand, in Mexico, the vigorous internal demand is expected to moderate over the next year, and in Argentina, the economic effects of the fiscal adjustment will drag down growth (table 1.1). The remaining LAC-6 countries will grow more in 2024 than in 2023.

Global growth forecasts for 2024 started to increase by the end of 2023, after steadily declining the first part of the year. While North America and

Table 1.1.
The Largest Economies of LAC-6 Are Expected to Grow Less in 2024 than in 2023

<table>
<thead>
<tr>
<th>Country</th>
<th>2023 estimate</th>
<th>2024 forecast</th>
</tr>
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<td>Argentina</td>
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<td>-2.8</td>
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<tr>
<td>Brazil</td>
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</tr>
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<td>Chile</td>
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<td>2.3</td>
</tr>
<tr>
<td>Peru</td>
<td>-0.6</td>
<td>2.7</td>
</tr>
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</table>

Note: The percent changes are based on projections (as of March 29, 2024). LAC = Latin America and the Caribbean; LAC-6 = Argentina, Brazil, Chile, Colombia, Mexico, Peru.
Eastern Europe have improved their forecasts, LAC-6 and Western Europe show continued slides (figure 1.7). Most countries in LAC-6 increased their growth expectations in the second half of 2023, after downward corrections in the first semester, due to the beginning of a monetary policy relaxing cycle, improved external conditions, and in the case of Mexico, dynamic internal demand. The most notable declines are Argentina, currently facing a sharp fiscal adjustment, and to a lesser extent, Colombia.

As stressed in previous volumes of the *Latin America and the Caribbean Economic Review* (LACER), the low forecasted growth rates are not an artifact of the pandemic. Growth rates in the 2010s were similar. These low levels are insufficient to pull families out of poverty and reduce social tensions. This cannot be allowed to be LAC’s “natural rate of growth.”

### Inflation and Monetary Policy: Landing on Target

The region continues to show one of the best inflation-fighting performances in the world, with inflation falling from 7.8 percent at the beginning of 2023 to 3.6 percent by the end, compared to 6.0 percent in the OECD. This encouraging performance is due to the dissipation of the supply shocks to food and fuel, as well as the easing of pandemic-induced supply chain congestion, and the energetic monetary policy response of the monetary authorities. While the October 2023 LACER attributed most of the progress to declines in the transitory components of inflation, such as food and fuel, core inflation is now trending downward, too (figure 1.8).

The current downward trend in inflation is expected to continue and bring inflation to the monetary policy target range by the end of 2024 for most countries (figure 1.9). The exception is Colombia, which began the cycle of monetary tightening later than its peers. However, the convergence is far from guaranteed, and the monetary authorities of the region will need to navigate the final descent to target in a challenging context. Inflation in the advanced countries remains more stubborn than expected. Renewed geopolitical tensions such as the conflict in the Middle East and an intensification of the Russia’s invasion of Ukraine, disruptions of shipments through the Suez

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1 World Bank (2023a).
2 World Bank (2023b).
Canal, and the El Niño phenomenon could generate upward pressure on tradable goods. In addition, in the context of shrinking interest rates differentials with the advanced economies, exchange rate depreciations and the associated pass-through increase inflationary pressures.

However, inflationary expectations remain well anchored across the medium term at the target range for most countries and central banks in the region have begun to cut their monetary policy rates (figure 1.10, panel a). The two most notable examples are Brazil and Chile, which began the cycle of monetary tightening earlier than their peers (and the advanced countries) and have been able to cut rates more vigorously, by 2 percentage points and 3 percentage points, respectively. Most other countries are expected to follow this trend. The loosening effect will likely be compounded over time. The rapid descent of inflationary expectations implies that real policy rates have fallen less than policy rates (figure 1.10, panel b). As inflation expectations reach the policy targets, real rates will also fall.
This said, there is unlikely to be a return to the era of easy money and low interest rates. In the medium terms, slower-than-expected rate reductions in the United States will put a floor under the rates that LAC countries can fall below without inducing capital outflows. In the longer term, the so-called “neutral rate of interest” in the United States, where economies grow steadily with full employment and 2 percent inflation, has been inching up in recent years after falling dramatically in the wake of the financial crisis. Its range has increased from 0.4 percent to 0.8 percent before the pandemic to 0.5 percent to 1.0 percent today.\(^3\)

A final consideration is in order. While central banks have been cutting policy rates throughout the region, the descent of inflation expectations implies that real policy rates have decreased less, limiting the impact of monetary policy on aggregate demand. Looking forward, as inflation expectations reach policy targets, the pass-through from nominal rates to real policy rates should increase, providing additional support for LAC economies.

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\(^3\) Fleming et al. (2024).
Can Nearshoring Lift Growth?

Supply chain complications during the pandemic and geopolitical tensions have led to a movement to bring providers closer to the United States and Europe. On November 3, 2023, at a meeting with Latin American heads of state, US Treasury Secretary Janet Yellen again laid out her vision for “friendshoring: diversifying our supply chains across a wide range of trusted partners and allies,” a prospect that she argued has “tremendous potential benefits for fueling growth in Latin America and the Caribbean.” The April 2023 LACER laid out the benefits for the region and the obstacles to realizing it, ranging from weak infrastructure to underskilled workforces to instability. In fact, despite the momentum for derisking supply chains, the inexorable rise in Chinese wages to exceed LAC levels, and the 2018 Trump tariffs on China, foreign direct investment (FDI) to LAC has declined considerably since 2010.

Somewhat encouragingly, FDI increased sharply during 2022 throughout the region (figure 1.11) reaching 2014 levels, although still substantially below 2010. LAC is the only region in the world that increased its FDI in 2022.

While this increase has benefited most countries in the region, it has been most notable in Brazil, which consolidated its position as the largest FDI destination, with an increase of almost 70 percent in 2022 (figure 1.12). Other countries, such as Chile and Argentina, have also experienced significant increases, but on considerably lower levels. Strikingly, Mexico, despite its proximity to the United States, experienced much milder increases.

Greenfield FDI announcements call into question whether these increases are part of a persistent phenomenon or are transitory blips in a continuing downward trend. Since 2020, announcements have increased in only two countries, Chile and Brazil. In no country do announcements reach the levels achieved during the commodity super cycle in 2010–14 (figure 1.13).

Looking at greenfield FDI announcements by sector (figure 1.14), the only sector improving with respect to the past decade is the energy sector, both fossil fuels and renewable energy. This pattern highlights the strong comparative advantage LAC holds in natural resources, but raises concern about the continued competitiveness of nontraditional sectors. In particular, and rowing against the nearshoring current, investment in manufacturing has been declining steadily over the last decade, falling by half in real terms.

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**Figure 1.11.**
**FDI to LAC Increased Considerably in 2022**

US$, billions, at constant 2015 prices


Note: Converted to real terms with consumer price index (CPI) from the U.S. Bureau of Labor Statistics; countries included are from the World Bank Macro Poverty Outlook list of countries.

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Footnote: 4 World Bank (2023a).
Figure 1.12.
**FDI Inflows Increased for Most LAC Countries, Especially Brazil**

Total FDI, US$, billions, at constant 2015 prices

![Graph showing FDI inflows for LAC countries](image)

**Source:** World Bank staff calculations using United Nations Conference on Trade and Development (UNCTAD) FDI database.

**Note:** The figure shows flows to LAC’s Top 6 recipients of FDI, as well as an aggregate for other LAC countries. Values have been converted to real terms with the Consumer Price Index (CPI) from the U.S. Bureau of Labor Statistics. FDI = foreign direct investment; LAC = Latin America and the Caribbean.

Figure 1.13.
**Greenfield FDI Announcements Have Slowed**

Percent of GDP

![Graph showing greenfield FDI announcements](image)

**Source:** World Bank staff calculations using fDi Markets database.

**Note:** FDI = foreign direct investment. Countries included are from the World Bank Macro Poverty Outlook list of countries.

Figure 1.14.
**While Greenfield Investment Announcements in Energy Have Improved, They Have Fallen in Other Sectors, Especially Manufacturing**

US$, billions, at constant 2015 prices

![Graph showing greenfield announcements by sector](image)

**Source:** World Bank staff calculations using fDi Markets database.

**Note:** The figure plots announcements of greenfield FDI in Latin America and the Caribbean by sector. Values have been converted to real terms with the Consumer Price Index (CPI) from the U.S. Bureau of Labor Statistics. FDI = foreign direct investment. Countries included are from the World Bank Macro Poverty Outlook list of countries.
Brazil illustrates this trend (figure 1.15). Greenfield investment has risen in services, coal, oil and gas, and renewable energy, but is partially offset by a sustained decline in manufacturing FDI. Chile has also seen a dramatic increase in renewables investment. Only Mexico has shown an increase in manufacturing—but, again, is still below levels of 2010–14. While there are some encouraging increases in Central America and the Caribbean (box 1.1), overall, the nearshoring trend is largely bypassing LAC. This points to the need for a wide-ranging set of necessary reforms, as well as more aggressive recruitment of FDI opportunities by the region’s governments.5

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5 Maloney (2024).
Box 1.1.  
**FDI inflows in Central America and the Caribbean Could Be a Signal of Nearshoring Picking Up**

The trajectory of foreign direct investment (FDI) inflows in Central America and the Caribbean is encouraging, potentially indicating an upswing in nearshoring activities. Despite the relative moderation in absolute investment levels compared to larger economies in the region, the sustained growth in FDI is a noteworthy development, particularly evident in the cases of Costa Rica, the Dominican Republic, and Panama (figure B1.1.1).

Costa Rica, at the forefront of regional FDI, attracts investments across diverse sectors (figure B1.1.2, panel a). Greenfield FDI announcements in 2020–22 came mainly from the subsectors “Hotels and Accommodation,” “Medical Devices,” and “Semiconductors.” The latest data available, covering the first nine months of 2023, highlights a noteworthy surge in FDI announcements specifically within the “Medical Devices” sector.

In the Dominican Republic and Panama (figure B1.1.2, panels b and c), the predominant focus of FDI flows over the past decade has been directed toward the mining sector. Recent greenfield FDI announcements (2020–22) in the Dominican Republic reveal a strategic shift toward diversification, notably in the areas of “Hotels and Accommodation” and “Renewable Energy.” Similarly, Panama’s recent FDI announcements are associated with “Renewable Energy” and “Warehousing and Storage,” indicative of a broader economic landscape.

Figure B1.1.1.  
**Total FDI Inflows to Main Destination Countries in Central America and the Caribbean**

US$, millions, at constant 2015 prices


Note: The figure shows flows to Central America and the Caribbean's Top 8 recipients of FDI. Values have been converted to real terms with the Consumer Price Index (CPI) from the U.S. Bureau of Labor Statistics. FDI = foreign direct investment.
Box 1.1. FDI inflows in Central America and the Caribbean Could Be a Signal of Nearshoring Picking Up (continuation)

Figure B1.1.2. Greenfield FDI Announcements in Costa Rica, the Dominican Republic, and Panama

US$, millions, at constant 2015 prices

a. Costa Rica

b. Dominican Republic

c. Panama

Note: The figure plots announcements of greenfield FDI by country and sector. Values are converted to real terms with the Consumer Price Index (CPI) from the U.S. Bureau of Labor Statistics. FDI = foreign direct investment; IT = information technology.
Twin Deficits: Fiscal and Current Account

Fiscal deficits continue to be high, averaging 5.4 percent of GDP over 2023 (figure 1.16), reflecting a combination of structural factors (such as low taxing capacity and increased demand for public goods) and cyclical factors (such as sluggish economic growth, continued transfers instituted during the pandemic, and more burdensome debt services arising from high interest payments).

Figure 1.16.
Fiscal Deficits Remain High

The continued high debt level, averaging 26 percentage points above 2010 levels suggests a need to take more energetic measures both on the revenues and expenditures side. Associated debt service also increased by 0.4 percentage points of GDP on average, despite relatively low interest rates until last year (figure 1.17). Only a few economies are expected to have lower debt as a percent of GDP than in 2019 (figure 1.18).

Figure 1.17.
Both Debt and the Debt Burden Have Increased
The fiscal imbalance, in turn, fuels the imbalances in current accounts. All of the LAC-6 countries have run current account deficits since before the pandemic, mostly attributed to excess spending on the government side (figure 1.19). With the exceptions of Argentina and Chile, in the third quarter of 2023, the private sector was a net saver in the region, while the government ran deficits in all countries. In some countries, the private sector has increased its savings or decreased borrowing needs even more, while their governments have run larger fiscal deficits.

Figure 1.18.
Only a Few Countries Are Expected to Improve Their Levels of General Government Debt

![Graph showing general government debt levels for different countries.](image)

Note: Values are based on projections (as of March 29, 2024). The regional data are calculated by converting nominal local currency units (LCU values) into current US dollar values. 2024f = 2024 forecast.

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Figure 1.19.
Twin Fiscal-Current Account Deficits Remain Deep

![Graph showing fiscal and current account balances for different countries.](image)

Source: World Bank staff calculations based on Haver Analytics.
The Banking Sector Remains Sound, although Non-Performing Loans Have Increased

The recent cycle of monetary tightening in LAC has driven an increase in non-performing loans (NPLs) in most countries as households and firms struggle with higher interest rates (figure 1.20, panel a). In Brazil, Chile, and Colombia, NPLs sit marginally above the average of the last five years and merit monitoring until lending rates fall substantially. The increase in NPLs since 2020 has been significant in Peru, rising, at the aggregate level, from 3.7 percent in January 2020 to 4.8 percent in January 2024. The more disaggregated data for Peru show that while NPLs have risen in most sectors (figure 1.20, panel b), NPLs for medium firms have jumped the most, from 7.1 percent in January 2021 to 14.2 percent in January 2024, followed by NPLs for credit cards, which increased from 4.4 percent in February 2020 to 13.3 percent in February 2021, reflecting the sluggish dynamism of the Peruvian economy.

Figure 1.20.
Non-Performing Loans Have Increased

a. Share of non-performing loans to total gross loans, Brazil, Mexico, Chile, and Colombia

b. Share of non-performing loans to total gross loans in Peru

Source: National statistics.
Note: Households debt is composed of mortgages and consumption loans. Non-performing loans are loans for which the contractual payments are delinquent, defined as the NPL ratio being overdue for more than 90 days in the case of Brazil, Chile and Mexico, and 30 days in the case of Colombia.

Source: National statistics.
Note: Non-performing loans are defined as direct credits that are in “overdue” or “judicial collection” state. In the case of corporate credits, large and medium-sized firms, an overdue status applies if the payment delay exceeds 15 days. For credits extended to small firms and micro-enterprises, this period extends to 30 days. Similarly, for mortgage and consumer credits, a credit is considered overdue after 20 days of delay, with the entire balance deemed overdue after 90 days.
Labor Markets and Social Conditions

Jobs: Employment Has Recovered, but Unevenly across Groups

Employment rates have peaked after the initial strong post-pandemic recovery (figure 1.21, panel a), as GDP growth rates continue to underperform. Most demographic groups are now close to full recovery; however, low-skilled workers and seniors lag (figure 1.21, panel b). The reason is twofold: an inability to find jobs, coupled with portions of these demographic groups exiting the labor market. Of particular concern is the falling participation by seniors, whose reduced capacity to save for retirement compounds the demographic challenges emerging in the region (box 1.2).

Figure 1.21.
Employment Rates Have Recovered from 2020, but Lag Pre-Pandemic Levels in Some Countries

a. Employment-to-population ratio by country
Index, 2019:Q1 = 100

b. Employment-to-population ratio by demographic groups
Index, 2019 = 100

Note: The employment-to-population ratio is total employment divided by working-age population.

Note: The employment-to-population ratio is total employment divided by working-age population. Ratios are based on LAC’s simple/unweighted average of eight countries: Argentina, Brazil, Chile, Colombia, Costa Rica, Ecuador, Mexico, and Peru. Youth includes ages 15-24; prime age includes ages 25-54; and senior includes ages 55-64. Educ. = education; LAC = Latin America and the Caribbean.
Box 1.2.
The Challenges of an Aging Workforce

The Latin America and Caribbean (LAC) region is undergoing a seismic shift in its demographics: fertility rates are decreasing rapidly while life expectancy is increasing (figure B1.2.1, panel a). As a result, the population pyramid is losing its base and is converging to the shape already seen in Europe and Asia (figure B1.2.1, panel b).

The dependency ratio (the share of the non-working-age population relative to the working-age population) is projected to reach a minimum in 2027, based on estimates from the United Nations World Population Prospects 2022. This turning point signifies a pivotal moment as declining fertility rates and an aging population will begin to place a growing socioeconomic burden on the working-age population. The demographic transition implies that, by 2047, there will be more old-age dependents than children in the average household (figure B1.2.2, panels a and b).

This change is unavoidable and brings on a series of challenges for countries in the region. First, there is the looming issue of productivity growth. In a region characterized by low total factor productivity (TFP), the impending decline in the labor force becomes a critical concern. Extensive research emphasizes the persistent underperformance of LAC in terms of economic growth. Not only has LAC grown less than other emerging markets and developing economies (EMDEs) but the rate at which the region has grown has slowed during the last decade. While the decline in TFP is the main driver of this slowdown, the contribution of labor has also decreased (figure B1.2.3, panel a). Meanwhile, the demographic shift means that the region is on the brink of reaching the peak in terms of the working-age population. Absent any changes, a decline in the quantity of available labor is imminent, ushering in a phase where labor’s contribution to growth will become progressively smaller. This will add significant pressure to the region’s growth perspectives because productivity increases will not be led by labor.

Second, increased expenditures will strain fiscal resources even more. Rising old-age dependency ratios will inflict additional stress on government budgets to finance public pensions and health care systems (including long-term care), which are often underdeveloped in the region. A large share of current pension recipients claim that the income they receive is insufficient to meet basic consumption needs, suggesting that the current systems are inadequate in providing financial security for retirees (figure B1.2.3, panel b). Moreover, the demographic shift will inflict an increasing burden on future government spending (figure B1.2.3, panel c).

Figure B1.2.1. Population Dynamics Are Shifting in LAC: Decreasing Fertility and Increasing Life Expectancy Have Reshaped the Population Pyramid

a. LAC demographic indicators: 1970 versus 2021
b. LAC population pyramid: 1970 versus 2021

Note: Total fertility rate = live births per woman. LAC = Latin America and the Caribbean.
Third, families will grapple with new challenges as they transition from caring for the young to caring for the elderly. According to time-use surveys, women in the region spend two to four times more time than men on unpaid domestic and care work (figure B1.2.3, panel d). Policy responses must address this shift to ensure that the increasing burden of old-age care is not disproportionately shouldered by women. Furthermore, families often lack the necessary training and specialization required to address the diverse physical and mental conditions prevalent among the elderly. This underscores the urgent need for targeted interventions and support systems to alleviate the strain on untrained caregivers and ensure quality care for the aging population.
Box 1.2. The Challenges of an Aging Workforce (continuation)

Figure B1.2.3. The Aging Population Will Pose Policy Challenges in Terms of Growth, Poverty, Public Spending on Social Welfare, and Gender Inequality

a. Potential growth in LAC and other EMDEs, 2000–10 versus 2011–21

b. Pensions: Percent of older adults with insufficient pension income to meet minimum consumption needs in 2022

c. Public spending on education, health care, and pensions in LAC: 2015 versus 2045

Sources: World Bank staff calculations using Feenstra, Inklaar, and Timmer 2015; Kilik Celik et al. 2023. Note: The LAC sample includes 16 countries. The EMDEs sample includes 35 countries. Weighted averages computed using GDP weights from the Penn World Table, version 10.01 (Feenstra, Inklaar, and Timmer 2015). EMDEs = emerging markets and developing economies (excluding LAC); LAC = Latin America and the Caribbean; TFP = total factor productivity.

Source: CEPALSTAT database (Economic Commission for Latin America and the Caribbean, ECLAC). Note: Weighted averages computed using population weights. Quintiles are per capita income quintiles. LAC = Latin America and the Caribbean.

Source: Rofman and Apella 2020. Note: Estimates for 2045 incorporate forecasts of demographic and policy changes. While future demographic trends are well defined, the main underlying assumption regarding policy changes is that, by 2045 public benefits throughout LAC will try to converge to current levels exhibited in most OECD countries. As child dependency decreases, Education spending (as percent of GDP) should not grow as much as the Health and Pension components. In the simulation exercise, Health includes health care spending on the non-elderly (ages 0–64), health care spending on the elderly (age 65+), and long-term care spending (age 65+). LAC = Latin America and the Caribbean; OECD = Organization for Economic Cooperation and Development.
**Box 1.2. The Challenges of an Aging Workforce (continuation)**

d. Gender inequality: Disproportionate burden for women in LAC on unpaid domestic and care work

![Image of graph showing gender inequality in hours spent on unpaid domestic and care work]

Source: World Bank staff calculations using time-use surveys compiled by the United Nations Department of Economic and Social Affairs (UN-DESA) Statistics Division SDG Global Database.

Note: The latest available data point is displayed for each country. Data labels use International Organization for Standardization (ISO) country codes. LAC = Latin America and the Caribbean.

a. UN-DESA (2022).
b. Ñopo (2020).
c. See Kose and Ohnsorge (2024).

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**Remuneration: Real Labor Incomes Still Lag their Pre-Pandemic Levels Due to Inflation**

As discussed in the October 2023 LACER, the decline in real labor incomes arising from inflation—a drop of about 5 percentage points from 2019 to the end of 2022—facilitated labor market adjustments primarily through prices (that is, through variations in wages and earned income) rather than through shifts in employment (figure 1.22). The situation could improve as inflation recedes.

Household income is also being squeezed by declining social transfers, which peaked during 2020 but had been withdrawn overall by 2022. However, social transfers in certain countries, such as Brazil, the Dominican Republic, and Peru, have not yet returned to 2018 levels, posing continued pressure on the budget (figure 1.23).

**Figure 1.22.**

**Real Individual Labor Income and Wages Have Deteriorated since 2019**

Real individual labor income and real wages, by demographic groups (Index, 2019 = 100)

![Image of bar chart showing real individual labor income and wages]

Source: World Bank Poverty and Equity Global Practice based on SEDLAC (CEDLAS and World Bank).

Note: Colored bars display the evolution of the real individual labor income (wage income plus self-employment income) since 2019; lines with circles track the real wage in main activity. Both measures are displayed as an index (2019 = 100). Values within brackets at the top of the figure are displayed in 2017 PPP dollars. Figures are based on LAC’s simple/unweighted average of 8 countries: Argentina, Brazil, Colombia, Costa Rica, Dominican Republic, Ecuador, Paraguay, Peru. ILI = individual labor income; LAC = Latin America and the Caribbean; PPP = purchasing power parity.
Poverty and Inequality

The combination of stagnant labor incomes and the reduction of social transfers has led to an overall decrease in real household incomes relative to their pre-pandemic levels in several countries across the region. The main implication has been that, in many of these economies, poverty rates are estimated to remain above their 2019 levels by the end of 2023. Nonetheless, for the LAC region as a whole, the poverty rate is already below its pre-pandemic level, mainly due to the influence of Brazil and Mexico (figure 1.24). In Brazil, the lower expected poverty rate in 2023 is associated with new social benefits, particularly under the Bolsa Familia transfer program, and improved labor earnings, especially in the services sector which employs a large share of the poor workforce. Increased labor earnings are mostly responsible in Mexico, combined with slight decreases in unemployment and informality, and a mild increase in the participation rate, displaying continued improvement of labor market conditions.7

Figure 1.24.
Poverty in LAC Is Already Below its 2019 Level, Mainly Explained by Brazil and Mexico
Evolution of poverty rates

Source: World Bank Poverty and Equity Global Practice based on SEDLAC (CEDLAS and World Bank).
Note: The bars for LAC present a simple/unweighted average of 7 countries: Argentina, Brazil, Costa Rica, Dominican Republic, Ecuador, Paraguay, and Peru. LAC = Latin America and the Caribbean; PPP = purchasing power parity.

7 Detailed country-level poverty analysis available at the World Bank Macro Poverty Outlook, April 2024 (forthcoming).
Inequality (as measured by the Gini coefficient) has slightly decreased in most countries (figure 1.25), largely due to falling incomes among the top quintiles of the income distribution (figure 1.26). On a related note, recent data harmonization efforts by the World Bank have allowed some light to be shed on the status of poverty and inequality in some of the countries of the Caribbean that have historically had the least data. In particular, for Grenada, Jamaica, Saint Lucia, and Suriname, consumption-based measures indicate moderate to low poverty rates compared to other upper middle-income countries, but high inequality (box 1.3).

### Violence

A final measure of well-being that the LACER series will begin tracking periodically is the level of violence in the region. Almost 20 percent of LAC’s population considers violence to be the most pressing problem in their country, displacing the social concerns of five years ago, and with reason. The region is the most violent in the world (box 1.4). This is an impediment not only to the welfare of citizens, but the instability discourages investment, both domestic and foreign. Further, much of the violence is being driven by illicit trade, especially in narcotics, which is expanding into countries previously immune. These activities not only undermine social stability, but they impede other goals, such as protecting the Amazon, and in some cases, threaten the integrity of the state. The World Bank, along with the Inter-American Development Bank (IDB) and the Development Bank of Latin America and the Caribbean (CAF), have begun a joint initiative to better understand violence and how it may be combatted. Violence constitutes one of LAC’s principal challenges going forward.
The Caribbean Subregion Has Moderate Poverty but High Inequality

Data scarcity in the Caribbean poses a significant challenge for monitoring poverty and living standards. According to the World Bank Statistical Performance Indicator (SPI), the region ranks lowest globally in statistical performance: many countries lack recent poverty estimates, hindering the tracking of Sustainable Development Goals (SDG 1 and SDG 10) and the development of effective poverty alleviation strategies.

In this context, the World Bank, along with other international development agencies, has supported steps to close data gaps in Caribbean countries. An important effort along these lines has been the harmonization of data from household budget and living conditions surveys for four Caribbean countries (Grenada, Jamaica, Saint Lucia, and Suriname). Such harmonization can help not only to track progress toward reducing poverty but also to benchmarking performance with respect to the rest of the region and the world.

Overall, Caribbean countries have moderate to low poverty rates compared to other upper-middle-income countries, but high inequality. In the two countries in the harmonization effort with the most recent data, Suriname (2022) and Jamaica (2021), poverty rates using the poverty line of $6.85 per person a day in terms of 2017 purchasing power parity (PPP) dollars are 17.5 percent and 13.9 percent, respectively. In Grenada (2018) and Saint Lucia (2015), where data are available only from before the COVID-19 pandemic, the corresponding poverty rates are 13.8 percent and 8.4 percent, respectively. Compared with other middle-income countries, these rates are moderate to low (figure B.1.3.1). The Gini inequality index for each of the four countries harmonized in this recent effort is: 43.8 in Grenada, 43.7 in Saint Lucia, 40.2 in Jamaica, and 39.2 in Suriname. These measures are close to or exceed the global cutoff of 40 that suggests high inequality by World Bank standards. Nonetheless, inequality in the four Caribbean countries is lower than that for the Latin American and Caribbean (LAC) region as a whole. These comparisons, however, should be viewed cautiously. Inequality in the Caribbean is measured using consumption and thus might be lower than when measured using income.

Figure B1.3.1.
Poverty Rates in Selected Caribbean Countries are Moderate to Low When Using Consumption-Based Measures

Poverty headcount rate at US$ 6.85 a day per capita (2017 PPP dollars)

Source: World Bank staff calculations for Grenada, Jamaica, Saint Lucia, and Suriname. World Bank Poverty and Inequality Platform for all other countries.

Note: Bars show headcount rates for upper-middle-income countries, for the latest years with available data within the 2015–20 period. PPP = purchasing power parity.

a. The Caribbean refers to English-speaking countries and Haiti. It excludes the Dominican Republic, which has had patterns of data availability similar to the rest of the LAC region.

b. The harmonization followed the latest World Bank guidelines for consumption-based welfare measurement (Mancini and Vecchi 2022).

c. Comparisons of poverty and inequality indicators between this group of Caribbean countries and those from the rest of the LAC region should be made with caution. Income is the most common welfare indicator for measuring poverty and inequality in most Latin American countries. This key difference in the data source limits the comparison between the new consumption-based harmonized Caribbean data and the rest of Latin America.

d. Generally, consumption-based inequality tends to be lower than income-based inequality because consumption aggregates are closer to the “permanent income” concept. That is, households tend to save money when their financial situation is favorable and then use those savings or borrow during challenging periods to keep their consumption relatively stable.
Box 1.4. Generating Knowledge and Forging Partnerships to Address Organized Crime and Violence

Violence from organized crime, such as the recent upswing in gang violence in Ecuador and Haiti, is a critical issue in the well-being of citizens in Latin America and the Caribbean (LAC). The average homicide rate is four times higher than the global average, five times higher than the rate in North America, and two times higher than the rate in Africa (figure B1.4.1). Moreover, LAC is the only region where this figure has been rising. The region is home to 9 percent of the population and one-third of the world’s homicides. It comes as no surprise that concerns about security are also on the rise among LAC citizens. One-fifth of the LAC’s population considers it to be the most important problem in their country (figure B1.4.2).

LAC countries are more violent than their GDP per capita or their poverty rates would predict, suggesting that the high levels of violence are not explained by the development stage. The average LAC country by GDP per capita exhibits a homicide rate 4.8 times higher than a comparable country elsewhere, while the average LAC country by poverty has a homicide rate 5.4 times higher than its counterpart in other regions (figure B1.4.3, panels a and b). So, why are LAC countries so much more violent than the rest of the world? Some studies show that inequality has a more robust correlation with violence than poverty, but still, LAC countries are more violent than others with similar inequality levels. The region has historically struggled with different types of violence, but since the early 2000s, the primary source of violence has been organized crime linked to drug trafficking and other illegal activities.

Organized crime and the violence it generates are increasingly a source of destruction and stagnation in the region. The repercussions of violence extend to economic growth, productivity, and the state’s capacity. Violence affects economic growth through several channels. When it threatens property rights, it affects private investment decisions. In Colombia, for instance, a study showed that when the peace agreement seemed imminent, business creation increased, but it stopped when the agreement was rejected in a national plebiscite. Also, in the face of crime and violence, government resources are diverted toward security and away from development. Last but not least, violence affects human capital accumulation and labor market engagement among victims, hurting their productivity and incomes and overall productivity.

For the reasons discussed, talking about development and economic growth in LAC requires deepening and broadening the conversation about how to address organized crime and the violence it generates. The problem surpasses national borders and requires coordinated regional solutions. This concern drives an alliance between the World Bank, the Inter-American Development Bank (IDB), and the Development Bank of Latin America and the Caribbean (CAF) to work together in generating information and knowledge that can shine a light on adequate policy routes and facilitate exchanges between academics and practitioners across countries.

Figure B1.4.1. LAC Has the Highest Homicide Rate by Far among World Regions

**Box 1.4. Generating Knowledge and Forging Partnerships to Address Organized Crime and Violence (continuation)**

**Figure B1.4.2.**
Nearly One-Fifth of the People in LAC Consider Crime/Public Safety to Be the Most Important Problem in their Country

<table>
<thead>
<tr>
<th>Problem</th>
<th>Percent of Respondents</th>
</tr>
</thead>
<tbody>
<tr>
<td>The economy</td>
<td>44</td>
</tr>
<tr>
<td>Crime/Public safety</td>
<td>18</td>
</tr>
<tr>
<td>Corruption</td>
<td>8</td>
</tr>
<tr>
<td>Political situation/Political problems</td>
<td>7</td>
</tr>
<tr>
<td>Health problems</td>
<td>4</td>
</tr>
<tr>
<td>Education problems</td>
<td>4</td>
</tr>
<tr>
<td>Conflicts with neighboring countries</td>
<td>2</td>
</tr>
<tr>
<td>Other</td>
<td>8</td>
</tr>
<tr>
<td>None</td>
<td>1</td>
</tr>
<tr>
<td>Do not know</td>
<td>4</td>
</tr>
</tbody>
</table>

Source: Latinobarómetro 2023.
Note: The figure displays regional results for LAC to the survey question: “In your opinion, which is the most important problem facing the country today?”

**Figure B1.4.3.**
LAC’s High Levels of Violence Are Not Tied to the Level of Development and Pervasiveness of Poverty in LAC countries

**a. Intentional homicide rate per 100,000 people and GDP per capita, per country**

The average country in LAC has a homicide rate that is 4.8 times higher than the average country in the rest of the world.

Sources: World Bank staff calculations using United Nations Office on Drugs and Crime (UNODC) Statistics and World Bank’s World Development Indicators (WDI).
Note: GDP is in 2017 PPP constant international US dollars. PPP = purchasing power parity.

**b. Intentional homicide rate per 100,000 people and poverty headcount ratio, per country**

The average country in LAC has a homicide rate that is 5.4 times higher than the average country in the rest of the world.

Sources: World Bank staff calculations using United Nations Office on Drugs and Crime (UNODC) Statistics and World Bank’s World Development Indicators (WDI).
Note: The average poverty headcount ratio uses a poverty measure of US$1.95 per capita per day.

b. Bernal et al. (2024).
Conclusion

A year and a half beyond the pandemic, LAC continues to muddle along with some important successes, but an equal balance of frustrations. Performance in fighting inflation remains excellent by world standards, central bank interest rates are beginning to fall, and financial sectors remain solid, despite an increase in household and firm non-performing loans. The regional poverty rate is already below its 2019 level (mainly explained by Brazil and Mexico, with other countries gradually converging), while inequality has actually fallen.

However, progress on reducing the debt accumulated during the COVID-19 crisis and closing the budget gaps has been disappointing, potentially undermining macro stability and leaving no fiscal space for growth promoting investments in important areas such as infrastructure. The dramatic episodes of violence, and the expansion of illicit activities to countries that were previously immune, threaten to: undermine the attractiveness to investors offered by the laudable gains in macroeconomic management. And despite a rebound, FDI flows remain below the levels of a decade ago. FDI is not driven by the momentum toward reshoring but is again concentrated in resource-based sectors and not in manufacturing. Despite wages competitive with those of China, LAC’s non-wage costs—in terms of poor infrastructure, an undertrained workforce, and high domestic costs, among others—make the region less attractive than many advanced countries. A strong reform agenda in these areas, as well as energetic outreach to potential investors, is necessary if the region is to surf the nearshoring wave, or, for that matter, exploit opportunities offered by the green transition.

All these factors complicate efforts to address the 200-pound capybara in the room, persistent low rates of growth that are not sufficient for either poverty reduction or socioeconomic mobility. Previous LACERs have dealt with elements of the necessary reform effort, as well as the potential of digital technologies and green technologies. The next chapter examines another critical dimension—the complex role that increased competition could play to inject new life in LAC’s economies.
References


Chapter 2

Competition: The Missing Ingredient for Growth?
LAC's Ambivalent Relationship to Competition

Policy makers everywhere are ambivalent about the free play of market competition across international borders. On the one hand, the benefits of increased competition to consumers are clear. Argentine families were driving the Ford Falcon 21 years after the model was discontinued in the United States because protective measures prohibited imports of modern options. Throughout the region, low competition makes consumers pay higher prices and face lower-quality options for goods ranging from toilet paper to internet connectivity to food, reducing overall welfare. The lack of competition also contributes to higher inequality, affecting households differently along the income distribution. Monopoly prices on essential goods and services cut more deeply into the budgets of lower-income households. While more affluent households can exclude themselves from monopolized local markets and obtain goods and services from more competitive foreign markets, the poor cannot. In urban Mexico, relative welfare losses from monopoly power in markets for essential goods—corn tortillas, processed meats, chicken, eggs, and milk—have been assessed to be 20 percent larger among the poorest households than the more affluent. There is simply no question that increased competition from low-cost consumer imports contributes to raising the standard of living of families across the income spectrum, particularly the poor.

Competition is also necessary to prod domestic producers to adopt new products and technologies that contribute about half of economic growth. Competition in the global market does this and helps diffuse these productivity- and growth-enhancing innovations. Further, competing in a dynamic and demanding domestic market is the best preparation for exporting. Latin America and the Caribbean (LAC) underexports, given the opportunities offered in the myriad free trade agreements it has signed.

On the other hand, foreign competition is seen as destroying local industry and jobs, and not without reason. Industrial sectors across the region have struggled with the arrival of Chinese imports during the 2000s.

And therein lies a perceived tension facing policy makers: whether to ensure that firms are driven to strive for the technological frontier and consumers get the best products possible, or to protect existing jobs and firms while possibly foregoing dynamic growth and consumer welfare.

This chapter argues that this choice is a false one. It finds that greater domestic competition induced by competition authorities yields unambiguously positive results in terms of overall welfare. Greater external competition has delivered more ambiguous results partly because LAC firms lack adequate preparation to compete with firms at the global frontier. The necessary complement to reap the gains from greater competition is a broad and challenging agenda in building the capabilities of firms and workers and reforming national innovation systems. This chapter also argues that high market power in LAC translates too often into business political power and interference in policy making, thus perpetuating and increasing that business and market power, with unmeasurable development costs. Actions to rebalance power, including investing in strengthening competition laws and agencies, will go a long way.

LAC: Land of Giants

Markets in Latin America and the Caribbean are characterized by a few giant firms at the top and a multitude of tiny businesses of 10 or fewer employees at the bottom, most of them falling in the range of 1 to 4 employees. Fragmentation at the bottom end of the business size distribution is even higher when self-employment is taken into account. A defining characteristic of LAC markets distinguishing them from those in advanced economies is a largely absent segment of small and medium firms of 11 to 50 employees and 51 or more employees, respectively (figure 2.1).

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1 Rodríguez-Castelán (2015).
2 Buera and Oberfield (2020).
3 Michael Porter (1985) noted this relationship decades ago.
4 The technological frontier refers to technology that is at the cutting edge: the highest form of technology available.
5 National innovation systems comprise actors, networks, and institutions contributing to developing, diffusing, and utilizing new ideas, products, and processes.
Figure 2.1.
Seventy Percent of Workers in LAC are Self-Employed or Work in Businesses with Less than 10 Employees

Employment-weighted business size distributions

<table>
<thead>
<tr>
<th></th>
<th>Self-employment w/o employees</th>
<th>1-4 employees</th>
<th>5-10 employees</th>
<th>11-50 employees</th>
<th>51 or more employees</th>
</tr>
</thead>
<tbody>
<tr>
<td>LAC</td>
<td>32</td>
<td>9</td>
<td>11</td>
<td>26</td>
<td>43</td>
</tr>
<tr>
<td>United States</td>
<td>27</td>
<td>12</td>
<td>16</td>
<td>20</td>
<td>32</td>
</tr>
<tr>
<td>Europe: higher-income</td>
<td>9</td>
<td>11</td>
<td>28</td>
<td>38</td>
<td>15</td>
</tr>
<tr>
<td>Europe: lower-income</td>
<td>11</td>
<td>13</td>
<td>10</td>
<td>28</td>
<td>17</td>
</tr>
<tr>
<td>Australia</td>
<td>10</td>
<td>12</td>
<td>28</td>
<td>33</td>
<td>15</td>
</tr>
<tr>
<td>Korea, Rep.</td>
<td>38</td>
<td>20</td>
<td>26</td>
<td>23</td>
<td>20</td>
</tr>
</tbody>
</table>


Note: Each bar presents the employment-weighted average of countries. Only those workers who are 20 years or older who report positive income and status along the relevant dimensions are counted. Latin America and the Caribbean (LAC) (11 countries): Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, the Dominican Republic, Mexico, Paraguay, Peru, Uruguay. Europe, higher-income (above mean European Union per capita income) (13 countries): Austria, Belgium, Denmark, Finland, France, Germany, Ireland, Italy, Luxembourg, Sweden, Switzerland. Europe, lower-income (below mean European Union per capita income) (13 countries): Bulgaria, Croatia, Cyprus, Czech Republic, Estonia, Greece, Latvia, Lithuania, Poland, Portugal, Romania, Serbia, Slovenia, Slovakia, Spain. Cutoffs for Argentina are 11–40 employees and 41 or more employees. Cutoffs for Costa Rica are 11–30 employees and 30 or more employees.

This skewed distribution is a result but also a source of low productivity and high inequality in a region that stands out precisely for these features. At the bottom, workers who are self-employed or work in tiny businesses engage, for the most part, in low-productivity activities. At the top, the absence of a large segment of high-productivity small, medium, and even large firms translates into highly concentrated markets where giant players dominate (figure 2.2), and high levels of average market power resulting in large rents in the hands of a few (figure 2.3). The evidence suggests that increases in concentration in LAC manufacturing are driven by the single largest firm in terms of revenue in each market, which also tends to be the firm with the greatest market power. This power is associated with slightly higher productivity and higher average wages, suggesting that firms with market power are sharing some rents with their workers—albeit unevenly, because labor shares still represent lower shares of income in these markets. However, over the long term, if high market power translates into lower productivity growth, it will also lead to lower wage growth and, hence, less progress in raising overall social well-being.

Figure 2.2.
Giant Firms Dominate LAC Markets

Revenues of the 50 largest firms as percent of GDP

<table>
<thead>
<tr>
<th></th>
<th>Percent</th>
<th>SOEs</th>
<th>MNCs</th>
<th>Private domestic</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chile</td>
<td>80</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mexico</td>
<td>68</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Brazil</td>
<td>50</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Colombia</td>
<td>47</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Argentina</td>
<td>40</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Schneider 2021; S&P Capital IQ dataset; World Development Indicators.

Note: Companies are assigned to a country based on their country of incorporation. State-owned enterprises (SOEs) are those in which a national or subnational government holds a majority share. Multinational corporations (MNCs) are identified by the headquarters of the ultimate corporate parent of the companies. Revenue data are for 2019.
Market concentration is central to one of the region’s most pressing challenges—restarting the motor of economic growth after a decade of stagnation (see chapter 1). Once the commodity boom ended in 2013, LAC’s growth trajectory changed (figure 2.4, panel a). Between 2014 and 2022, per capita GDP grew at an average annual rate of only 0.14 percent, a pace much lower than the previous decade and insufficient to generate prosperity and welfare (figure 2.4, panel b).

Figure 2.3.
Markups in Latin America are Higher than in the Rest of the World and Constant over Time

Average markups, 1987–2016

Note: Average markups by year are estimated as the year fixed effects from a linear regression on the average markup by country, with year and country fixed effects. OECD (1990) corresponds to countries that belonged to the Organisation for Economic Co-operation and Development (OECD) in 1990. Rest of the world corresponds to all countries in the sample that are not part of Latin America.

LAC’s Productivity Crisis and Its Roots in Weak Competition

Market concentration is central to one of the region’s most pressing challenges—restarting the motor of economic growth after a decade of stagnation (see chapter 1). Once the commodity boom ended in 2013, LAC’s growth trajectory changed (figure 2.4, panel a). Between 2014 and 2022, per capita GDP grew at an average annual rate of only 0.14 percent, a pace much lower than the previous decade and insufficient to generate prosperity and welfare (figure 2.4, panel b).

Figure 2.4.
Growth in LAC is Low and Has Stagnated in the Past Decade

a. GDP growth, 2000–22
b. Per capita GDP and trend, 2000–22

Source: World Development Indicators.
Note: GDP per capita trendline uses data from 2000 to 2013. In panel b, vertical dashed lines indicate the difference between trend and actual GDP per capita.
Economic growth in the region, when it has occurred, has not resulted from improved productivity levels or good productivity dynamics capable of sustaining future growth but rather in response to often volatile external market forces and factor accumulation. Overall, productivity has contributed little and often negatively to economic growth in LAC (Figure 2.5). Its low contribution to economic growth relative to factor accumulation makes the region strikingly different than other emerging markets and developing economies (Figure 2.6).

**Figure 2.5.** **Productivity Contributes Little or Negatively to Long-Term Output Growth in LAC**

Decomposition of per capita output growth, 1962–2017, annualized

<table>
<thead>
<tr>
<th>Country</th>
<th>Productivity</th>
<th>Factors</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dominican Republic</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Chile</td>
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<tr>
<td>Costa Rica</td>
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<tr>
<td>Colombia</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Brazil</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Trinidad and Tobago</td>
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<td></td>
<td></td>
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<tr>
<td>Uruguay</td>
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<td></td>
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<tr>
<td>Barbados</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Mexico</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>LAC</td>
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<tr>
<td>Ecuador</td>
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<td>Bolivia</td>
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<td>Argentina</td>
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<td>Jamaica</td>
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<tr>
<td>Venezuela, RB</td>
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</tbody>
</table>


**Figure 2.6.** **Low Productivity Weighs More as a Factor Limiting Economic Growth in LAC than in Other Developing Countries**

Real and projected average annual economic growth rates decomposed into the contributions of productivity, capital, and labor accumulation, 2000–30

Source: Kose and Ohnsorge 2023.

Note: Projections for 2022–30. TFP is the measure in the economic literature that synthesizes the productivity of all factors of production. EMDEs = emerging markets and developing economies; LAC = Latin America and the Caribbean; TFP = total factor productivity.

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8 See Daude and Fernández-Arias (2010); Fernández-Arias and Fernández-Arias (2021); Fernández-Arias and Rodríguez-Apolinar (2016).

9 Productivity is defined as that part of growth that cannot be explained by the accumulation of physical capital, labor, and other factors of production and that depends on managerial ability and innovation and, at the aggregate level, on the allocation of resources toward the more productive firms and sectors and away from the less productive ones.
Aggregate productivity is the sum of the individual productivities of all productive units weighted by their contribution to output. That means it depends on productivity at the firm level driven by innovation that increases firms’ capabilities.\textsuperscript{10} But it also depends on how well capital, labor, and other factors of production are allocated across firms and sectors; if they are not allocated to the more productive units, aggregate productivity will suffer.\textsuperscript{11} And it depends as well on the rate at which more productive firms enter the market and less productive firms exit.\textsuperscript{12} The survival and persistence of low-productivity firms lowers aggregate productivity. Competition is a key part of the operating environment that contributes across all three channels of productivity growth (figure 2.7). As discussed later in this chapter, human capital and innovative capacity are a critical complement to ensure that competition translates into improved firm performance and the entry of more productive firms.

Figure 2.7. 
**Competition is a Central Component of the Operating Environment that Contributes to Productivity Growth**

Operating Environment: Defending Competition, Removing Distortions, Resolving Market Failures

- Human Capital and Innovative Capacity: Education Quality, STI, Entrepreneurial and Managerial Capabilities

  - Factor reallocation to the most productive firms and sectors
  - Improved firm–level capabilities
  - Net entry of higher productivity firms

Productivity Growth

Source: Inspired by Cusolito and Maloney 2018.

Note: STI = science, technology, and innovation.

More specifically, competition affects productivity through four principal channels.\textsuperscript{13} First, weak competition leads to insufficient selection. Competition forces the less productive firms to exit the market while the more productive firms survive and grow. Without competition, low-productivity firms survive. In this way, competition increases productivity through firm entry and exit: the more productive firms contribute a larger share of output, boosting aggregate productivity. A body of empirical work confirms the role of competition in selecting the more efficient firms and increasing productive efficiency.\textsuperscript{14} However, this effect also depends on other elements of the operating environment, such as access to financing. Further, the emergence of new and more productive firms, in turn, rests on a set of capabilities—technical, managerial, and entrepreneurial. The constant churning and entry of low-productivity informal firms generate little in the way of new economic dynamism.

Second, competition is an incentive for innovation. In its absence, firms with a captive consumer base may choose to operate at a higher cost and not upgrade to the more efficient technology available. Suboptimal managerial choices and effort may result from reduced incentives, and monopolists may see no need to innovate if they can survive and continue to make rents without upgrading their technologies.\textsuperscript{15}

However, the empirical evidence on the beneficial effects of competition is mixed.\textsuperscript{16} One view argues that too much competition reduces a firm’s expectation of its ability to reap the profits from its innovation investments; hence, moderate levels of market power may be desirable from the point of view of innovation.\textsuperscript{17} An alternative explanation

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\textsuperscript{10} This is the within-firm or innovation channel for productivity.

\textsuperscript{11} This is the between-firm or allocation channel for productivity.

\textsuperscript{12} This is the selection channel for productivity. See, for example, Melitz and Polanec (2015).

\textsuperscript{13} For a complete discussion on the channels through which market power affects productivity, see Motta (2004), chapter 2.

\textsuperscript{14} See Baily, Hulten, and Campbell (1992); Barreto and Haskel (2005); Foster, Haltiwanger, and Krizan (2011); Glied and Pakes (1996).

\textsuperscript{15} See Hart (1983); Hermalin (1992); Horn, Lang, and Lundgren (1994); Mäggli (1998); Scharfstein (1988).

\textsuperscript{16} Scherer and Ross (1990).

\textsuperscript{17} Schumpeter (1942).
for low innovation, even within competitive operating environments, is that to respond to competition, firms need to be able to identify, adopt, and implement these technologies in order to “escape” competition, and if they cannot, they will fall behind and contract. This literature points, again, to the need for firms to have high levels of technical and managerial capital and to be embedded in well-functioning innovation systems. The reaction of an economy to increased competition depends on firms’ proximity to the technological frontier and the underlying productivity distribution of firms.

Third, more competitive markets make the adoption of technology less costly and broaden the scope of technology diffusion, allowing more firms to benefit from efficiency gains. This technology may be, for instance, embedded in intermediate inputs or capital.

Fourth, firms with high market power often divert resources from productive activities to engage in rent-seeking. To maintain or augment their market power, they may leverage political influence and lobbying power, distorting policy trajectories for their gain. Businesses frequently advocate for policy measures that lead to lower competitive pressures (and low productivity), including weak antitrust institutions. This type of conduct is one reason individuals in the region identify major corporations as one of the most influential elites in their nations.

Import Competition and Productivity in LAC

Despite high levels of concentration and market power in LAC and the link established in the economic literature between market competition, innovation, and productivity, empirical evidence about these forces for LAC markets is relatively limited because reliable microeconomic data are scarce and difficult to access. An exception is the research examining the effects of import competition on firm productivity and innovation, discussed next.

Studies have found positive effects of increased import competition on productivity, product quality, the number of products, innovation, and job rotation, exploiting the exogenous trade liberalization episodes of the 1980s and 1990s. Evidence of the impact of imports, mainly of Chinese origin, on Latin American producers has focused chiefly on outcomes at the sector level. At a regional level, the competitive force of Chinese imports has favored producers and exporters of raw materials while hindering industries specializing in commodity chains, electronics, automobiles, and auto parts. For instance, the influx of Chinese goods into the United States has crowded out Mexican exports to that country. On the other hand, it has also led to increased innovation outcomes in Mexico, such as quality certification training and worker participation and training programs. Similarly, industry exposure to trade liberalization in Argentina stemming from the MERCOSUR trade agreement between Argentina, Brazil, Paraguay, and Uruguay incentivized firm-level investments in innovation. In Chile, imports from China and India stimulated firm-level quality upgrading.

However, specific country findings across LAC reiterate that firm-level responses depend on firms’ productivity level. More productive firms in the region upgrade product quality to differentiate themselves from competing foreign goods, while less productive firms that cannot increase their quality react by reducing prices. Tariff liberalization in Chile and Colombia led to varying results in plant productivity; more productive, larger, or export-focused firms were more likely to survive and benefit from the ensuing competition shock. Similarly, reforms in Chile oriented toward trade liberalization were successful in eliminating the artificial protection of smaller and less productive firms, which were more likely to close under increased competitive pressure. International trade has benefited firms in Peru; those that participate either as exporters or importers have had consistently higher productivity than firms that do not trade internationally. At the product level, Mexican producers have responded to trade liberalization under the North America Free Trade Agreement (NAFTA) by focusing on their core competencies.
A forthcoming World Bank report, Competition and Productivity Growth in Latin America and the Caribbean, discusses new evidence contributing to this literature and the broader body of international literature examining the impact of increased competition from trade liberalization on market outcomes (box 2.1).\(^33\) This new evidence underscores that the effects of import competition on productivity and innovation in LAC are the result of varying responses at the firm level that depend on preexisting productivity and markups (rents) and closeness to the productivity frontier.\(^34\) Focusing on manufacturing sectors in Chile, Mexico, and Peru, these effects are studied in the context of two defining features of LAC countries’ experience with international trade in the twenty-first century: the trade shock resulting from China’s expansion into world markets; and the liberalization of trade through the negotiation of binational Preferential Trade Agreements (PTAs) with other emerging and advanced economies.

The evidence shows that the most productive firms—those closer to the productivity frontier—are most able to upgrade and survive under increased import competition, while the smaller, less productive businesses shrink or exit altogether, in line with the preceding discussion. The economy-wide impact on productivity and growth critically depends on the shape of the underlying productivity distribution. Given that in LAC, the productivity distribution is shifted toward a few top firms, a considerable share of those firms and workers in exposed sectors will likely suffer in the face of import competition.

For example, in Mexico, rising exposure to products of Chinese origin between 1995 and 2004 led to an expansion of the larger firms (by sales) and the exit or contraction of the smaller ones (figure 2.8, panel a).\(^35\) Increased import competition also elevated the likelihood of firms restructuring their output portfolio to focus on core competencies by prioritizing products with larger output shares and halting the production of marginal goods with a lower relative weight in their portfolios (figure 2.8, panel b). An increase of 1 percent in imports of a specific product from China increased the probability of a Mexican producer of that product withdrawing it from the market by 0.6 percent for a product in the bottom 10 percent of output share but did not affect the exit probability for a product at the top 10 percent. In essence, the larger firms and core products were shielded from the increased competition. These results are interpreted as leading to increased aggregate productivity despite an overall contraction in sales because of the exit of less productive businesses and the expansion of more productive ones.

Figure 2.8.
In Mexico, Foreign Competition from China Hurt Smaller Firms and Affected Marginal and Core Products Differently

\(^{33}\) Vostroknutova et al. (forthcoming).

\(^{34}\) The report draws on three studies: Iacovone, Rauch, and Winters (2013); Cusolito, Garcia-Marin, and Maloney (2023); and Tello and Tello-Trillo (2023).

\(^{35}\) See Iacovone, Rauch, and Winters (2013).
Box 2.1. 
**International Evidence on the Effects of Increased Import Competition**

There is a consensus in the economic literature that competition from trade liberalization increases aggregate productivity. The international evidence has highlighted several mechanisms underlying this relationship. Foreign entry into a domestic market equates to an increase in competition that reallocates resources toward the more efficient producers, and away from lower productivity business units operating at higher costs. As the more productive producers gain market share and the less productive firms are pressured by the increased competition into losing relevance or exiting the market altogether, aggregate productivity increases. Market penetration by foreign competitors may also shrink existing profit margins and bring down prices. It can thus push firms into increasing efficiency to maintain price competitiveness relative to imported products. At the same time, the increased availability or reduced cost of intermediate inputs brought about by trade liberalization may represent an incentive to firms to adopt efficiency improvements.

Competitive shocks from imports have been shown to generate differential impacts across firms. For instance, firms in the United States that were exposed to competition from countries with relatively lower wages, like China, were less likely to survive or grow, but plants that were capital-intensive and high-skill intensive were less affected. Nonetheless, evidence in other advanced economies such as Belgium also suggests that while Chinese competition may have induced skill upgrading, it did not necessarily translate into a higher likelihood of firm exit.

Similarly, at the product level, a trade shock may lead firms to make reallocation decisions regarding their product mix. Although the evidence on this front is scarcer, it reveals that firms are likely to drop products that are less important in terms of sales in favor of increasing the weight of their core products on output. Firms in the United States have been found to adjust their output portfolio or even shift toward other industries in reaction to trade pressures from countries with lower wages. In the context of increased competition from Chinese imports, the contribution to growth in the US manufacturing sector of product reallocation within firms has been as large as that of the reallocation between firms in the market. However, changes in firm-level product mixes stemming from trade liberalization in India, which contributed to output growth in manufacturing, did not entail product displacement but rather portfolio expansion. In contrast, competition has been found to reduce diversification among Canadian producers.

The forces at play between increased competition from trade and the spur of innovation as the vehicle for long-lasting productivity enhancements are more nuanced. While entry may elevate competition, it may do so at the cost of constraining incentives for firms to make investments in innovation. Evidence for the United Kingdom supports the notion that initial increases in competition foster industry-level innovation, but pressures beyond the point at which firms are able to reap benefits from innovation as a strategy to escape competition may eventually translate into lower productivity. This relationship is mediated by a firm’s proximity to the technology frontier. Indeed, more productive firms have the incentive to incur the cost of innovating in an attempt to shield themselves from competition and reap higher future rents, while less productive firms are discouraged from innovating due to a higher trade-off with respect to expected rents. Analogously, the effect of increased competition on innovation outcomes in France was negative for firms in output markets, while it was slightly positive for firms in input markets. Greater exposure to Chinese import competition in 12 European countries led to aggregate technological upgrading by means of an increase in the volume of firm-level innovation through patenting, a reallocation of the workforce from low-technology to high-technology firms, and a decreased likelihood of survival for low-technology firms.

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a. See Amiti and Konings (2007); Eslava et al. (2013); Fernandes (2007); Krishna and Mitra (1998); Manzell (2004); Pasinj (2002); Trefler (2004).

g. Liu (2010).
j. Goldberg et al. (2010).
m. Aghion et al. (2015).
n. Aghion et al. (2020).
o. Aghion et al. (2021).
These reallocation effects, however, may not tell the whole story. In Chile, the increase in Chinese imports from 2000 to 2007 contributed to lowering average markups and improving average product quality, but led to a decline in overall spending on innovation and the likelihood of engaging in process and product innovation (figure 2.9).\footnote{Cusolito, Garcia-Marin, and Maloney (2023). Results obtained using plant-level data for the Chilean manufacturing sector covering plants with 10 or more employees, from the Annual National Industrial Survey and the Technological Innovation Survey.} Frontier firms, defined as the 10 percent at the top of the productivity distribution, sought to escape the new competition with investments in innovation that allowed them to become more competitive and productive. However, the bottom 90 percent of businesses, further from the technological frontier, decreased innovation. On average, the effect on aggregate productivity was null. The long-term impacts of the vast majority of firms decreasing their innovation is hard to know.

Figure 2.9.
In Chile, in Response to Increased Competition from China, Most Innovation Outcomes at the Plant Level Fell, but Product Quality Increased

Percentage change in innovation outcomes for the average plant in Chile’s manufacturing sector, 2000–07

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\caption{Overall innovative spending}
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\includegraphics[width=\textwidth]{figure_b.png}
\caption{R&D spending}
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\includegraphics[width=\textwidth]{figure_c.png}
\caption{Patents}
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\caption{Process innovation}
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\includegraphics[width=\textwidth]{figure_e.png}
\caption{Product innovation}
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\begin{subfigure}{0.32\textwidth}
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\includegraphics[width=\textwidth]{figure_f.png}
\caption{Product quality}
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\end{figure}

Source: Cusolito, Garcia-Marin, and Maloney 2023.
Note: The figure shows within-plant trajectories for different innovation outcomes (marginal increases in innovation) in Chile’s manufacturing sector before and after China’s entry into the World Trade Organization (WTO) in 2001. The lines and whiskers indicate 95 percent confidence intervals. R&D = research and development.

Consistent with the theory that rents are necessary for innovation, the negative impacts of competition on production and innovation were mitigated to the degree that firms enjoyed rents (markups). The least productive firms in markets with decreasing markups experienced the greatest contractions in overall spending and process innovation (figure 2.10, panel a). The most productive firms in markets with increasing markups displayed the most notable increases in R&D spending, product innovation, and product quality (figure 2.10, panel b).
In Peru, tariff reductions under Preferential Trade Agreements (PTAs) with the United States, China, and the European Union (EU), starting in 2009, 2010, and 2013, respectively, affected domestic producers differently depending on whether tariff reductions applied to final products or production inputs (which are one channel of technology diffusion), and, depending on the case, on whether firms were exporters or non-exporters.\(^{37}\) Tariff reductions on final products under the EU and China PTAs hurt productivity growth of non-exporters but helped boost that of exporters. In contrast, under the United States PTA these tariff reductions hurt all domestic producers, exporters and non-exporters. However, tariff reductions on production inputs operated in the opposite direction under the US PTA, boosting productivity growth for all domestic producers and contributing to increased average productivity growth. Tariff reductions on production inputs under the EU PTA also contributed to higher productivity growth among the businesses that do not export.

The evidence from Peru points again to the heterogeneous effects of import competition across firms, with only the firms at the top of the productivity distribution—those able to export—able to reap the benefits from the lowering of trade barriers affecting both input and final output markets.

\(^{37}\) Tello and Tello-Trillo (2023).
The policy recipe of generalized trade liberalization fails as a booster of economic growth when the productivity distribution is highly skewed to the right: that is, when only a small number of firms, usually the largest, are close enough to the productivity frontier to survive and gain from the increased import competition. Thus, the critical question that remains is how to ignite the motors of innovation and productivity at the firm level.

While evidence on the impact from other sources of enhanced competition is limited, research examining the effect of entry of large foreign players into domestic markets points in a similar direction, highlighting the tradeoffs that come with increased competition. For example, the entry of multinational retail chains in the Mexican local markets resulted in reduced prices and costs-of-living for households, productivity gains for domestic suppliers, higher exits of local stores, lower domestic store profits, and lower incomes among traditional retail sector workers. Similarly, in Uruguay, the entry of hypermarkets increased exits of local stores. Both cases illustrate a seeming tradeoff between maintaining jobs and incomes in the expectation of more dynamic growth at the aggregate level.

LAC: Land of Micros, Too

The preceding findings all correspond to firms with 11 or more workers. However, as figure 2.1 notes, more than two-thirds of the LAC workforce is found in smaller businesses that are not captured in firm-level surveys or censuses—the workforce is known only from household surveys and population censuses. Studies find significant variation in firm-level productivity performance before exposure to competition from external sources, even among the larger firms captured by these firm-level surveys or censuses, suggesting that productivity dispersion across business units in LAC is highly understated.

The LAC story is also one of highly fragmented markets at the bottom of the business size distribution, usually below the radar when it comes to innovation policy or other productivity-improving policies, and more often the target of entrepreneurship programs that rarely enhance productivity and are conceived more as a form of social policy. Their owners and workers would be better off were they to transit as employees to more productive growing businesses— if such businesses existed. For several reasons, these tiny businesses cannot be left out of the discussion about competition. Because their adoption of technology and productivity is so low, most of them cannot exert any competitive pressure on the businesses above them in the size and productivity distributions the way their counterparts do, for example, in the United States. It has been argued that the decline in competition and dynamism within the United States is precisely due to the decline in the diffusion of new technologies among smaller competitors that prevent the big firms from being copied and challenged. The resulting reduced competition accounts for more than 70 percent of declining business dynamism in the United States. Second, although below the radar from a data point of view, these firms are also affected by competition. For example, the arrival of big box stores in many countries threatens the livelihood of many people working in these tiny businesses, most of them in the informal sector, which they have entered for lack of more attractive jobs in larger firms or the formal sector.

As the section that follows will discuss, the challenge of creating the conditions for innovation and productivity improvement at the firm level—so that a larger segment of small and medium firms emerges, captures a larger share of the workforce, contributes more to aggregate productivity, and is better prepared to face competition from external sources—is closely connected to the challenge of putting in place and supporting sound institutions to defend competition in the local markets. Part of the reason for LAC’s low-productivity/low-growth equilibrium is that most LAC firms have surged and operated in environments with low levels of competition, missing the incentives from competition to innovate and improve their capabilities for survival and growth. Good competition policies and regulatory systems can address that.

38 See Atkin, Faber, and Gonzalo-Navarro (2018); Javorcik, Keller, and Tybout (2008); Lazrume et al. (2015).
39 See Borza et al. (2014); Busso and Galiani (2019); Lira, Rivero, and Vergara (2007).
40 Even the Mexican Economic Census, the most encompassing firm-level data source available in LAC, which covers part of the informal sector, captures only 42 percent of the country’s workforce.
41 Akcigit and Alex (2023).
Does Domestic Competition Policy Work?

Competition Laws and Agencies

Competition laws or antitrust or antimonopoly laws are the policy lever that countries can use to control market power abuse and promote fairer competition. These laws oversee the activity of firms with high levels of market power to prevent and punish misbehavior. Their design and enforcement mechanisms shape the power firms are, in practice, able to exert, and determine firms’ ultimate efficiency and equity effects. Recent research highlighting increasing market power and profits in advanced economies has prompted calls for strong antitrust enforcement worldwide.

Currently, 20 Latin American and Caribbean countries have competition laws and agencies. But these policy frameworks in most countries are relatively recent, in contrast with high-income economies such as the United States and Europe, and the agencies have been outgunned. Large economic players and groups have been fixtures at least since the nineteenth century. However, the privatization of public oligopolies and monopolies and the encouragement to gain the scale needed to compete promoted by the Washington Consensus contributed to the emergence of more firms and groups with market power in the absence of sound competition policy enforcement.

It was hoped that the opening to international trade and the entry of multinational corporations would provide the necessary competition. In practice, free trade proved to be a disciplinary device with uneven effectiveness. Large national and multinational corporations engaged in anticompetitive practices at the expense of other, mainly smaller, firms. These anticompetitive practices have surfaced in later antitrust investigations.

Over the last two decades, 8 LAC countries have introduced new competition laws and 11 others have amended preexisting competition laws. These developments have predominantly occurred in Latin America. Today, only Bolivia and Guatemala lack comprehensive antitrust regulations. Many countries have undertaken legal reforms and issued regulations in anticipation of forthcoming free trade agreements with either the United States or the European Union, as these agreements typically incorporate provisions mandating the adoption of competition laws and the establishment of competition authorities. On a supranational scale, the Andean Community of Nations issues competition policy regulations for its member countries. In the Caribbean, only four countries—Barbados, Guyana, Jamaica, and Trinidad and Tobago—have competition laws and authorities. The Caribbean Community (CARICOM) Competition Commission serves as a regional antitrust authority for others lacking such legislation.

Competition laws are, of course, only as effective as their enforcement. To ensure their efficacy, the independence of the enforcement agency or commitment mechanisms, ensuring its limited discretion in decision-making, is essential. In most LAC countries, however, the enforcement agency is a national state authority, meaning it part of the executive branch, and the president has the authority to replace its head at will.

Further, LAC competition agencies are understaffed and underfunded compared to peers from other regions (figure 2.11). The average competition budget is lower in LAC than the OECD and significantly affected by a few larger jurisdictions in LAC with a particularly high competition budget. While budgets alone do not provide a flawless gauge of the region’s antitrust activity and agencies’ ideal size in staffing and budget is justifiably tied to the size of the local industry, these budget and staffing data offer insights into agencies’ capacity and positioning within governmental policy priorities.

42 The forthcoming World Bank report, Competition and Productivity Growth in Latin America and the Caribbean, and Chapter 3 of the 2021 UNDP LAC Human Development Report served as inputs for this section.
43 See Aguzzoli, Longo, and Motta (2013); Asker (2010); Baker (2013); Barkley (2012); Besley, Fontana, and Limosso (2011); Bitlingmayer (1993); Crennell and Winston (2003); Duss, Neven, and Röller (2007); (2007); Guam and Sujaya (2002); Ekinowski and Dina (2011); Kaas (2014); Porter and Zina (1993); Stac and Wolfram (2002).
44 See Berry, Gigny, and Morton (2013); De Loewer and Eeuwoud (2004); De Loewer and Eeuwoud (2004); De Loewer, Eeuwoud, and Unger (2003); Khan (2018); Marinescu and Posner (2018); Rose (2019); Salop (2012); Shapiro (2019); Wu (2018).
45 The 20 LAC countries are Argentina, Barbados, Brazil, Chile, Colombia, Costa Rica, the Dominican Republic, Ecuador, El Salvador, Guyana, Honduras, Jamaica, Mexico, Nicaragua, Panama, Paraguay, Peru, Uruguay, Trinidad and Tobago, and República Bolivariana de Venezuela.
46 The US Federal Trade Commission was founded in 1914 and the first European Commissioner for Competition dates to 1958.
47 The term “Washington Consensus,” coined in 1989, refers to 10 economic policy recommendations considered to be the standard reform package promoted by the International Monetary Fund (IMF), the World Bank, and the US Department of the Treasury for developing countries facing crisis.
48 New laws were enacted in Barbados (2002); El Salvador (2006); Honduras (2005); Nicaragua (2005); Trinidad and Tobago (2006); Uruguay (2007); the Dominican Republic (2008); and Ecuador (2011).
50 Miranda (2019).
51 OECD (2022).
Not surprisingly, despite progress over the last three decades, LAC competition agencies underperform compared to peers by several measures:

► **Lower number of ex officio investigations.** Measured by the average number of cartel investigations launched by the competition authority on its own initiative (ex officio investigations) each year, LAC significantly underperforms compared to almost any group of countries (figure 2.12, panel a). While this might indicate a smaller industrial sector, it suggests that many cartels must continue undetected.

► **Less use of leniency programs.** LAC makes less use of leniency programs to detect cartels than Europe, the Asia-Pacific, and the OECD (figure 2.12, panel b). These programs induce cartel members to self-report their conduct and cooperate with an investigation, providing insider evidence about clandestine meetings, communications, and agreements. Incentives typically include lower fines, shorter sentences, less restrictive corrective orders, and even complete immunity from prosecution. While before 2000 fewer than 10 jurisdictions worldwide had leniency programs, the number rose to more than 60 by 2010 and 89 in 2017. In LAC, despite the rising number of programs in place, leniency applications are comparatively low (18 per year in LAC versus 210 worldwide in 2020). They peaked in 2016 and have been declining, on average. This trend may be explained by the relative newness of these programs in LAC. Leniency programs often need to exist for at least 10 years before they receive any applications. Experience shows that these programs effectively uncover conspiracies that would otherwise go undetected.

► **Fewer dawn raids in LAC.** Another way of deterring companies from anticompetitive behavior is by effectively investigating detected cases through “dawn raids”—unannounced inspections to investigate infringements of the competition law. Such unannounced raids are considered to be the second most effective tool to obtain direct and circumstantial evidence of cartel formation, after leniency programs. On average, 85 percent to 90 percent of dawn raids in each jurisdiction focus on detecting cartels, while the rest focus on abuse of dominance. Controlling for the economic size of jurisdictions, competition authorities in LAC conduct fewer dawn raids than authorities in any other regional grouping, and this number seems to be decreasing (figure 2.12, panel c). In fact, most competition authorities in LAC lack the legal power to carry out unannounced inspections. Authorities in only five countries (Brazil, Chile, Colombia, Mexico, Peru) have such legal powers.

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52 OECD (2022), OECD CompsStats database.
53 OECD (2022).
54 OECD (2022). In the United States, following revisions in the leniency program in 1993 to clarify and enlarge the scope of amnesty, applications increased to more than 20 per year and led to several convictions and fines totaling well above US$1 billion between 2001 and 2010 (OECD 2022). OECD member countries that have leniency programs praise the ability of these programs to detect and punish cartels.
Low monetary sanctions. The average value of fines imposed on cartels by competition authorities in countries across LAC are low relative to sanctions in OECD jurisdictions (figure 2.13). Information from the World Bank’s Anti-Cartel Enforcement Database shows that fines imposed in LAC represented only 3 percent of the expected excess profits of cartels. This number falls on the lower bound of fines in OECD countries, which vary widely between 3 percent and 189 percent of cartel gains. The gap in fines’ size between LAC and other regions has also increased over time. Between 2015 and 2019, average cartel fines increased by 58 percent, mainly driven by OECD countries. In contrast, in LAC, they increased by only 17 percent over the same period (figure 2.13, panel a). However, some recent cases in LAC have resulted in higher sanctions, hinting at a movement by competition agencies in the right direction (box 2.2).

The weakness of competition agencies in LAC is well captured by general perceptions of their effectiveness in curbing market power. The World Economic Forum’s Executive Opinion Survey assesses the perceived effectiveness of competition authorities. Respondents assign grades on a scale from 1 (not effective) to 7 (extremely effective). For
Box 2.2.
Some Recent Cases in LAC that Resulted in Significant Monetary Sanctions for Anticompetitive Misbehavior

Increasing the expected costs of misbehavior is an effective mechanism to deter anticompetitive behavior. Expected costs are the compound result of the probability of being investigated by a competition authority, the probability of being found guilty and punished, and the size of the punishment. This is why sanctions that are significant in value raise hope about the potential effectiveness of competition policies in Latin America and the Caribbean (LAC). Some outcomes of recent cases fall in this category:

► In 2021, Peru’s national competition agency (Indecopi, for its acronym in Spanish) fined Sociedad Eléctrica del Sur Oeste, the incumbent electricity supplier in mid-southern Peru, the equivalent of US$1.2 million for abusing its dominant position in the electricity supply market to exploit and retain customers. The supplier offered consumers an exemption from a requirement to give one-year’s notice to change their status to the unregulated market, conditional on retaining the defendant as supplier. The company was also fined for similar conduct in northern Peru.

► In 2021, the Chilean competition authority (TDLC, for its acronym in Spanish) upheld abuse of dominance claims brought by a mail company Envía against Correos de Chile, a state-owned postal service provider, and imposed a fine equivalent to US$4.5 million. Correos de Chile was found to have offered Envía’s customers discounts unjustified by cost or other objective considerations to steal them away from Envía. Correos de Chile was not found to have engaged in predatory pricing, however. Rather, TDLC ruled that it had engaged in unfair competition practices by putting pressure on a customer to accept an exclusive deal.

► In 2022, the Mexican competition authority (COFECE, for its acronym in Spanish), imposed a fine equivalent to US$42 million on Mexico City’s international airport (AICM, for its acronym in Spanish) for preventing a luxury bus company from providing services to and from Puebla. AICM was a repeat offender that had been previously subject to sanctions for monopolizing practices.

► In 2022, the Brazilian competition authority (CADE, for its acronym in Portuguese) fined a group of telecom operators, including Claro, Oi, and Telefónica, the equivalent of US$152 million for forming a cartel in a competitive procurement process launched by Empresa Brasileira de Correios e Telégrafos (the state-owned postal service company) in 2015. CADE accused these firms of entering an agreement to reduce competition in the tender, which resulted in bids higher than they would have been otherwise.


Figure 2.13.
Sanctions against Cartels are Low in LAC Compared to Sanctions in the OECD

Note: The figure uses 2015 exchange rates. The data are robust when presented in nominal and real terms and using the number of sanctioned cases instead of amounts. “All” refers to 66 jurisdictions (Americas, Asia-Pacific, Europe, and Middle East and Africa).
the 2017–18 survey wave, the average score in LAC stands at a mediocre 3.3 compared to 4.2 in Europe and 5.6 in the United States. At the lower end of the spectrum, Haiti, the República Bolivariana de Venezuela, and the Dominican Republic score below 2.5, and Nicaragua, Paraguay, and Argentina closely follow, scoring below 3.0, also placing in the lower tier. On the opposite end, Chile holds the 35th position out of 137 countries, with a score of 4.4, followed by Costa Rica, Brazil, Jamaica, and Panama (figure 2.14).

### Figure 2.14.
LAC Competition Authorities are Perceived as Ineffective

Weighted average of scores by respondents of the 2017–18 survey wave

Survey question: In your country, how effective are anti-monopoly policies at ensuring fair competition? (1=not effective at all; 7=extremely effective)

Note: LAC = Latin America and the Caribbean.

### Sound Competition Policy in LAC Leads to Increased Productivity

To date, evidence on the impact of stronger competition laws and authorities on productivity in LAC has been limited. To remedy this, the forthcoming World Bank report, Competition and Productivity Growth in Latin America and the Caribbean, constructed novel datasets capturing detailed information on competition policy interventions. Two country-case studies contribute clear evidence on the potential impact of stronger competition policy enforcement in the region.

### Removal of Regulatory Barriers to Entry in Peru

In Peru, each of the country’s 1,800-plus municipalities has its code of business regulations, the TUPA (for its acronym in Spanish). While, in principle, these codes must be aligned with the national legislation, in practice, this is often not the case. For example, in 2013, almost one-third of municipalities did not comply with the national legal policy framework for issuing business operating licenses. Several municipalities outright refused to issue licenses or construction permits to new firms. All over the country, would-be entrants faced significant barriers from ad hoc local government regulatory frameworks.

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58 Vostoknovskova et al. (forthcoming).
59 Texto Único de Procedimentos Administrativos (TUPA).
60 Martinez Licetti and Goodwin (2015).
In 2013 a reform empowered the Peruvian national competition authority, the National Institute for the Protection of Competition and Property Rights (Indecopi, for its acronym in Spanish) to counter regional and local rules that did not align with the national framework or lacked economic sense. If a municipality persisted in imposing such barriers, firms could report it, prompting a swift sanction by Indecopi. This approach, alongside a 400 percent increase in fines, effectively removed local regulatory obstacles. With mayors and officials facing personal fines as high as the equivalent of US$27,500, municipalities had strong incentives to remove regulations declared to be illegal.

One-quarter of municipalities, 13 major sectors, and 16 percent of formal firms in Peru were affected. Firms operating in municipalities and sectors that eliminated barriers to entry as a result of the competition policy intervention experienced a significant increase in productivity growth relative to comparable firms in the same sector not located in municipalities affected: an 11 percent increase in revenue productivity (TFPR) (figure 2.15).

Penalties for Anticompetitive Behavior in Mexico

A unique feature in Mexican competition law is the use of fines and supervised orders (such as cease and desist orders, injunctions, and compliance directives) to stop any illegal behavior by the involved parties. The impact of the antitrust penalties imposed by the Mexican competition authority, the Federal Economic Competition Commission (Cofece, for its acronym in Spanish) between 1993 and 2018 was evaluated using 90 cases from the universe of 261 investigations into suspected market power abuse practices, for which a suitable control group was identified. During this period, about 40 percent of economic activity was investigated for anticompetitive practices in Mexico (figure 2.16).

Monetary sanctions in antitrust cases translated into increased sales of between 3.8 percent and 5.8 percent in the sectors affected (the estimated increase varies depending on the methodological approach). This research shows that the identification and penalization of anticompetitive practices was effective in reversing declining sales in sectors previously monopolized.

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61 Schiffbauer, Sampi, and Coronado (2022), using firm-level data from Peru’s Annual Economic Survey (EEA) for the period 2008–17. This sample is representative cross-section of firms with annual sales exceeding 1,700 tax units (US$2 million) in agriculture, manufacturing, utilities, construction, trade, transport, communication, and other services.

62 Reed et al. (2022).
Gains reached consumers and workers. Consumers benefited from increased sales, resulting from either reduced prices and higher quantities, or higher prices accompanied by quality improvements. Workers saw increases in average wages and employment. The wage bill went up by between 4.8 percent and 5.5 percent per year after sanctions, while average wages rose (by 1.3 percent to 2.8 percent per year) and employment increased (by 3.3 percent to 6.5 percent annually). These results challenge the idea that antitrust enforcement harms labor markets. Productivity also increased (by 0.9 percent to 1.1 percent annually), confirming that antitrust measures improved revenue productivity growth at the sector level.

There is also evidence from Mexico on the potential of monitoring vertical relations—those that result from interactions between parties that meet along the same vertical production chain (such as producers of inputs and final goods, producers of final goods and distributors, and wholesale and retail sellers). Such relations often translate into explicit contractual agreements or “vertical restraints” that rule both parties’ behavior, such as minimum and maximum prices, franchise contracts, quantity fixing, and exclusivity clauses. While many vertical restraints enhance efficiency and fall in a grey area where they cannot be clearly identified as undesirable in terms of their effects on competition, dominant firms may use them for anticompetitive purposes. In a vertical restraint case investigation that closed with no sanction, sales and wages were found to fall and profit margins to rise once the investigation closed, suggesting that COFECE was right to question firm behavior in the first place.

Other Evidence on the Effects of Competition Policy

Evidence from antitrust enforcement in the cases of Chile, Colombia, and Uruguay is weaker and less robust to different methodological approaches for measuring outcomes. An interesting exception comes from an estimation showing that, in Uruguay, ex officio investigations started by the competition authority’s initiative had a higher impact on revenue productivity than those opened in response to private complaints. This result suggests that the Uruguayan authority’s action was appropriately targeted and illustrates the importance of building the internal capacity of competition authorities.

A reason why positive effects from antitrust enforcement may be challenging to capture in LAC, aside from access to adequate microeconomic data, is that enforcement activity covers only a fraction of the misbehavior in the market, so isolated interventions may not suffice to produce significant changes (box 2.3). Moreover, as shown by the Peruvian case study concerning subnational governments, competition policy works in tandem with other regulatory frameworks, that if not well aligned with it, can limit its effectiveness.

Evidence from regulation of natural monopolies in the information and communications technology (ICT) sector stresses the critical complementary role of other regulatory frameworks in helping markets function well. In industries where having a sole provider is the most efficient arrangement because of the shape of the cost function (natural monopolies), a precondition for good market performance is ex ante regulation, which provides the incentives for good conduct before firms go to the market. In Peru, ex ante regulations aimed at raising the quality standards of service provision in the ICT sector resulted in an increase in firm-level revenue productivity of about 20 percent. This result demonstrates the potential of these regulatory frameworks in complementing competition policy as a driver of innovation and productivity. The improvement was driven mainly by firms in the telecommunications industry and in the top 5 percent of the productivity distribution. This pattern highlights, yet again, the unequal preparedness of firms along the productivity distribution to benefit from incentives to innovate, regardless of whether these incentives come from sound ex ante regulation or competition policy.

Overall, the impact of even these underfunded and undermanned competition authorities is largely positive, especially in terms of improving productivity. This solid performance stands in contrast to the mixed results from the experience of import competition in the region, as discussed in the first section of this chapter. One possibility is that with respect to trade competition, LAC firms are relative laggards compared to frontier international competitors and, hence, do not have the managerial or technical capabilities to invest to “escape” the new competition. Domestic competition authorities are effectively forcing firms to compete with “local” frontier firms against which they have a better chance.

63 This result is robust across methodological approaches (Sampi, Urrutia, and Vostroknutova 2023).
64 Arayavechit, Jooste, and Arrieta (2022).
Box 2.3.

**Cartels are Pervasive in LAC**

A 2021 analysis of more than 300 cartels detected in Latin American and Caribbean (LAC) countries between 1980 and 2020, based on the World Bank Group Anti-Cartel Enforcement Database, found that at least 21 percent of cases affected basic consumption products such as sugar, toilet paper, wheat, poultry, milk, and medicine. Within this category, the countries with the highest number of cases were Mexico (15), Colombia (11), and Brazil (10). Among those cartels for which price information was available, most had increased consumer prices by 5 percent to 25 percent above the levels a competitive market would dictate, and in at least 4 percent of cases, cartel-related surcharging effectively doubled consumer prices. In addition to reducing disposable income, especially for low-income groups, cartels may thwart efforts to reduce poverty in developing contexts by diverting valuable public resources toward antitrust enforcement.

The abundance of cases involving anticompetitive corporate agreements across LAC provide evidence of the outsized influence of the region’s main business players over the markets in which they participate. For instance, a sugar producers' association was sanctioned by Colombia’s national competition authority (SIC) for engaging in commercial practices that restricted competition in the market, curtailing the entry of foreign businesses, and limiting the supply of products to other industries dependent on sugar as a production input. In Mexico, price fixing by cartels in the tortilla market and discriminatory pricing in cable television services affecting both consumers and competitors were widely publicized in the media.

The involvement of cartels in government procurement constrains the supply of public goods and services. In some cases, cartels may even distort the market for government bonds. At least one in four LAC cartels formed between 1980 and 2020 centered on government procurement processes, with taxpayers bearing the burden of overcharges. In Peru, 31 providers of hemodialysis abstained from participating in the health administration’s bidding process so they could effectively increase reference prices for subsequent tenders, leading to surcharges of approximately US$10 million per tender between 2010 and 2012. In 2021, the country’s national competition authority sanctioned a cartel of engineering firms involving anticompetitive actions related to contracts for the expansion of the public highway network between 2017 and 2019. In Mexico, 7 banks and 11 brokerage firms were sanctioned for entering into at least 142 agreements to manipulate prices in the Mexican sovereign bond market between 2010 and 2013 by limiting the sale and acquisition of certain bonds. This scheme resulted in losses of more than US$1.4 billion.

During 2000–20, the average number of cartels detected in LAC was 66 percent higher than the European Union (EU) average. Since the 1980s, about 35 percent of cartels detected in LAC have been in the manufacturing sector. The wholesale and retail trade and transportation sectors has accounted for 15 percent each (figure B2.3.1). In

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**Figure B2.3.1.**

**Cartels Distort Virtually Every Sector of the LAC Economy**

Cartels prosecuted in LAC, by sector, 1980–2020

Box 2.3. Cartels are Pervasive in LAC (continuation)

manufacturing, cartels have been particularly common in meat processing in Brazil, Chile, and Panama, and in production of basic chemicals in Argentina, Brazil, Colombia, Panama, and Peru. In the pharmaceutical sector (both wholesale and retail), cartels have been found in Brazil, Chile, Honduras, and El Salvador. In the transport sector, Chile imposed a US$95 million fine on six shipping lines for colluding in tender processes to provide maritime transport to manufacturers and consignees of imported cars. Mexico, meanwhile, sanctioned seven shipping lines for making nine agreements to divide the car-transport market among them.¹


b. Purfield et al. (2016).

h. The number is the per country average, averaged across years.

Big Business Political Power

If this glimpse into the potential transformative action of a sound competition policy is so telling, why are LAC countries not making it a priority to strengthen these institutions? Why do LAC markets remain so concentrated and why is cartel activity so pervasive? As the chapter noted earlier, the rent-seeking dimension of market power is one channel through which competition (or its absence) can affect productivity. This theme reemerges because the lack of effective competition institutions is not independent of the way business power is concentrated in the region.⁶⁵

A good example is provided by the communications sector in Mexico, where concentration and oligopolistic pricing have been extensively documented.⁶⁶ In this sector, neither the competition agency nor the sector regulator could initially control monopoly power. Telmex and other giant firms in the telecoms industry are referred to in the literature as poderes fácticos (de facto powers)—powerful actors able to dilute or evade government control through interference across the three branches of government: the legislature (Congress), the executive, and the judiciary.⁶⁷ The telecommunication elite and the media have systematically lobbied for favorable legislation and used the Mexican judicial system to stymie regulators (box 2.4). These behaviors resulted in the Pacto por Mexico, an agreement among the three largest political parties in 2013 to regain state control over de facto powers in this and other sectors. This agreement resulted in substantive changes to the Mexican Constitution in matters of competition. However, these changes have not yet translated into changes in the structure of the telecommunication sector, which remains dominated by the same firms.

Powerful businesses have used courts and other legal provisions in some countries to obtain injunctions against antitrust measures.⁶⁸ For example, the constitutional right of amparo (legal protection), granted to citizens in some countries to stop potentially harmful policies, has been used to tie up antitrust rulings in court.⁶⁹ This practice has been so widespread among firms that consulting businesses specializing in amparos for business have emerged.⁷⁰ In Brazil, defendants can challenge rulings by the Administrative Council for Economic Defense through up to four levels of appellate courts. In Chile, the Supreme Court and other courts have been used to overturn judgments of the national economic prosecutor or achieve reduced penalties.

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¹ See discussion in Schneider (2021).
⁶⁵ See Levy and Walton (2016).
⁶⁶ Trejo (2013).
⁶⁷ The courts often also helped businesses challenge tax increases. On Guatemala, see Bogliaccini and Madariaga (2019).
⁶⁸ Elizondo (2009).
⁷⁰ Schneider (2021).
Trade protection can also work to fix minimum prices in ways similar to cartels, and it is often the result of intense lobbying. The difference between domestic and international prices represents another nonmarket transfer from consumers to businesses, the net distributional effects depending on who consumes the goods, and whether workers in protected businesses receive a part of the transfer.

Political scientists and political economists have examined the factors particular to the region that contribute to enhanced business political power. Three stand out:

► **Electoral rules resulting in fragmented party systems.** Majoritarian presidential elections and proportional representation elections for legislatures are standard in Latin America and rare elsewhere. This combination of electoral rules results in fragmented party systems and presidents elected without legislative majorities. Party support in legislatures through legislative coalitions is, then, built through political transactions. In fragmented party systems—a natural byproduct of proportional electoral systems, small groups of legislators extract rents from the executive in return for votes on legislation. This fragmentation allows businesses to finance parties or candidates using these negotiations over votes in their favor.

► **Media concentration.** Big business and media in all their forms are closely interwoven, and media ownership is highly concentrated throughout LAC. The dominant media firms are well-known business groups. Some started as newspapers or radio businesses in the twentieth century and have become dominant in other media markets: notably, large and diversified corporate groups in the media exist in Argentina, Brazil, Chile, Mexico, and Peru. Others started in different sectors and moved into media—the path taken by other groups in Argentina, Chile, Colombia, and various Central American countries. Concentration is high across all media (print, radio, and television) and communication services in the region. The largest four operators control 82 percent of the market, ranging from about two-thirds in radio and print media to more than 90 percent in television. At a minimum, these firms are not likely to use their media programming to argue for using regulation to restrict media concentration. Beyond content, media firms also deploy their power in traditional ways. There are many cases of big businesses using democratic legislatures to pursue their interests.

72 Schneider (2013).
74 Becerra and Madrini (2010).
Influence of family-owned firms. There are three hypotheses about the role business families play in politics. First, opposition to taxation, regulation, and other measures that adversely affect family patrimony will likely be much more intense among family members with control over the company than hired managers. Second, families have advantages in politics because of their longer time horizons relative to managers. If families agree to support politicians, they can more effectively monitor their performance over time and reward or punish accordingly. Third, families resolve agency problems in both management and politics. Later generations sometimes go into politics, giving business families trusted representation within the political elite. The family-ownership factor is not negligible. On average, in Latin America, 22 percent of corporations listed on the stock exchange and 28 percent of large firms (with 100 to 5,000 employees) are family-owned (figure 2.17). Family-owned businesses are among the largest 50 businesses and contribute at least 30 percent of revenues from this group (in Brazil) to up to more than 90 percent (in Mexico) (figure 2.18).

Figure 2.17.
In LAC, 22 Percent of Corporations Listed on the Stock Exchange and 28 Percent of Large Firms are Family-Owned

Figure 2.18.
Family-Owned Firms are Among the Largest by Revenues

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76 Schneider (2013).
77 Schneider (2008).
The menace of capital flight and disinvestment enhances business influence on policy. If the government thinks a regulation or policy intervention will lead businesses to reduce investment, hurting economic growth and employment generation, it may withdraw the measure. Reactions to business behavior are often anticipated reactions, whereby governments drop policy proposals over the concern that the proposals may lead to disinvestment even before the proposal is adopted.\(^7\) Business leaders weaponize this power when they claim specific policies will provoke disinvestment. Governments are more likely to worry about depressing business investments if elections are near and unemployment is high.

Such entanglements between firms, government, and elites are found everywhere, but are more likely where the economy is dominated by very few large firms, as in LAC. In the context of transitioning to greener economies in LAC, they present a significant concern (box 2.5). Developing more rules-based economies requires a sustained process of reform. Critical steps to moving the region forward include revising regulations to eliminate those that favor private interests and not the general welfare and strengthening the power and independence of competition laws and agencies. The path for reform in the correct direction can be paved by taking other measures to rebalance economic and political power, such as regulating campaign financing and lobbying activities and taking the global conversation on taxing the super-rich seriously.

The Complementarity between Competition and Innovation Policy

The previous section examined prerequisites for rebalancing power and promoting fair competition in domestic markets. This is a necessary starting point—truly establishing a level playing field for all firms in LAC. This section revisits the interplay of competition with firm-level and national innovation capabilities, focusing on the challenges for enhancing innovation and productivity at the firm level in LAC. The discussion recognizes that for most businesses, poor performance may result from deficiencies at the firm level and national level that translate into a lack of capacity to innovate, even in face of the correct incentives to innovate.\(^8\)

To give a sense of where LAC stands, figure 2.19 shows the results from four studies on the share of firms that will innovate when confronted with more competition. Having a lower share of “leaders” results in lower growth.\(^9\) Historically—dating back to 1900, when faced with the heightened competition arising from the new technologies of the second industrial revolution, LAC has had very few global leaders and hence has subcontracted entire industries (most critically, mining) to outsiders.

Because economic activity in the region has historically taken place in an environment highly sheltered from competitive pressures, the LAC productive apparatus is ill prepared to compete. Firm-level productivity

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\(^7\) Fairfield (2015) offers detailed empirical studies of the Lagos government in Chile in the early 2000s when the Finance Ministry moderated tax increases to avoid a backlash from business.

\(^8\) The approach to innovation policy in this section is from Cirera and Maloney (2017).

\(^9\) See Aghion et al. (2009); Aghion et al. (2022); Bombardini, Li, and Wang (2018); and Cusolito, Garcia-Marin, and Maloney (2023).
Box 2.5.
The power to impede or facilitate the transition toward greener energy

While the Latin America and the Caribbean (LAC) region, on average, has a clean energy matrix, there is significant variation among countries. The challenge of phasing out fossil fuels such as coal, oil, and gas remains. Foreign markets are increasingly scrutinizing goods to ensure they are produced using sustainable energy sources. Those who can quickly substitute fossil fuels with renewables will have a competitive advantage, and those who can’t will likely lag behind.

However, even considering the social costs of environmental damage, implementing a green growth plan faces obstacles in replacing fossil fuels with renewable energy as economic pressures rise. The demands of industry, commerce, transportation, and urban households are increasing the need for extensive electrification. Technological, financial, and political hurdles, along with opposing interests, make this transition more difficult. Both government and private interests may obstruct the shift to renewable energy instead of relying on fossil fuels in the region.

A survey conducted in 2018 by FGV-RI and KAS-ELKA on the geopolitics of renewable energy in 10 Latin American countries showed a consensus among academics, civic leaders, government representatives, and businesspeople regarding the necessity for a sustainable transition. A majority of respondents (51 percent) believed solar power was the most promising renewable source in the region, followed by wind (17 percent) and hydro (12 percent). Additionally, 92 percent agreed that increasing renewable energy would benefit foreign relations in the region. However, many also acknowledged that lobbying by national (75 percent) and foreign (69 percent) oil companies could impede progress. Concerns were raised about lobbying efforts pushing for further development of the fossil fuel market. These perceptions highlight the influence of corporations and government bureaucracies in hindering efforts toward a sustainable energy matrix.

The energy transitions of Mexico and Uruguay demonstrate potential paths forward and reveal challenges in pursuing sustainability. In the 1970s, both countries had similar per capita electricity consumption and produced half of their electricity from fossil fuels while the other half came from hydroelectric projects. By the mid-2010s, Uruguay had significantly increased per capita electricity consumption, surpassing Mexico. Over the four decades, Mexico’s reliance on fossil fuels grew to 90 percent of energy consumption, while Uruguay reduced this share to less than 50 percent. Similarly, Mexico reduced its hydropower electricity production to 10 percent, whereas Uruguay maintained around 60 percent from hydro sources (figure B2.5.1, panel a).

Recent events illustrate how political decisions can shift a country away or bring it closer to a sustainable transition. Mexico’s 2021 energy reform, halted by the Supreme Court precisely for its anti-competitive effects, intended to favor state-owned electricity production, which relies on older thermal energy plants and limit the entry of private renewables producers. Moves like this can hinder Mexico’s commitments under the Paris Agreement to reduce greenhouse gas emissions.

Contrastingly, Uruguay has been actively pursuing an energy transition focusing on renewable sources. The Los Caracoles wind farm project received funding through the Clean Development Mechanism and the Kyoto Protocol. This initiative aimed to generate carbon credits, which were used to reduce Uruguay’s debt. By 2015, Uruguay had established itself as a leader in clean energy with significant wind energy capacity. Currently, Uruguay is targeting transportation emissions by implementing an e-mobility strategy.

The difference in energy strategies between Uruguay and Mexico is evident in the percentage of energy consumption from renewable sources over the past 25 years (figure B2.5.1, panel b).

Sources: FGV and ELKA-KAS (2019); Thwaites (2016); UNDP (2021).
Box 2.5. The power to impede or facilitate the transition toward greener energy (continuation)

Figure B2.5.1
The divergent energy strategies in Mexico and Uruguay are evident in the evolution of their fossil fuel dependence and energy consumption from renewables

a. Electricity production from oil, gas, and coal sources, 1971–2015, percent of total

b. Renewable energy consumption, 1990-2020, percent of total final energy consumption

is low, in part because this shelter has translated into low incentives for innovation and overall improvement of business capabilities. So, higher levels of competition are a welcome push for firms to move in the right direction. However, for precisely the same reason, the increased competition from external sources can destroy a large share of this precarious productive apparatus—and, with it, the income source of much of the population, leaving LAC countries worse off.

Hence, for LAC, competition, and firm upgrading and national innovation policies are complements. Higher competition levels, facilitated by sound antitrust enforcement and procompetition regulatory frameworks, in general, will provide the correct incentives for firms to upgrade technology. Good innovation policy will move more firms closer to the technological frontier, where they can respond to competition by improving their capabilities instead of exiting the market. As a result, aggregate productivity dynamics will improve and economic growth will increase.
Why is Innovation So Low in LAC When the Potential Returns from Investment in Innovation Are High?

Complementary Factors and Supporting Institutions

There is a clear link between the operating environment and innovation capability, as figure 2.7 notes. If a country or firm invests in innovation but cannot import the necessary machines, contract trained workers and engineers, or draw on new organizational techniques, the returns on that investment will be low. A broad set of complementarities, such as physical and human capital, are needed to make such investments pay off. The gap in such necessary complementarities grows more acute with distance from the technological frontier. The returns and, hence, the quantity and quality of innovation are also affected by the underlying conditions that impede firms and individuals from accumulating physical, human, or knowledge capital—the costs of doing business, the trade regime, the competitiveness framework, an educational system that provides a skilled workforce, and capital markets.

In LAC, policy makers’ conception of innovation systems must go beyond the usual innovation institutions (such as ministries of innovation or innovation agencies) and the usual policies (such as innovation grants or incentives) to include these broader complementary factors and supporting institutions. Relatedly, conventional measures of benchmarking innovation performance (such as gross domestic expenditure on R&D) will be misleading if the stock of other complementary factors is not considered.

Managerial and Organizational Practices

An extensive literature argues that to innovate and manage innovation projects effectively, firms must acquire a range of capabilities fundamental to the processes of increasing productivity and upgrading quality. The evidence shows that managerial and organizational practices are crucial inputs and complementary factors for innovation. The World Management Survey (WMS) has documented that firms in LAC and other developing countries lag in a wide range of critical capabilities in both the best and worst firms. Average scores in monitoring, internal feedback mechanisms, long-run planning and goal stretching, and human resource policies in developing country firms are well below those in advanced economies (figure 2.20). Firms lacking the capabilities to respond to market conditions, identify new technological opportunities, develop a plan to exploit them, and then cultivate the necessary human resources will find it difficult to innovate.

Of course, firms with the best managerial and organizational practices will find innovation difficult without a skilled workforce. However, 29 percent of LAC firms report being unable to grow, let alone innovate, due to a lack of skilled labor. This gap is partly a function of deficient education systems. Just over one-third of 15-year-old students meet minimum standards in science and mathematics and half of all 10th graders cannot read an age-appropriate text. Public training programs tend to be weakly aligned with private sector needs. Universities in LAC fail to place among the top 100 in the world, and continue to graduate relatively few engineers and scientists: 18 percent of graduates versus 25 percent for the world and 28 percent for East Asia.

Perennial shortfalls in mid-level technical graduates are now being addressed in Brazil, Chile, Colombia, Panama, and Uruguay through short cycle programs, but the gap remains large.

Government Capabilities

For developing countries, the greater magnitude of the market failures to be resolved and the diversity of missing complementary factors and institutions increase the complexity of innovation policy; at the same time, governments’ capabilities to design, implement, and coordinate an effective policy mix to manage it are weaker. Governments require building capabilities for policy making across four critical dimensions. First, policy design requires the ability to identify market failures, design the appropriate policies to redress them, and establish clear metrics for success. Many failed experiments in developing countries result from importing institutional models and best practices from advanced countries that do not address the actual failures or are not politically viable; and many agencies lack a clearly defined mission and incentives that align them with identified clients and goals and shield them from capture.

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81 Hallak (2006); Sutton (2012); Sutton and Treffer (2016); Teece and Pisano (1994).
82 Cirera and Maloney (2017), chapter 2.
83 Maloney and Sarrias (2017).
84 Times Higher Education (2023).
85 Ferreyra et al. (2021).
Second, effective implementation requires solid public management practices and processes for evaluating, adapting, and modifying or terminating policies when needed. Third, policy must be coherent across ministries and agencies. In practice, it is often balkanized across agencies and administrative levels, and there is little alignment between the stated policy goals and actual budgets. Fourth, policy consistency and predictability require systems that cultivate innovation policies and institutions over time. Instead, the consensus on the importance of the innovation agenda and high-level political commitment is often limited, so backing for policy is weak and policy is frequently reversed. None of these capabilities is easy to generate or maintain.

These issues are all present in the area of government support for firm innovation. Government support for R&D is low by global standards but also badly allocated. Much is often channeled through universities that are poorly connected to business needs; LAC ties with Africa for last place among regions in their collaboration with the private sector. Poorly designed subsidies to R&D have had the effect of substituting weaker domestic technologies for foreign ones, precisely at the cost of productivity. They have effectively functioned as subsidies for firms to move into protected sectors and have discouraged the entry of innovative firms and the exit of the less productive.

The “Capabilities Escalator”

Choosing the appropriate combination of innovation policy instruments—the policy mix—in the context of scarce government capabilities becomes critical. The “capabilities escalator” offers a framework where policies to support firm upgrading are prioritized according to the capabilities level of the private sector, policy makers, and institutions and ratchet through progressively higher stages of sophistication (figure 2.21). The first stage primarily supports production and management capabilities. The second stage increases the focus on supporting technological capabilities. The third stage expands the support to invention and capabilities to generate technology.

This framework is helpful to highlight overlooked policy considerations. For example, many advanced countries such as Italy, Japan, Singapore, and the United States continue to invest heavily in the first stage of the escalator. Developing third-stage capabilities is a decades-long agenda that must be started simultaneously with efforts in the earlier stages and cannot be considered a substitute for the policies to support first-stage capabilities.

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87 See Acemoglu et al. (2018). For Brazil, see de Souza (2022).
Rethinking Innovation Policy to Complement Competition as a Driver of Productivity

In sum, innovation in LAC is not simply about the markets where new knowledge is generated. The LAC countries face more challenging barriers than advanced economies. So fostering innovation in a way that supports the forces of competition, allowing countries to benefit from them and breaking free from the low-competition/low-productivity equilibrium, requires rethinking innovation policies along three lines:

► The scope of innovation systems must include everything that affects the accumulation of all types of capital—physical, human, and knowledge—and their supporting markets. What looks like an innovation problem may reflect barriers to accumulating other factors, including physical and human capital.

► Firm managerial and technological capabilities are a central complement to narrowly defined expenditures on innovation, and their cultivation is critical to fomenting a continual process of technological adaptation and quality upgrading. This cultivation requires rebalancing policy priorities toward education systems and management and technology extension instruments and away from a focus on promoting research and development. Recent World Bank research provides insight into improving managerial quality.88

► Because the complexity of building private sector capability is greater, and government capabilities are weaker, innovation policy needs an honest balancing of capabilities with tasks, which requires working on a selective set of issues rather than trying to import a full set of institutions and policies from elsewhere.

The rate of technological change is accelerating, and we do not know with assurance which sectors or industries will offer rapid routes to prosperity or what technologies will drive them. Raising firms’ capabilities to manage this uncertainty and chart their way forward is critical to preparing countries for future opportunities.

In LAC, there are strong complementarities between competition and innovation policy. The nature of the competition-innovation policy debate is not the same as the debate in advanced economies. In general, the closer firms are to the technological frontier, the more increased exposure to competition will boost innovation. Yet most of LAC’s firms—even medium and larger firms—are still far from the frontier and are woefully unprepared to compete. So, an innovation policy that increases firms’ capabilities to innovate and results in a larger share of firms near that

88 Iacovone, Maloney, and McKenzie (2019).
threshold where competition does indeed lead to more innovation will improve the effect of increased competition on aggregate productivity. In turn, competition policy and other regulatory frameworks that help to level the playing field for business and provide the correct incentives will be critical for innovation and productivity growth to materialize.

Providing access to technologies or opportunities for innovation and improvement of capabilities will not, by themselves, bring about productivity growth. Policy makers in LAC have an opportunity to build on the potential synergies between competition and innovation policies.

Unlocking the Potential of Competition as a Driver of Productivity

This chapter has argued that increasing competition is a critical ingredient to restart LAC’s stalled growth engine. However, for competition to work as a driver of productivity in LAC, attention must turn to improving productivity at the firm level. Evidence from import shocks in Chile, Mexico, and Peru uncovers the extent of LAC countries’ unpreparedness to compete, presenting a region where only a very small fraction of firms can escape increased competition by investing in innovation and enhancing productivity. Firms that can survive and benefit from external competition are at the top of the distribution of productivity, size, and markups.

Low firm-level productivity and the resulting unpreparedness to compete may be traced back to low-quality education, poor access to financing, and inadequate regulatory frameworks for business activity, among other factors. But a big part has to do with businesses appearing and operating in low-competition environments, shielded from the necessary incentives to stay alert about what goes on in the market and prioritize efforts to improve their capabilities. LAC markets stand out for their high levels of concentration, very high average markups by international standards, and the presence of a few giant dominant firms. They also stand out for missing a segment of vigorous and growing small and medium firms, able to put healthy competitive pressure on those above them in the business size distribution. Moreover, household surveys reveal that about 70 percent of the workforce in LAC is scattered across a multitude of tiny businesses with less than 10 workers not captured by firm-level surveys or censuses. These tiny businesses are usually not on the radar when it comes to crafting policies to improve productivity and support economic growth. All these businesses, which are contributing to low average productivity and low competition in local markets, will benefit from government efforts to limit rents from market power and punish anticompetitive behaviors of the largest firms that impede the existence of competitors in domestic markets.

Evidence on the impact of sound competition policy interventions in Peru and Mexico speaks to the critical role competition laws and antitrust agencies can play in disciplining markets in LAC and contributing to increased productivity. Competition laws and agencies are still young and weak in most LAC countries. This weakness is not independent of big business political power. Rents from high market power are often diverted toward lobby and rent-seeking activities interfering in policy making to perpetuate and increase that power, including thwarting competition law and competition agencies’ actions. So, strengthening competition policy institutions and ensuring that complementary regulatory frameworks are well aligned with them will require efforts to rebalance power in other policy dimensions.
Any temptation to solve unpreparedness to compete by attempting to limit competitive forces is likely to backfire, helping to keep the region in the low-productivity/low-growth equilibrium where it is stuck. Instead, the promotion of fair competition and procompetition policies must be paired with a clear, deliberate effort to put in place good innovation policies and working national innovation systems aimed at increasing productivity at the firm level and shifting the productivity distribution upward, so the share of firms prepared to compete internationally grows larger. LAC will benefit from building on the potential synergies between competition and innovation policy.

Innovation policies for LAC need to be rethought, understanding that innovation in the region requires action beyond remedying market failures related to knowledge, and includes considering everything that may limit knowledge, human, and physical capital accumulation and their supporting markets; managerial and technological capabilities critical to fomenting a continual process of technological adaptation and quality upgrading; and an honest balancing of government capabilities with tasks that allows working on a selective set of issues instead of importing institutions and policies from elsewhere.
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