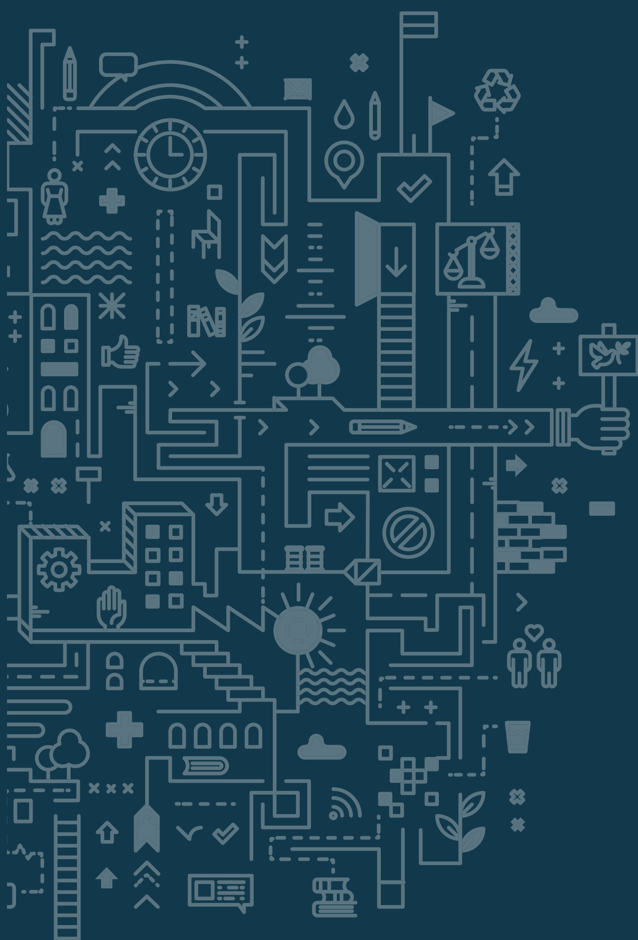
OVERVIEW

REGIONAL HUMAN DEVELOPMENT REPORT 2021

TRAPPED: HIGH INEQUALITY AND LOW GROWTH IN LATIN AMERICA AND THE CARIBBEAN

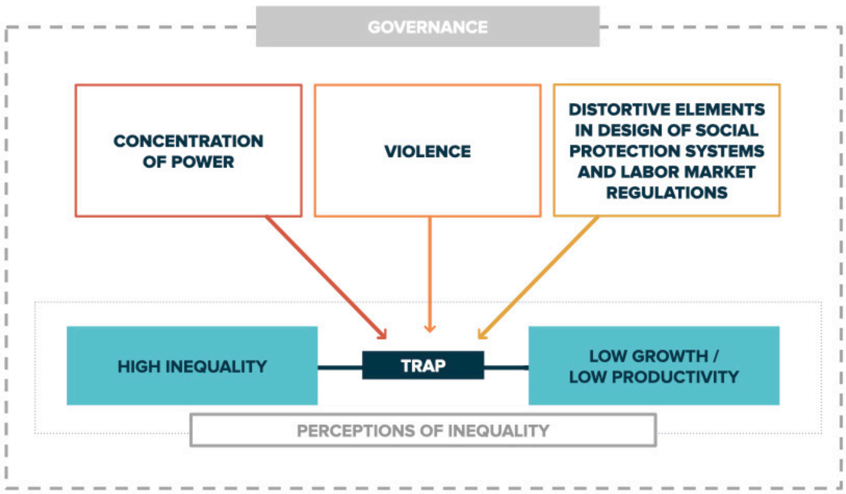


OVERVIEW

Latin America and the Caribbean (LAC) is in a development trap. Despite decades of progress, some of which could be wiped out by the COVID-19 pandemic, two characteristics of the region have remained largely undisturbed: high inequality and low growth. These two factors are closely related and interact with one another to create a trap from which the region has been unable to escape. This is not a new finding. This phenomenon is well documented in the region. A rich body of research has explored the different channels through which high inequality and low growth reinforce one another. However, many of our existing approaches in thinking about how to escape this trap inevitably leave us with a long list of "good policies" that work to address these channels separately. In LAC, this has often led to political incentives that foster fragmented policy responses with a short-term perspective—in some cases, deepening the existing distortions.

This report proposes a conversation beyond the individual links between inequality and growth to explore *the complex interactions of some of the factors that underlie the mutual reproduction of inequality and slow growth.* While there are other factors underlying the region's high-inequality, low-growth trap, this report focuses on three that are critical: the concentration of power; violence in all its forms, political, criminal and social; and distortive elements in the design of social protection systems and labour market regulatory frameworks. Perceptions of inequality and fairness also play a fundamental role because they contribute to shaping people's political attitudes towards different policies and may be crucial for building clout to support desirable policy reforms. In the end, of course, the ways in which the different factors interact are shaped by the (in)effectiveness of governance in each context. Figure O.1 provides a visual depiction of these interactions as considered in this report. Because the trap is the result of a complex interaction of factors, exiting it will require a more systemic policy approach that fundamentally considers these factors jointly and from a holistic perspective.

Figure O.1: The high-inequality, low-growth trap



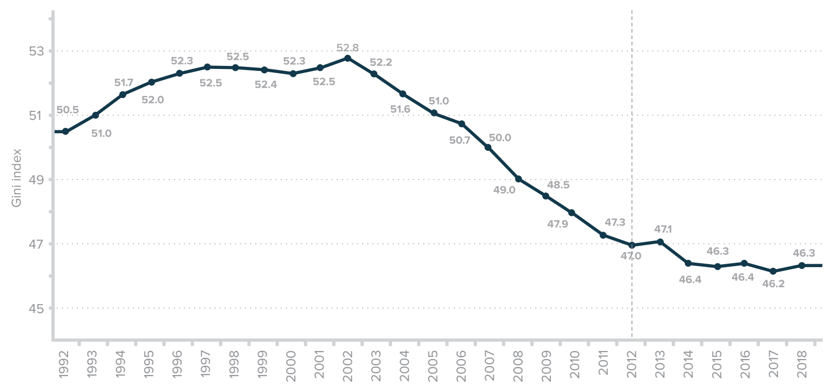
Chapter 1: Trapped? Inequality and Economic Growth in Latin America and the Caribbean

Inequality, like poverty, is multidimensional. This chapter explores vertical inequalities within groups (for example, based on differences in income or wealth) and horizontal inequalities between groups (for instance, based on differences in sex, ethnicity, or race, geographic location, vulnerability to climate change, sexual orientation, or gender identity). It also explores inequalities in access to a range of public goods and services and inequalities in voice and agency.

While the widespread reduction of income inequality (as measured by household surveys) in the early 2000s is to be celebrated, this trend stagnated in the 2010s and had started to revert in some countries even before the onset of the pandemic (figure O.2). The inequality declines in the early 2000s are explained by several factors, including economic growth, a reduction in returns to higher education that narrowed the skilled-unskilled wage gap, and redistribution via cash transfers (spotlight 3). In some countries, such as Argentina and Uruguay, labour unions also played a role; in other countries, such as Brazil, a rise in the minimum wage was also important. Despite this progress, the region remains the second most unequal in the world, and countries in LAC exhibit higher inequality than those in other regions at similar levels of economic development (figure O.3).

Figure O.2: Despite declining in the 2000s, income inequality remains high in LAC

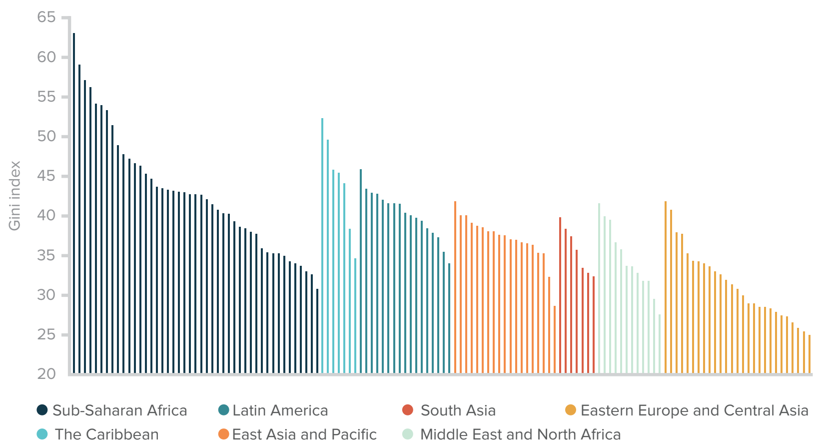
Income inequality (Gini index 1992–2018)



Note: Unweighted mean of the national Gini indices of the distribution of household per capita income. Data refer to all Latin American countries except El Salvador and Guatemala.

Figure O.3: LAC countries are some of the most unequal in the world

Gini indices on the distribution of household consumption per capita by region, circa 2017



Beyond income, other forms of inequality stubbornly persist. Gender gaps in labour market participation and unpaid time spent in care work continue to place women on an unlevel playing field. LGBT+ people continue to face discrimination at school and in the labour market and are more frequently than others the victims of violence. Ethnic minorities continue to lack recognition as active political and economic agents and to be left behind in access to basic services, including health care and education. These inequalities complete the picture of inequality in LAC. They contribute to income inequality, low productivity, and low economic growth. If talent is indiscriminately distributed at birth, unequal societies waste the talent of a relevant portion of society if they exclude a share of human capital from the labour market or sentence some groups to lower capital accumulation.

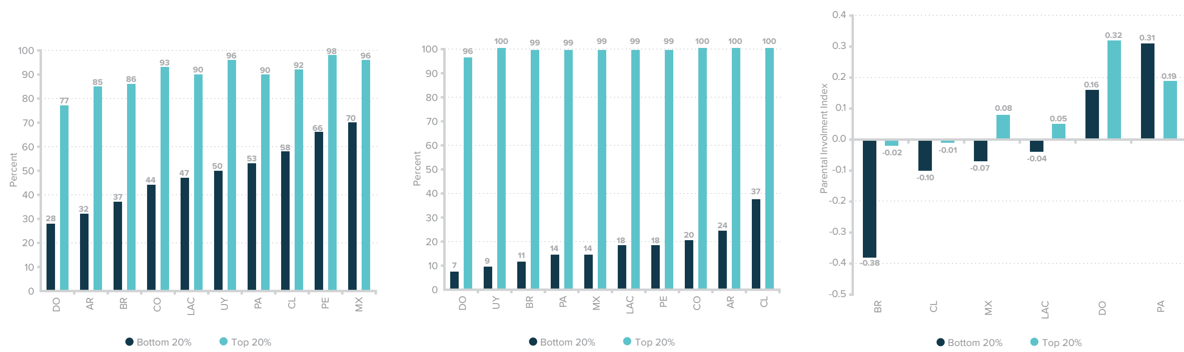
The multiple crises of the COVID-19 pandemic have weighed most heavily on those already left behind, exacerbating inequalities throughout 2020 and 2021. This has taken different forms, ranging from unequal impacts on household income to an increasing incidence of domestic violence. The unequal impacts of the pandemic on students is one of the most worrisome for long-term inequality trends. The shifts to remote methods of teaching and learning have been marked by pre-existing disparities in access to technological and academic tools at home, as well as disparities in learning support from parents, including disparities in parental educational levels (figure O.4). Before the COVID-19 pandemic, Latin America was already the region with the lowest intergenerational educational mobility. After considering progress from educational expansion over time, thanks to which the younger cohorts have more schooling than the older, adult schooling attainment in Latin America is still highly determined by parental schooling attainment. COVID-19 is likely to entrench this pattern.

Figure O.4: Unequal access to tools and support for at-home learning leave poorer students more vulnerable to falling behind

a. Students with a desk at home

b. Students with at least one computer at home

c. Parental involvement in school activities index



These patterns of inequality are fundamentally linked to the region's patterns of growth, characterized by high volatility and mediocre performance. Figure O.5 shows annual real per capita growth in gross domestic product (GDP) between 1962 and 2017 in 16 countries on which complete data are available. This instability holds even after filtering out business cycle fluctuations by computing seven-year averages: growth across this period oscillates between 0 percent and 3 percent per year. Growth was reasonably strong during the 1960s, but faltered in the late 1970s and collapsed during the debt crisis of the 1980s. It recovered after 1990 and accelerated during the 2000s, but strongly reduced its pace during the 2010s. Productivity performance, comprising both technological innovation and the efficient allocation of productive factors, explains much of the region's slow growth rhythm. Total factor productivity (TFP) growth has made a null and, in some cases, negative contribution to long-term output growth in LAC. Factor accumulation, by contrast, consistently made a positive contribution before and after 1990. The dominant role of factor accumulation may also be observed in each of the 16 countries considered (figure O.6). Even in the countries in which productivity growth made a long-term positive contribution, the contribution of factor accumulation was larger.

Figure O.5: Growth in LAC has been highly volatile

Dynamics of LAC historical per capita output growth, mean country, 1962–2017, %

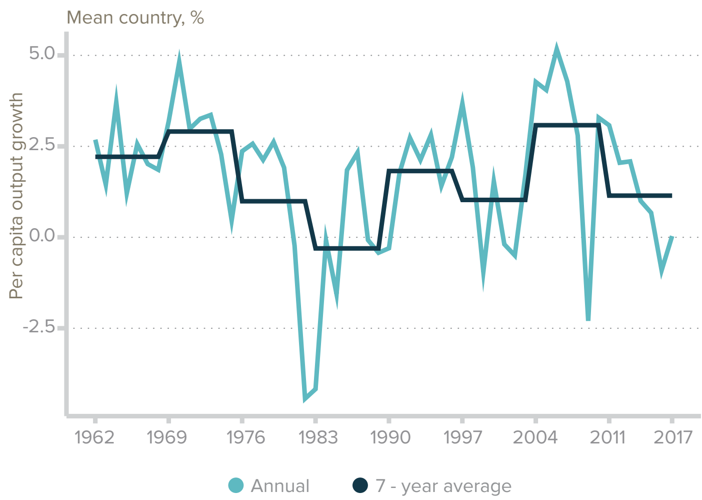
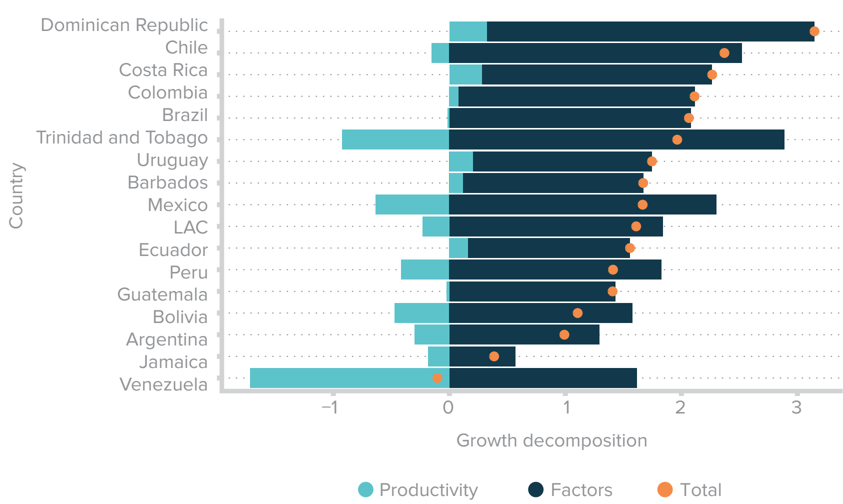


Figure O.6: Low productivity is at the core of LAC's mediocre growth performance

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



Chapter 2: What people think about inequality and how they think policy should react

Objective measures of inequality (such as the Gini index, income concentration at the top, and patterns of convergence in various capabilities, usually measured using household surveys) only reveal one part of the story. It is important also to consider subjective measures of inequality related to how people perceive it. This is essential because people's perceptions of inequality shape their political attitudes (and thus their support for different policy approaches) as well as their aspirations (and thus their efforts to achieve them). Understanding what people think about inequality in LAC is particularly crucial at the current moment given the wave of social unrest that swept across the region in late 2019 and early 2020. While the protests were driven by a range of country-specific concerns, people's grievances over inequality were among the largest common denominators.

New evidence from 2020 collected for this report by Latinobarómetro points to a few key findings in this regard. First, people are aware of how unequal the region currently is—falling far short of the distribution of income they consider desirable (figure O.7). This is accompanied by widespread perceptions of unfairness not only in the income distribution, but also in access to public services and rights (figure O.8). Moreover, whether people think that they are "winning" or "losing" from the system (whether they think that they are in the top 20 or bottom 20 of the income distribution) informs how fair they think the system is.

Figure O.7: Latin Americans generally know how unequal their societies are and desire a much more equal world

Objective, subjective, and desired distribution of income (% of income captured by each group)

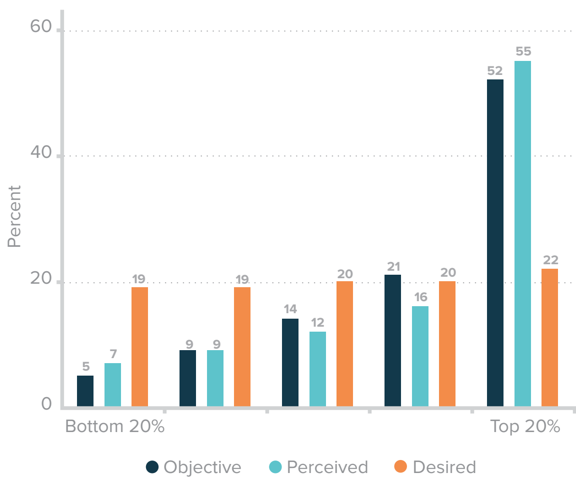
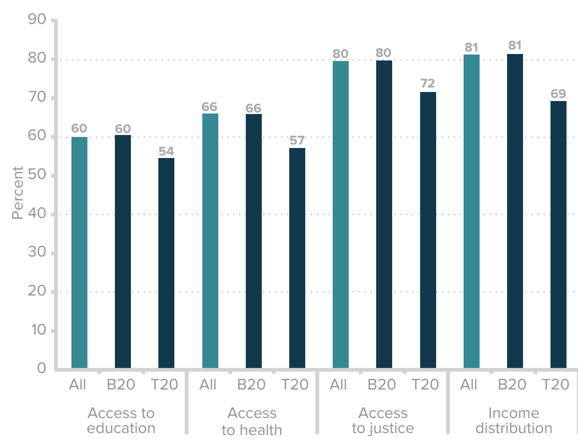


Figure O.8: Not only do they think their societies are unequal, but they also think that their societies are unfair

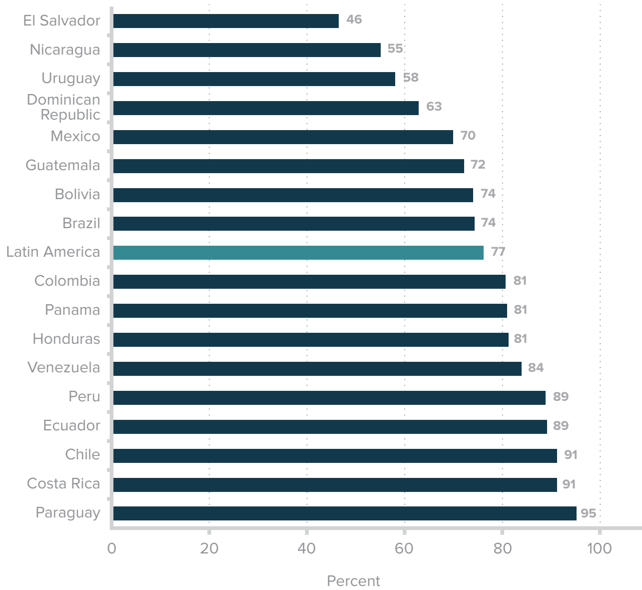
Share of respondents who think the system is unfair, by perceived place in the income distribution



People are frustrated not only about unfairness in outcomes, but also in processes—particularly about the outsized political influence of a few powerful groups. There is an overwhelming agreement among Latin Americans that their countries are governed in the interests of a few powerful groups and not for the greater good of all. In 2020, 77 percent of people in the region believed this to be so, and the share reached 95 percent in Paraguay and 91 percent in Chile and Costa Rica (figure O.9).

Figure O.9: These concerns run deeper to include a perception of unfairness in the underlying political process

Share of people who believe their countries are governed according to the interests of a few powerful groups



Perceptions of unfairness and inequality (in conjunction with where people think they fall along the income distribution) matter because they determine people's political attitudes and preferences for certain policies. For example, who should receive government transfers (figure O.10) and who should pay taxes (figure O.11). The perceptions data suggest that Latin Americans think that the tax burden should increase with income (with greater support for this view among those who think they are in the bottom 20 compared with the top 20, which poses an inherent political challenge) (figure O.12). Perceptions of unfairness and inequality can also determine different life paths. They can act as an incentive for effort if there is a conviction that better outcomes are attainable if more effort is exerted. However, if the aspirational reference seems too far away or unattainable, individuals can get discouraged, resulting in frustration and reasons for opting out of the social contract. Aspirations are built around the universe of possible futures that one may envision and the subset of these futures that seem achievable. Through their dynamic impact on the effort people choose to exert to realize them, on the types of investment decisions they make for themselves and their offspring, and on the broader trends in the preferences of society and in politics and policy, these aspirations contribute to reshaping future income and income distribution.

Figure O.10: Latin Americans agree that the poorest households should be more entitled to government support

By income decile, which households should receive free or subsidized government support in your country?

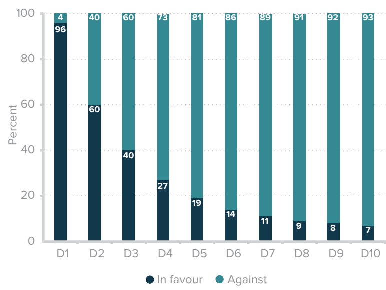


Figure O.11: Latin Americans agree that household responsibility to pay taxes rises with income

By income decile, which households should have to pay taxes in your country?

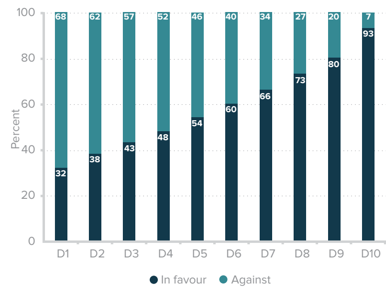
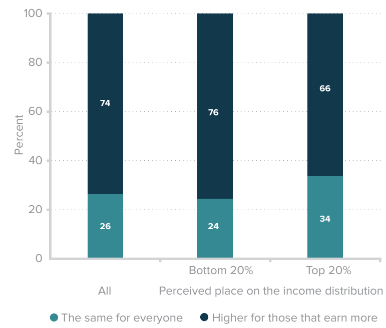


Figure O.12: Most Latin Americans think the tax rate should be higher for those who earn more

Share of respondents who agree with this statement



Chapter 3: Concentration of economic and political power

One of the most pernicious challenges of high inequality is the way that it concentrates power. The concentration of power in the hands of a few who defend their private interests rather than the public good is one of the factors that connect high inequality with low growth because it often results in distorted policies that are short-sighted and inefficient and in weak institutions. An overwhelming majority of people in the region think that this is the case, and about a quarter of them point to big business as the most influential powerful group.

This chapter explores the channels through which the concentration of power in the market contributes to sustaining high inequality and low growth in the region. It acknowledges that monopoly power and business political power are two sides of the same coin because monopoly rents translate into political power that, in turn, increases monopoly power, creating a vicious circle.

Indeed, markets in Latin America tend to be dominated by a small number of giant firms (figure O.13), and the region has historically been characterized by a high level of market power—a level to which other countries have recently begun to catch up (figure O.14).

Figure O.13: A small number of giant firms dominate Latin American markets

Revenues of top 50 firms (as % of GDP), selected countries, 2019

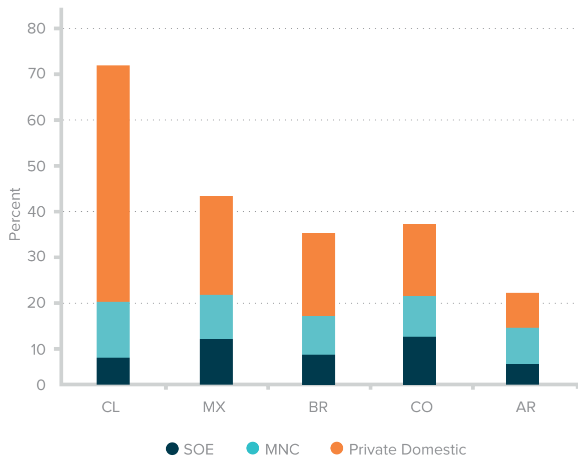
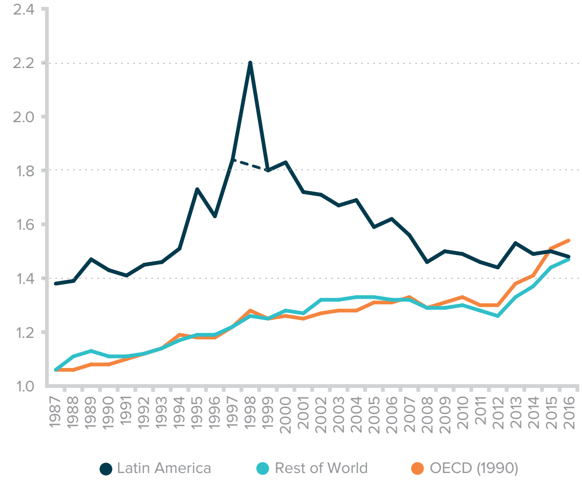


Figure O.14: Mark-ups in Latin America are higher than in the rest of the world and constant over time

Average mark-ups, Latin America, OECD and rest of the world, 1987–2015



Note: Average mark-ups by year are estimated as the year fixed effects from a linear regression on the average mark-up 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.

In the market sphere, there are three primary channels through which monopolies contribute to high inequality and low productivity growth: making consumers pay higher prices for goods and services than they would pay under competition (which hurts the poor more than the wealthy and redistributes from consumers and workers to business owners), allowing firms to forgo more efficient technology and hindering innovation because an uncontested monopolist has lower incentives to innovate. Competition policy (also referred to as "antitrust" or "antimonopoly" policy) is one policy lever that countries can use to contain monopoly power. All but two countries in Latin America have competition laws and authorities. In the Caribbean, in contrast, only four countries have them. Their absence in other Caribbean countries is somewhat compensated by a regional antitrust agency. However, no matter if there are competition laws or how strong they are on paper, they are only as effective as their enforcement. Despite progress over the last three decades, there is still a long way to go. Agencies often lack the required powers to investigate—for instance, through dawn raids—and are unable to offer attractive leniency agreements to promote whistleblowing among cartel members. They are also unable to contain abuses of market power and cartelization through adequate fines and penalties. Most of them also lack adequate personnel staffing in numbers and expertise. Depending on how their design and enforcement shape the de facto power of different firms, these laws have different efficiency and equity implications. The existence and effectiveness of competition laws and agencies are not exogenous to business political power. In contexts with close ties between political elites and business elites, factors such as the independence of the enforcement agency or commitment devices that ensure limited discretion in decision-making are essential for ensuring the efficacy of policies.

Big business political power also distorts policy beyond the market arena. Of particular concern in the context of the trap explored in this report are the effects on fiscal policy. A distinctive feature of fiscal systems in the region is their weak redistributive power (figure O.15). Gini indices in Latin America, with few exceptions, remain essentially unchanged after households pay taxes and receive government transfers. In addition, tax systems in the region fail to generate the necessary revenues to invest in development through the provision of quality services and public goods to the population. Indeed, LAC countries collect lower taxes as a share of GDP than countries at similar levels of development or inequality levels and also have a limited share of tax revenue from personal income taxes. While the pattern of low overall taxation and the relative scarcity of fiscal revenue from income tax collection are likely the result of different factors, one of them is the extent of corporate clout in the political sphere. Indeed, big business and business owners in Latin America are partly responsible for maintaining overall effective taxation low and steering fiscal systems away from more progressive taxation through their proximity to political power. This influence is exerted via their interference in tax reforms in ways ranging from blocking tax increases to business and business owners to compromising tax resources by pushing for exemptions and subsidies for their operations that crowd out redistributive spending.

Figure O.15: There is little redistribution through the fiscal system in LAC

Gini indices before and after taxes and transfers, circa 2014

Workers and, particularly, organized labour also have the power to distort policy in the market arena. However, the effect of labour unions on efficiency and equality in LAC is ambiguous. Unlike business elites, for which by and large the diagnostic is far from positive, unions are neither unequivocally “good” nor “bad”. Their impact in the region has been both positive and negative. In the political arena, they have three primary instruments to exert their influence. They can collude with big business and use their political power to reduce internal and external competition or obtain special tax treatments, subsidies, and privileges—ultimately perpetuating and exacerbating inequality and inefficiency. Alternatively, they can use their political power to introduce across the board protective regulations (such as minimum wages and severance payments) and lobby the government to devote more resources to their enforcement, a crucial concern in a region characterized by the widespread violation of labour and social security regulations. Here again, however, effects can be mixed because unions may only care about enforcement in large firms where their affiliates are present, leaving other workers without protection. In this case, unions can reduce inequality between firm owners and workers, but exacerbate it among workers. Finally, organized labour can oppose, delegitimize, and destabilize dictatorships or collaborate with them.

The fact that labour unions have ambiguous effects on development outcomes in LAC is consistent with the findings from a much larger body of literature on the economic impact of labour unions in Europe and North America. However, what we know about this issue in the specific context of the LAC region is still limited. There is only a partial theoretical understanding of how labour unions affect LAC societies; there is a lack of robust empirical evidence because data are usually limited, and causal inference particularly challenging; and there is relatively little research on labour unions as economic actors in LAC. Understanding the different impacts of labour unions on development outcomes in the region thus remains an open and important research agenda moving forward.

In sum, the chapter critically highlights how monopoly power and market concentration can translate into rent-seeking behaviours and, ultimately, into business political power. In the LAC region, this has led to multiple examples of economic elites interfering in policy design or implementation. In response to this interference, fiscal systems, competition policy, and market regulations have often been shaped to benefit a small group of citizens rather than the public good. Economic elites have seldom used their political power to push for reforms that would put their countries on a development path, increasing welfare for all. But they could.

Ultimately, sustainably moving out of the high-inequality, low-growth trap will require actions that tend to rebalance power. There is no single policy solution for addressing these types of power asymmetries and the distortions they create in both the market arena and the fiscal system. Depending on the context, however, efforts, such as regulating campaign financing and lobbying activities, strengthening the power and independence of competition policy and competition agencies, revising market regulations to eliminate those that favour private interests and not the general good, or taking seriously the global conversation about how to tax the super-rich, could all play important roles in moving this agenda forward.

Chapter 4: The Links between Violence, Inequality and Productivity

Violence remains all too common for many people across LAC. The region is home to only 9 percent of the world's population, but currently accounts for 34 percent of total violent deaths. LAC countries also struggle with non-lethal forms of violence, including sexual violence, robberies, police abuse, and human trafficking.

Greater inequality may foster the conditions for more violence through three distinct channels. First, greater disparities are likely to introduce incentives that make the returns to illegal activities comparatively more attractive than the returns to legal alternatives, particularly if enforcement in weak. Second, inequality engenders frustration and alienation among the dispossessed through perceptions of disadvantage, a lack of opportunity, and unfairness, which, together, spur violence. In the absence of effective governance mechanisms to process them peacefully, tensions created by perceptions of unfairness that weaken and tear at the social fabric over time often result in violence or the threat of violence as a means of "exit". When people perceive that the system is rigged in favour of a few (as is the case in LAC), they often lose faith in the capacity of "voice" as a means to reach and sustain new agreements. Third, inequalities in power, social status, and income make some population groups—such as women and gender and ethnic minorities—particularly vulnerable to violence. LAC currently grapples with violence associated with each of these three paths. Indeed, violence or the threat of violence has become a bargaining chip among state and non-state actors in various contexts to reach and sustain agreements, and it is thus a fundamental part of the struggle over the distribution of resources, rights, opportunities, and power in the region. Violence is therefore a common underlying factor that both propels and is driven by the region's high-inequality, low-growth trap.

While greater inequality can spur violence, violence can also increase inequality through its effects on developmental outcomes. Because it is often experienced disproportionately by populations already facing socio-economic adversities, it contributes to amplifying or perpetuating the state of deprivation of these populations. Violence often leads to the deterioration of rights and liberties, worsens physical and mental health, reduces educational and labour participation outcomes, and lowers political participation among victimized individuals. Violence can also fracture social capital, threaten democratic institutions locally and nationally, and obstruct public goods provision in victimized communities.

Violence is likewise linked to lower economic growth. It can reduce and distort investment by causing uncertainty about property rights, affect human capital formation and thus productivity, and destroy physical and natural capital.

LAC is the most violent region in the world (as measured by homicides; see figure O.16). Moreover, the countries in LAC exhibit vastly higher homicide and crime victimization rates than other countries at similar levels of inequality (figure O.17). To gather a broader understanding of how violence afflicts people in LAC, this chapter follows a typology to disentangle the following three types of violence: criminal violence (interpersonal or collective violence linked to criminal activities), political violence (interpersonal and collective violence that occurs in relation to socio-political agendas), and social and domestic violence (interpersonal and occasionally collective violence linked to conflicts among people who do not live in the same household [social] as well as those who do [domestic]).

Figure O.16: While LAC is home to only 9% of the global population, it concentrates one third of global homicides

Intentional Homicide Rate per 100,000 inhabitants in world regions and LAC subregions

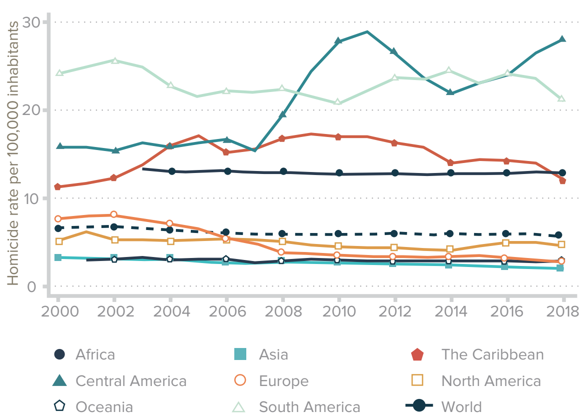
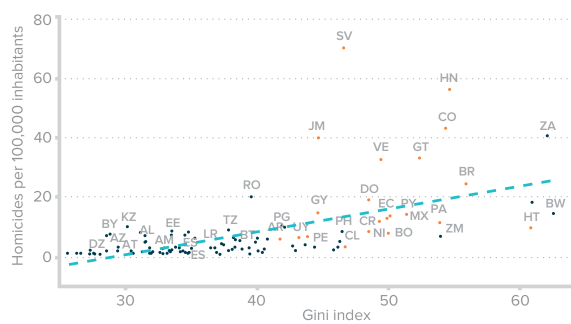


Figure O.17: LAC countries have higher homicide rates than countries with similar inequality levels

Homicide Rates and Income Inequality (Gini) – World (1995-2017)

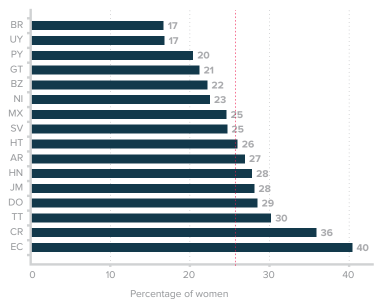


Note: LAC countries are represented by orange dots. Averages are calculated for each country using the available year observations from 1995 to 2017. The total number of countries is 106: Africa (21), Asia (24), Eastern Europe (21), LAC (21), North America (2) , Oceania (1), and Western Europe (16).

Different patterns broadly emerge for each of these different types of violence. While the 20th Century was largely characterized by patterns of political violence, this shifted more towards organized crime in the early 2000s (primarily associated with groups involved in illicit or illegal commercial activities, such as drug trafficking). However, the region still struggles with political violence, including violent protest; acts of state violence, such as police brutality, extrajudicial killings, and violent repression of protest; and violence against human rights defenders, environmental activists, politicians, and journalists. Social and domestic violence is also widespread in the region and particularly affects women (figures O.18 and O.19). This type of violence often manifests in different ways, including physical, sexual, and psychological abuse, and can be motivated by the victim's sex, gender identity, or sexual orientation. Both social violence and domestic violence are serious problems in LAC. Indeed, the region has some of the highest rates in the world of sexual violence and violence against LGBT+ populations, and femicide is a critical issue in many countries in the region (figure O.20). Acts of social or domestic violence also affect children and the elderly within the home and have been an area of increasing concern during COVID-19 lockdowns.

Figure O.18: Intimate partner violence against women in the region is widespread

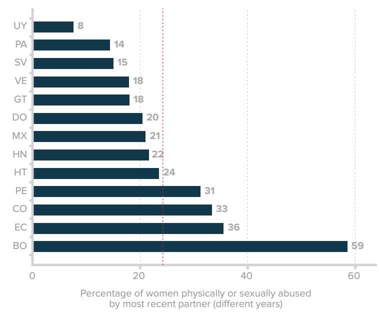
Percentage of women physically or sexually abused by any partner (last available year, 2003–2017)



Note: The dotted red line indicates the LAC average.

Figure O.19: In most countries more than 1 woman in 10 has been sexually or physically abused by her most recent partner

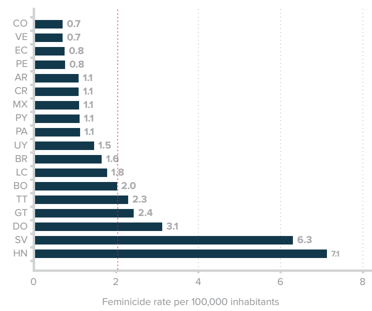
Percentage of women physically or sexually abused by most recent partner (last available year, 2003–2017)



Note: The dotted red line indicates the LAC average.

Figure O.20: Within LAC, Central America is the subregion with the highest levels of femicide

Average femicide rate per 100,000 inhabitants in LAC countries (2000–2019)



Note: The dotted red line indicates the LAC average.

Progress is possible, though it will only be achieved if the policies adopted address the underlying imbalances of power between actors to foster conditions in which conflicts may be settled through peaceful rather than violent mechanisms. There is no single policy solution that will work to address violence. This chapter highlights a few priority areas that may be more or less relevant depending on the context (see box 4.6). If these are successfully dealt with, progress in combating violence may pave the way towards more equal, more productive, and more peaceful societies.

Chapter 5: How effective are social protection policies in LAC?

Many policies have been implemented in the region to address inequality and low productivity, but with limited success. Given the political incentives for short-term policy solutions to combat the challenges of high-inequality and low-productivity, policy responses tend to be fragmented and ineffective and, in some cases, can even end up deepening existing distortions. Indeed, some of them have generated dynamics that have resulted in exacerbated inequalities and stagnated productivity. This chapter argues that only by considering how the different components of social protection policy interact between themselves and with other public policies will it be possible to design better ones. While there are many different possible entry points, this report highlights one that jointly addresses many of these different elements and can serve to break free from the high-inequality, low-growth trap: universal social protection systems, more specifically, universal social protection systems that are more inclusive and redistributive, fiscally sustainable, and friendlier to growth.

The current structure of social protection in the region (comprised of both social insurance and social assistance programmes) remains fragmented. While contributory social insurance is a cornerstone of social protection in LAC, many workers are left out. This segments the labour force into two categories: formal workers, covered by contributory social insurance (CSI) programmes, job stability and minimum wage regulations, and informal workers, receiving whatever benefits are offered by non-contributory social insurance (NCSI) programmes. The formal-informal segmentation of the labour force is a central feature of labour markets in LAC and results from a mix of legal exclusions and non-compliance. Segmented labour markets are not only a source of inequality, but also one of the contributing factors in low productivity growth. In parallel, some worker incomes may be so low as to place the workers in poverty, requiring additional programmes to increase their consumption (social assistance programmes). Thus, in a stylized representation of the structure of social protection in the region, access to social protection depends both on workers' labour market status (formal vs informal) and their income level (poor and non-poor) (figure O.21). In most LAC countries, there are more informal than poor workers (figure O.22). On the other hand, most poor workers are informal. Many workers frequently transition between formality and informality.

Figure O.21: The structure of social protection: Poverty and informality are not the same

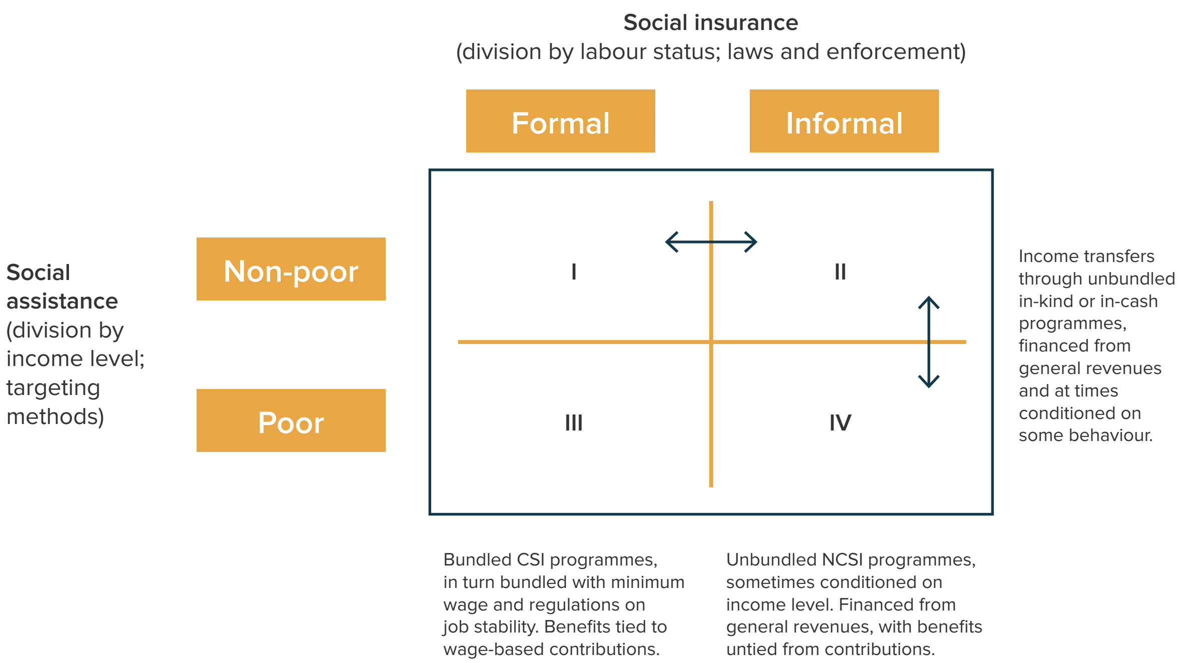
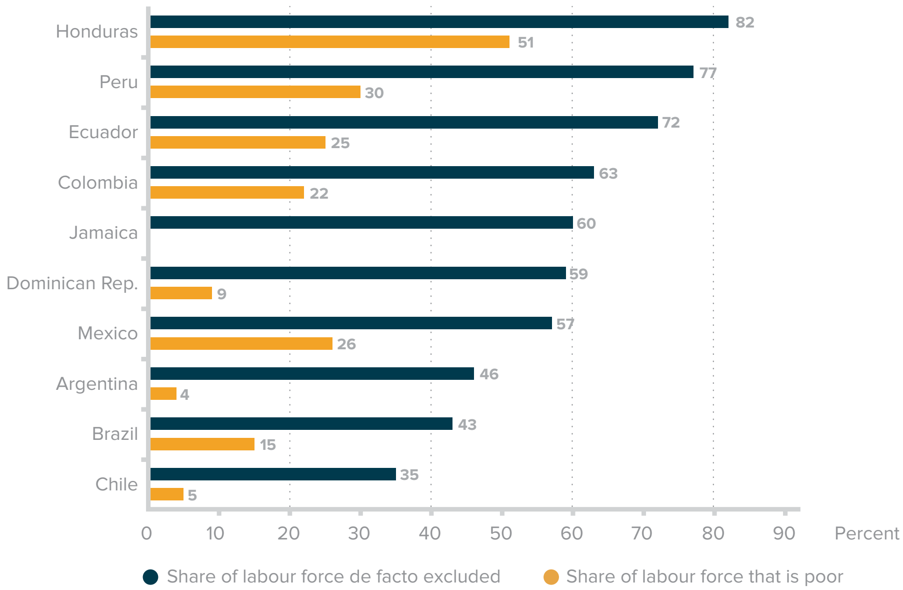


Figure O.22: Large shares of the labour force in LAC remain excluded from important social protection programmes

Share of the labour force excluded from CSI, selected LAC countries



Because of the fragmented nature of this system, households in the region (particularly low-income ones) bear many more risks on their own or through the network of family and friends than in countries of the Organisation for Economic Co-operation and Development (OECD), where these risks are more broadly shared. The mix of contributory and non-contributory pension and health programmes across the region, coupled with transitions between formal and informal status, asymmetries in the time spent in formality between low- and high-wage workers, and, at times, capricious rules and conditions for access, generates two outcomes: reduced efficacy of insurance and contradictory impacts on inequality. Social insurance and social assistance are complements and not substitutes in a working social protection system. Poor households need income transfers and insurance, not one or the other. And, for non-poor households, social insurance is key, especially if they are in a vulnerable position. Rather than acting ex ante to prevent poverty, at present, policies react ex post to ameliorate poverty once it is here. In LAC, poverty rates have fallen in large part because households receive income transfers, and not so much because poor household own-earned income has increased. The region should not expect targeted transfers on their own to eliminate poverty. These transfers must be more well integrated with social insurance policies, covering all the poor and non-poor under the same conditions and with the same level of quality.

The social protection architecture needs not only to support household welfare but also to incentivize workers and firms in a way that advances productivity. The interface between CSI and NCSI and poverty programmes impacts the decisions of workers and firms to be formal or informal, and the region's current social protection systems tend to tax formality, while subsidizing informality. Table O.1 lists the costs and benefits of formality, legal informality, and illegal informality. Note that legal informality is only relevant in countries where laws exclude some workers from the obligation to contribute to CSI programmes, as well as some firms, depending on their size or the type of work contracts they offer. In other words, in some countries, such as Ecuador, Honduras, Mexico and Peru, the three columns are relevant, while, in others, such as Argentina and Jamaica, the middle one is not. Looking at case studies of 10 individual countries in the region, one may see that the tax on formality increases as the actual benefits derived by workers from CSI programmes fall short of the costs and that the subsidy to informality increases with the generosity or quality of NCSI programmes (and social assistance programmes conditioned on informal status). This matters because informality is worrisome for social protection for three reasons. First, informal workers are less well protected from risks and in general receive lower-quality services than formal ones. Second, it is more difficult for poor informal workers to escape poverty and, if they do, to avoid falling back into it. Third, informality is strongly associated with self-employment or employment in small low-productivity businesses, which is a critical factor determining worker earnings (and also a critical factor in long-term growth).

Table O.1: The interface of different social protection programmes shapes the decisions of firms and workers regarding (in)formality

Formality	Legal Informality	Illegal Informality
Workers	Workers	Workers
Must pay a share of CSI contributions (full share if self-employed), but may not fully value the stipulated benefits	Self-employed, domestic, rural and others not required to contribute	Self-employed and others required to contribute to CSI may pay fines depending on enforcement and tacitly accepted social norms
Paid at least the minimum wage	Free NCSI benefits	Free NCSI benefits
In principle protected by job stability regulations, but access may be erratic	If poor, may also receive targeted transfers	If poor, may also receive targeted transfers
If poor, may lose targeted transfers		
Firms	Firms	Firms
Must pay their share of CSI contributions and pay workers at least the minimum wage	Not bound by CSI, minimum wage, or job stability regulations if there is no dependency relationship with workers, or if this relationship is ambiguous (particularly if the firm is small)	Pay fines if detected evading CSI, minimum wage and job stability regulations
Bear the expected costs of job stability regulations	Fuzzy border between self-employed and micro-firm, particularly if workers are unremunerated relatives	Enforcement dependent on size, at times substituted by tacitly accepted social norms

Throughout the region and with variation across countries, social protection policies segment the labour market, provide erratic protection to households against risks, do not redistribute income sufficiently towards lower-income groups and sometimes do so in the opposite direction, and bias the allocation of resources in ways that punish productivity and long-term growth. This situation is worrisome because social protection is one of the key tools to mitigate inequalities and foster social inclusion. It is difficult to think of a strong social contract in any society without a well-functioning social protection system. One cannot expect social inclusion from institutions and policies that segment. Looking forward, a key guiding principle for social protection in the region must be universality with respect to the relevant population, understood in three complementary dimensions: (1) the entire population exposed to a given risk needs to be covered through the same programme; (2) the source of financing should be the same for each programme based on the type of risk covered; and (3) if programmes provide benefits in kind, the quality should be the same for all. A social protection system built around this principle offers the region a route to increasing spending in social protection, while strengthening the foundations of long-term growth and a path to enhancing social inclusion.

The Way Forward

In late 2019, LAC returned, after many decades, to the map of social unrest with rising protests and demands for change. Throughout 2020 and 2021, LAC became a hotspot for COVID-19; despite rapid action and strict confinement measures, countries suffered a disproportionate burden of cases and deaths. This brought with it multiple economic and social crises, including a contracting economy with limited fiscal space, alongside rising poverty and hunger. This is a reflection of the political, economic, and social fragility bred by the vicious trap with which this report engages. The sustained combination of high inequality and limited growth can generate a fragile equilibrium because governments are unable to meet their fiscal needs and citizens are unable to achieve their aspirations for the lives that they have reason to value. Despite the region's hard-won progress towards becoming a middle-income region in recent decades, the dynamics of this trap have made this progress unstable, and the recent crises have shown how quickly reversals can occur. In the wake of this current crisis, rebuilding what the region had gained may take a long time. If future progress towards development is to be more sustainable, we must first address these underlying structural challenges that have for so long kept this trap in motion. This report is deliberately broad in terms of policy prescriptions. The UNDP network, covering more than 40 countries and territories in the LAC region, will continue to work with governments and non-governmental actors to discuss, draw lessons, and propose concrete paths of action in each context. This is the beginning of a fundamental conversation to define a renewed, prosperous, inclusive, and sustainable social pact in our region.