

Executive
summary

Unlocking growth in a changing world

Innovation, Integration, and Formalization
for Latin America and the Caribbean

CAF DEVELOPMENT BANK
OF LATIN AMERICA
AND THE CARIBBEAN



Latin
America and
the Caribbean

Each path is
an opportunity



Unlocking growth in a changing world

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Title

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The development problem for Latin America and the Caribbean

Latin America and the Caribbean (LAC) is marked by incomplete development. The region has achieved meaningful progress in areas such as democratic consolidation, macroeconomic stability, poverty reduction, and social protection expansion. Yet, when compared with more advanced economies, substantial development gaps persist.

The most critical expression of this underdevelopment is the large and persistent gap in per capita income relative to the developed world. For this reason, the report places economic growth at the core of the development agenda. This emphasis is not in opposition to other development priorities—on the contrary, it is grounded in the profound links between growth, social inclusion, and environmental sustainability. Removing the barriers to growth is an essential precondition for unlocking sustainable development.

To examine this challenge, this Executive Summary is structured in five sections. The first section establishes that the region's historically limited growth results partly from insufficient accumulation of physical and human capital, but fundamentally from chronic productivity stagnation.

The second section links the region's growth deficit to three critical structural obstacles: high informality, low innovation, and limited international integration.

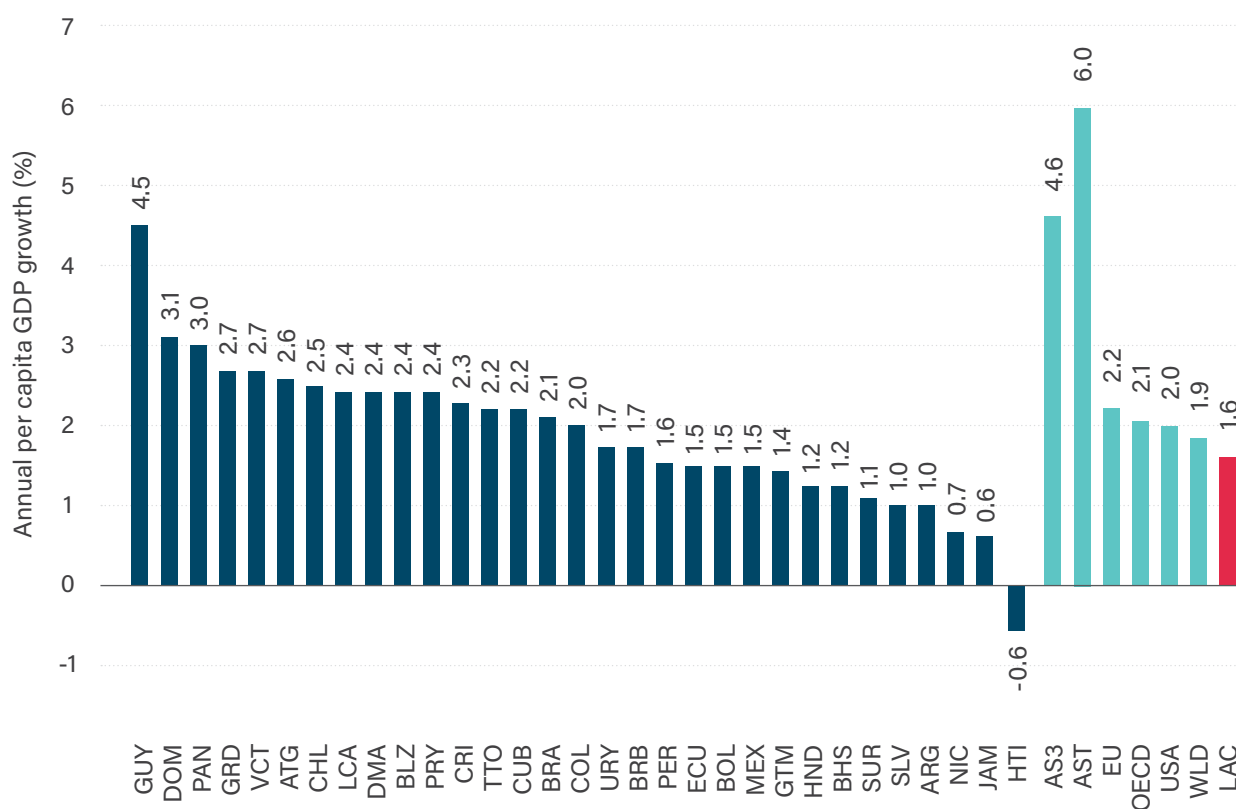
The third section looks ahead, identifying strategic opportunities within a challenging global context. Today, the region's natural wealth converges with digitalization and the green transition, opening pathways for sectors such as modernized agriculture and sustainable mining. In addition to capturing opportunities in these sectors, full development requires leveraging existing capacities to drive diversification and the development of a robust service sector, which will play a central role as a provider of critical inputs and jobs. At the same time, the geopolitical landscape highlights the value of strategic partnerships, especially with the European Union (EU), to access markets, financing, and knowledge.

To seize these opportunities and to foster productivity-based growth, the fourth section outlines a policy agenda specifically aimed at reducing informality, fostering innovation, and deepening international integration. Finally, the fifth section addresses the foundations required for any strategy to succeed: an agile state, sound public finances, and social consensus to ensure the viability of reforms.

An urgent need for robust growth

Since 1960, LAC's average annual GDP per capita growth rate has been just 1.6%, lagging behind the world average (1.9%), EU member countries (2.2%), the United States (2%), and Asian Tigers (6%) (Graph 1).¹ Only 12 of the 31 LAC countries grew faster than the EU average, and only five exceeded it by more than half a percentage point—a difference so small that, at that pace, it would take two centuries to close the per capita income gap with respect to the EU. Currently, the region's GDP per capita is barely one-third of the OECD average and about one-quarter of the US level.

Graph 1
A history of slow economic growth



Note: Bars show the geometric average growth rate in per capita GDP for the 1960–2024 period. AS3 includes the ASEAN countries (Association of Southeast Asian Nations), as well as China, Japan, and South Korea.

Source: Authors based on World Bank (2025).

1. Within the region, there are examples of relative success. For instance, Panama and the Dominican Republic had per capita incomes equivalent to just 26% and 16% of the US in 1990, respectively. By 2023, these figures had climbed to 49% and 31%.

The region must pursue not only convergence with the income levels of developed economies but also eradicate internal subnational disparities. LAC exhibits profound territorial inequalities reflected in large income gaps between leading urban hubs and outlying areas (Alves, 2021). These territorial divides are not merely a matter of equity—they constitute a structural barrier to growth. Low productivity in lagging territories prevents local talent from reaching its maximum potential, while isolated firms struggle to achieve economies of scale or benefit from agglomeration dynamics. Likewise, individuals in remote areas face limited opportunities to accumulate human capital.²

This internal gap points to deep structural barriers that call for a place-based strategy focused on unlocking each region's potential through strategic investments in three areas: physical and digital connectivity, human capital, and local institutional capacities.

Sources of the GDP growth

Economic growth hinges on two forces: on the one hand, by accumulating high-quality physical and human capital, and on the other, by continuously improving the efficiency with which these assets are used.

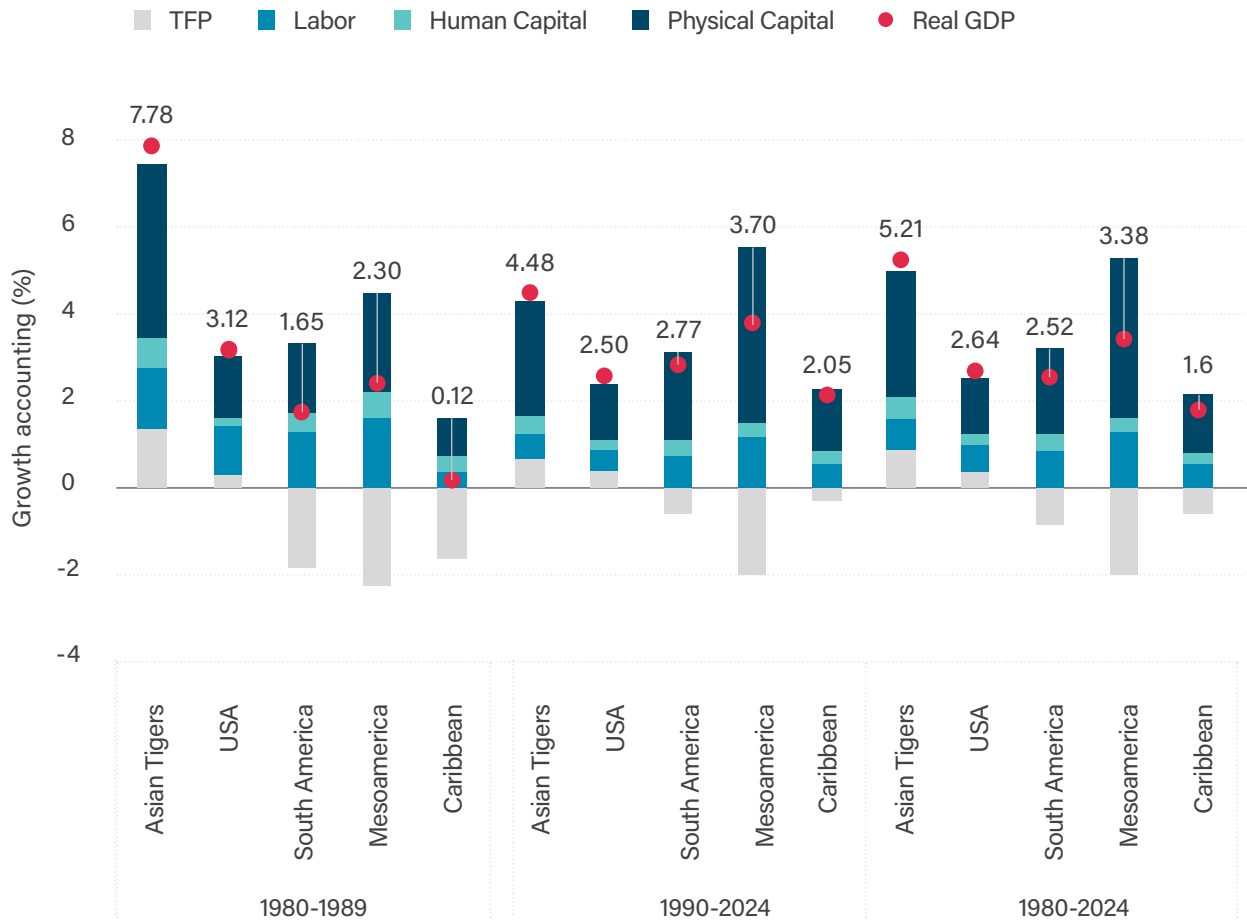
Over the past decades, growth in LAC has been driven by factor accumulation, with no contribution from Total Factor Productivity (TFP).³ In contrast, in countries that closed the per capita GDP gap with the developed world, such as the Asian Tigers, factor accumulation and intense TFP growth fueled growth (Graph 2).

Currently, TFP levels in South and Mesoamerica stand below 60% of the US level, and around 50% in the Caribbean, whereas Asian Tigers approach 80%.

A common argument attributes the region's productivity lag to an economic structure concentrated in low-productivity sectors. However, productivity is low across nearly all sectors. Indeed, value added per worker is low in commerce (34% of the US level) and agriculture (30%), the two largest employment sectors (23% and 15% of regional employment, respectively). Yet, value added per worker is similarly low in other sectors: below 40% of the U.S. level in key services—such as finance, transport, and business services—and in mining, and below 20% in manufacturing. The core challenge is therefore to raise productivity across the board.

-
2. As de la Mata et al. (2022) find, children of parents without high school education are 20 percentage points more likely to complete school themselves if they live in an urban relative to a rural area. Territorial disparities are not merely a snapshot of underdevelopment, but a powerful mechanism for its perpetuation.
 3. Conceptually, aggregate productivity is a measure of how efficiently economies employ their factors of production. It depends, on the one hand, on the efficiency of all the firms that make up the economy, and on the other, on how these factors are allocated among them. In growth and development accounting exercises, Total Factor Productivity (TFP) is calculated as a residual. As such, this measure inevitably captures not only productive and allocative efficiency but also other factors such as measurement errors or capacity utilization. However, there is a broad consensus that productivity plays a leading role in explaining growth differences and income levels across countries.

Graph 2
Growth accounting by region (1980-2024)



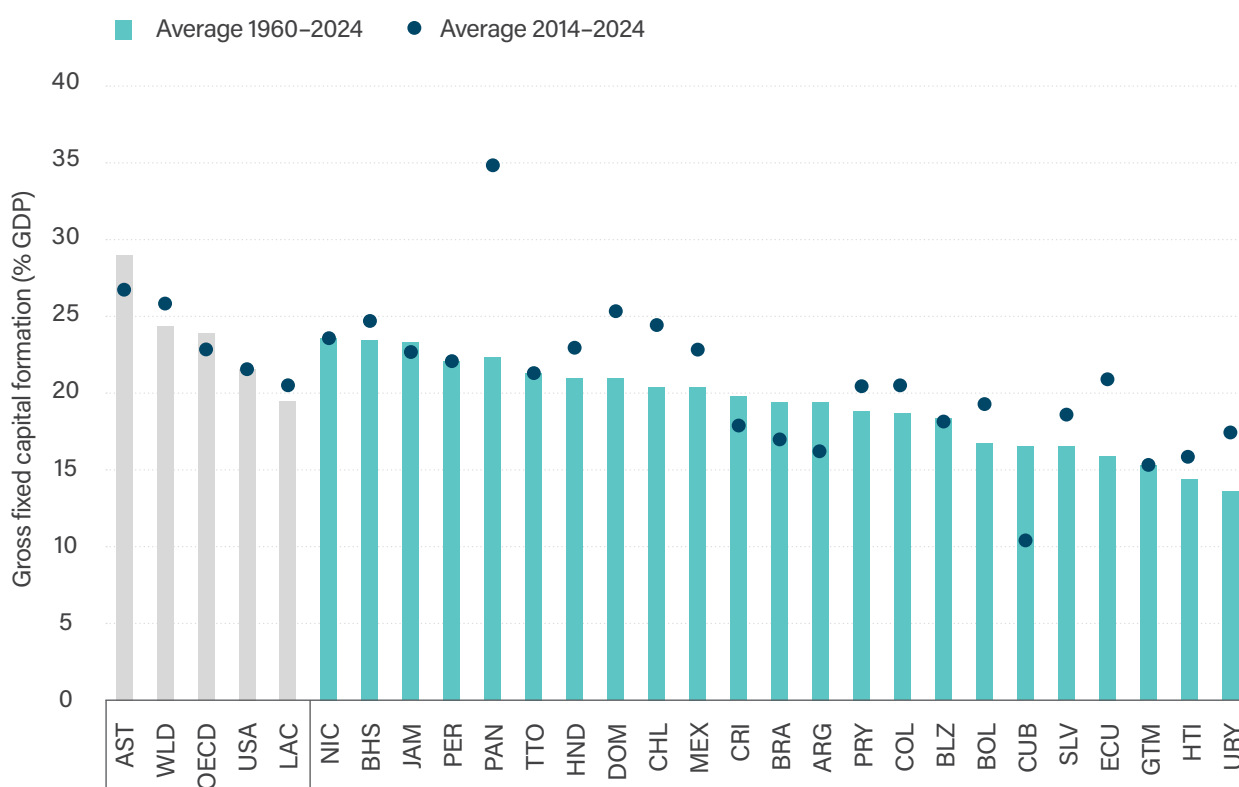
Note: The values shown for each period represent simple averages across years. The figures for the Asian Tigers and LAC subregions are also simple averages across the countries included in each group. The Asian Tigers group comprises South Korea, Taiwan, Hong Kong, and Singapore. South America includes Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Paraguay, Peru, Uruguay, and Venezuela. Mesoamerica comprises Costa Rica, Guatemala, and Mexico. The Caribbean includes the Dominican Republic, Jamaica, and Trinidad and Tobago. The components of growth accounting correspond to the following variables in the underlying databases: human capital refers to the Contribution of Labor Quality to real GDP growth; physical capital to the Contribution of Total Capital Services to real GDP growth; labor to the Contribution of Labor Quantity to real GDP growth; and TFP to the Growth of Total Factor Productivity. Real GDP growth is measured as the Growth in real GDP.

Source: Author based on The Conference Board (2024).

The fact that regional growth has been driven by physical and human capital accumulation does not imply the absence of gaps in these inputs. On the contrary, on this front, LAC also exhibits structural weaknesses that must be addressed.

Gross fixed capital formation as a share of GDP has consistently trailed global averages, developed countries, and high-growth countries such as the Asian Tigers (Graph 3). This translates directly into a reduced endowment of machinery, technology, and infrastructure per worker, limiting productivity and global competitiveness. Currently, capital per worker for South America, Mesoamerica, and the Caribbean represents 0.3%, 0.3%, and 0.5% of the U.S. level. Without a major increase in public and private investment, equipment and infrastructure gaps will continue to constrain growth.

Graph 3
Gross fixed capital formation (% of GDP)



Note: Gross fixed capital formation refers to acquisitions less disposals of fixed assets during the accounting period, including specified expenditures on services that increase the value of non-produced assets. The indicator is expressed as a percentage of Gross Domestic Product (GDP), defined as the total income generated through the production of goods and services within an economic territory during an accounting period. The OECD region excludes all Latin American countries.

Source: Authors based on World Bank (2024b).

Human capital shows similar weaknesses. While LAC achieved universal enrollment in primary and lower secondary education, critical challenges remain. Upper-secondary education is plagued by low enrollment and high dropout rates, while access to tertiary education and technical training remains limited. This translates to lower educational attainment: average years of schooling in the region represent less than 10 years, compared to over 12 in the OECD and almost 14 for the US (Graph 4, Panel A).

Moreover, the region exhibits severe deficits in educational quality, evidenced by the large share of students lacking basic cognitive competencies in PISA assessments. Although these deficits are substantial across all socioeconomic groups, they display a clear socioeconomic gradient. In Brazil, for example, the share of students who fail to reach basic proficiency in mathematics is around 50% among the richest quartile and reaches nearly 90% among the poorest. This stark quality gap across socioeconomic groups perpetuates intergenerational inequalities (Graph 4, Panel B).

The region also faces a critical shortage of digital skills required for innovation and digital transformation. Fewer than 20% of higher-education graduates specialize in STEM fields, versus nearly 30% in East Asia and the Pacific or the Middle East and North Africa (WIPO, 2024). Likewise, PIAAC data suggests a scarcity of digital skills among salaried workers in countries of the region and even more acute deficits among informal workers (OECD, 2021).

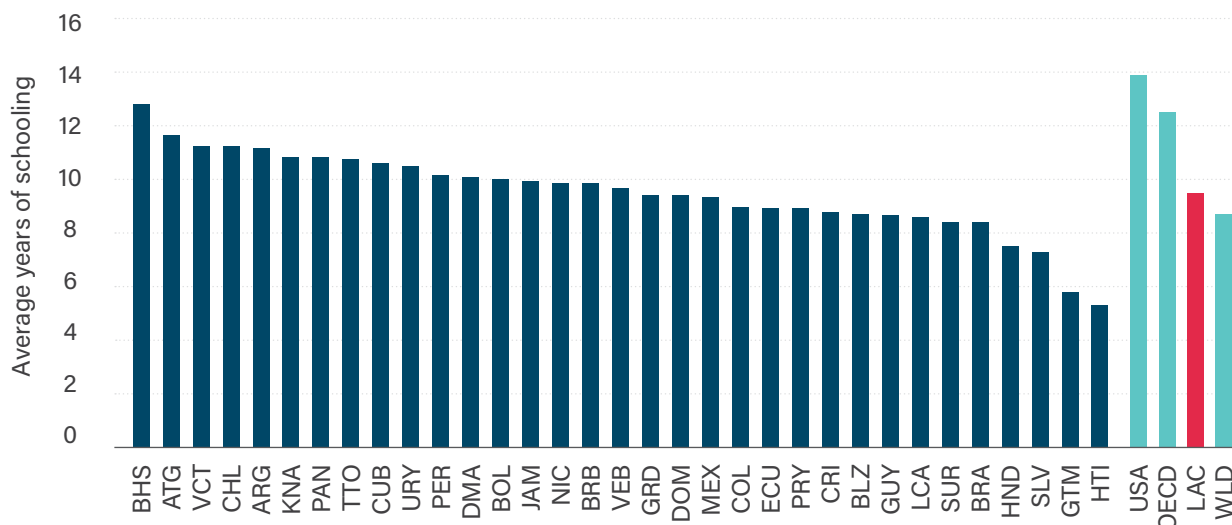
The diagnosis delivers a clear message: sustained growth requires improving both the quantity and quality of physical and human capital, but this alone is insufficient. Differences in productivity explain most of the income differences between countries (Hsieh and Klenow, 2010).

Moreover, factor accumulation and productivity growth reinforce each other. Investment is a key enabler of Total Factor Productivity (TFP) growth, as economies incorporate technological advances embodied in new capital goods and machinery. Higher productivity, in turn, raises the returns on investment, encouraging firms to accumulate more physical capital. The same logic applies to human capital: a more skilled workforce facilitates innovation and productivity growth, while higher productivity increases the returns to skill formation. Igniting this virtuous cycle is essential for achieving sustained development.

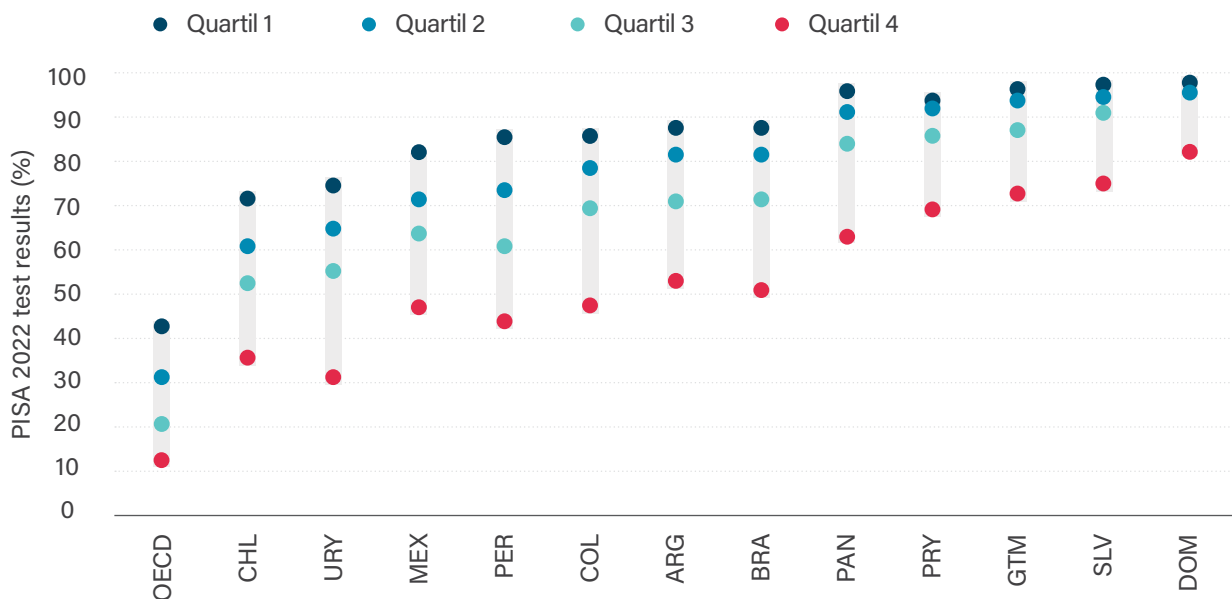
Graph 4

Two dimensions of human capital: years of schooling and PISA scores by country

Panel A. Average years of schooling by country



Panel B. Quality of education: PISA 2022 test results by socioeconomic level



Note: Panel A presents the average number of years that adults in a country have spent in formal education. OECD figures exclude LAC countries. Panel B shows the percentage of students who do not reach a minimum level of performance in mathematics in the PISA 2022 tests, by socioeconomic level (ESCS socioeconomic status index quartile). The ESCS (economic, social, and cultural status) index is derived from students’ responses on household possessions and their parents’ education and occupation.

Source: Authors based on OECD (2023) and UNDP (2025).

The three factors linked to the region's income lag

While the root causes of the region's low productivity and growth are deep and manifold, three phenomena are particularly relevant to understanding these dynamics in LAC: high informality, low innovation, and limited international integration. Addressing these immediate manifestations provides the basis for an actionable policy agenda.

Informality: A pervasive drag on productivity and inclusion

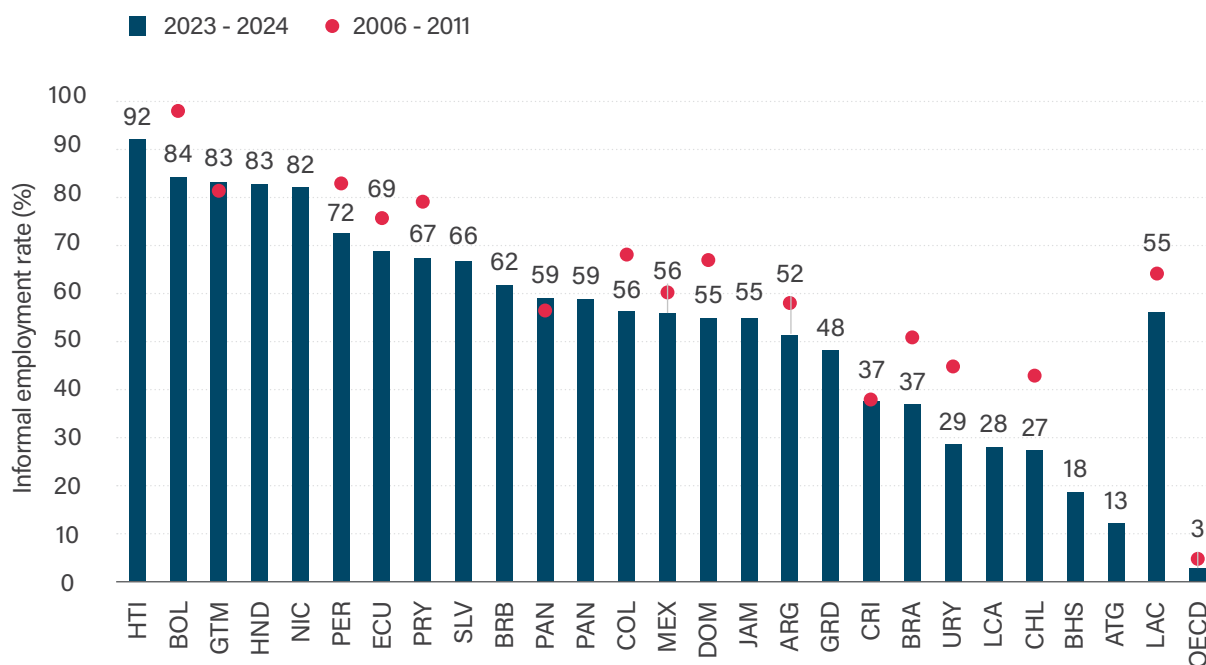
Informality is a structural and defining feature of LAC that weighs heavily on growth. It refers to the degree to which economic activities comply with the regulations that governments establish. By operating informally, workers and firms avoid taxes and other regulatory costs. However, informality has a large and pervasive impact on aggregate productivity growth and inequality.

Informality appears along two margins. First, economic units (employers or self-employed) may operate entirely without registration. Comparable data on the share of formally registered firms is scarce, yet evidence from Mexico shows that more than 90% of firms with five workers or fewer are not formally registered, and over 70% of firms with 6–10 workers. Rates decline for larger firms but remain substantial. Patterns are consistent across the region: in Colombia, 82% of firms were not registered in the corresponding chamber of commerce in 2022; in Peru, 84.8% of micro and small enterprises (MSE) lack a National Taxpayer Registry; and in the Dominican Republic, roughly 85% of micro, small, and medium enterprises (MSME) are unregistered.

Second, the fact that an economic unit is registered does not guarantee that it complies with regulations, including registering its employees. Labor informality is one of the most commonly used and comparable indicators across countries. It captures the share of the workforce (salaried and self-employed) without social security coverage, regardless of a firm's legal status. On average, labor informality in LAC stands at 55%, compared to 3% in the OECD.⁴ This average masks marked heterogeneity: Haiti (92%), Bolivia (84%), and Guatemala (83%) are at one extreme, while Antigua and Barbuda (13%) and the Bahamas (18%) in the Caribbean and Chile (27%) and Uruguay (29%) in South America are at the other (Graph 5). In any case, labor informality in LAC is typically higher than in countries with similar income levels in other regions; this is referred to as an "excess of informality." Although most countries reduced informality during the 2000s, that progress has since stalled, underscoring its structural nature.

4. The share of informal labor attributable to formally registered firms is considerable, accounting for 56% in Mexico, at least 40% in Brazil, and 32% in Peru (Samaniego de la Parra and Bujanda, 2024; Ulyssea, 2018; Cisneros-Acevedo, 2022).

Graph 5
Informal employment rate (%)



Note: The graph shows the most recent available rate of informal employment for each country (2023 or 2024), along with the corresponding rate from the 2006–2011 period. For the following countries, the most recent data correspond to earlier years: Haiti (2012), Honduras (2017), Nicaragua (2012), Barbados (2016), Bahamas (2019), and Antigua and Barbuda (2018). The LAC average for the most recent period includes all countries in the sample. OECD figures exclude LAC countries. Informality is defined using the ILO’s harmonized indicator, based on the employment status and characteristics of a worker’s main job.

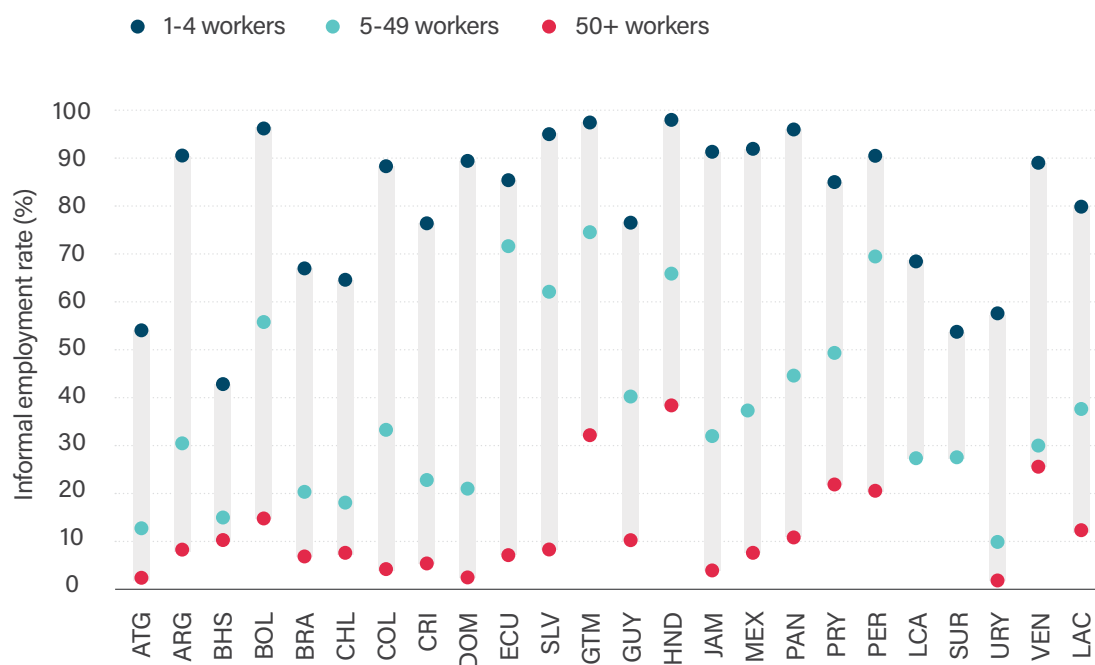
Source: Authors based on ILOSTAT data (ILO, 2025d).

The prevalence of self-employment—averaging 39% of total employment, and ranging from 22% in Barbados to 66% in Bolivia—offers a clear reflection of labor informality in LAC. For most, informal self-employment is not an entrepreneurial choice but a means of subsistence.⁵

Firm size is also a key determinant of labor informality: micro and small enterprises with 1–4 workers are four times more likely to be informal than firms with over 50 workers. However, in LAC, labor informality is significant even in large firms. In Honduras, Paraguay, Peru, and Venezuela, for example, the rate of informal wage earners in firms with more than 50 workers exceeds 20% (Graph 6). Informality also varies widely across sectors. Agriculture and commerce stand out as critical hotspots: they not only exhibit informality rates above the national average but also employ a large share of workers, concentrating the bulk of informal employment.

5. The labor informality rate among the self-employed is particularly high in countries like Paraguay, Colombia, and Bolivia, where it exceeds 90%. In countries such as Argentina and Brazil, the rate is lower but still remains above 65% (Álvarez et al., 2020).

Graph 6
Informal employment rate by firm size (%)



Note: The graph displays the most recent available rate of informal employment by firm size category for each country (2023 or 2024). Informality is defined using the ILO’s harmonized indicator, based on employment status and the characteristics of a worker’s main job. For the following countries, the latest available data refer to an earlier year: Bahamas (2019), Honduras (2017), Guyana (2019) and Venezuela (2017).

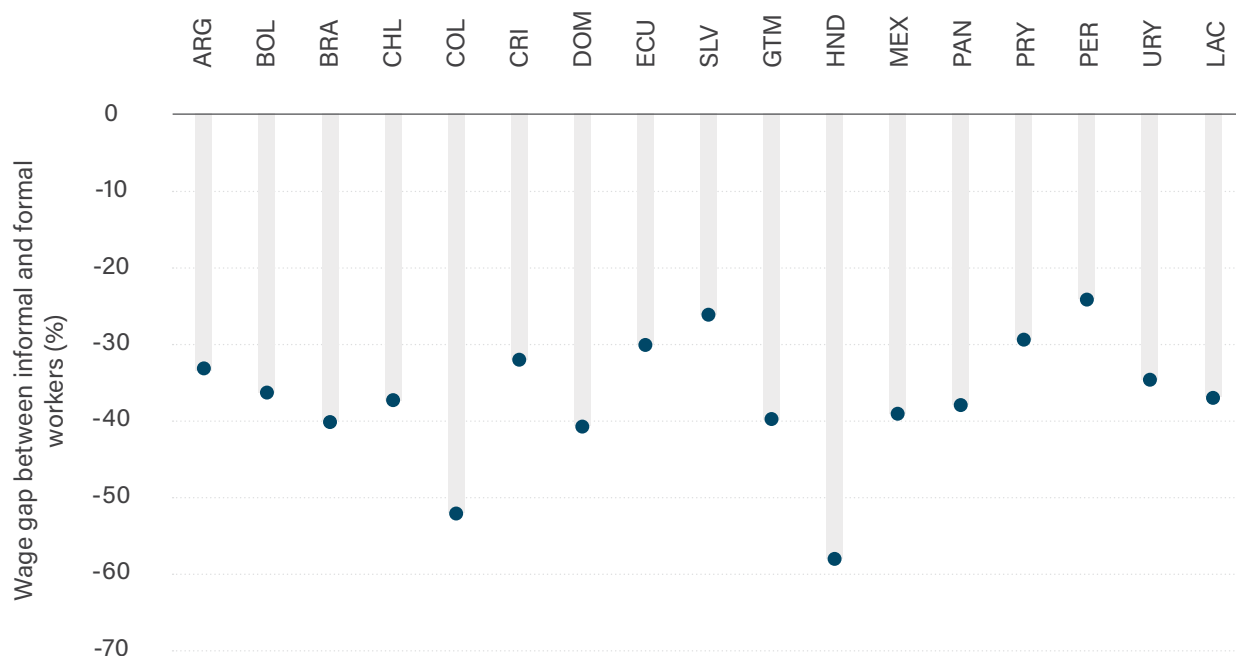
Source: Authors based on ILOSTAT data (ILO, 2025c).

Informality affects growth and productivity through several interconnected channels. At the firm level, it suppresses investment, as informal firms operate at a sub-optimal scale to evade detection. It also leads to severe resource misallocation, allowing inefficient firms to survive by evading taxes, which traps capital and labor that could be used by more productive formal firms. Furthermore, it erodes human capital accumulation; informal jobs offer little on-the-job training, and by lowering the return on education, labor informality also reduces the ex-ante incentive for young people to invest in their own skills. Finally, it isolates firms from global value chains, credit markets and public support.

Informality is also a key driver of inequality in LAC. Informal jobs constitute low-quality employment for two primary reasons. First, they pay significantly lower wages (Graph 7), reflecting the concentration of informal workers in low-productivity, less dynamic firms. This wage penalty persists even after controlling for observable characteristics, such as education and occupation. Second, informal workers have limited access to contributory health and pension systems.⁶ Moreover,

workers from lower socioeconomic backgrounds, particularly those with lower educational attainment, are disproportionately represented in the informal sector. In LAC, labor informality exceeds 70% among those who did not complete upper-secondary education, while it is around 25% among those with tertiary education (Graph 8). Reducing informality is not merely a strategy to foster productivity, but also a critical policy for promoting equality and inclusion.

Graph 7
Wage gap between informal and formal workers

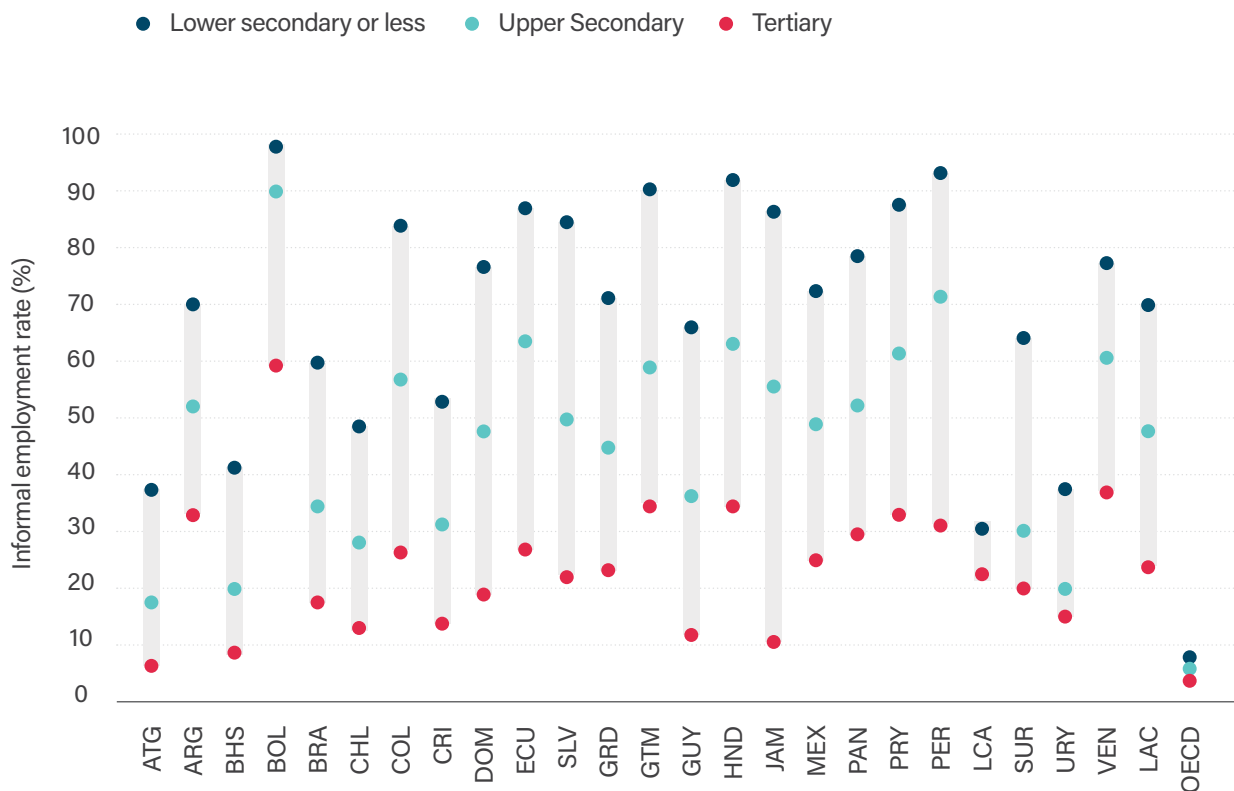


Note: The graph shows the percentage difference in average hourly earnings between informal and formal workers across countries in LAC. The wage gap is calculated as the difference between the average hourly wage of informal workers and that of formal workers, divided by the latter. Negative values indicate that informal workers earn less on average. Figures are unadjusted for observable worker or job characteristics. The LAC value corresponds to the unweighted average across countries. The vast majority of observations correspond to the years 2022 and 2023. However, for the following countries, the most recent available data refer to earlier years: Bolivia (2021), Guatemala (2014), and Honduras (2019).

Source: Authors based on household survey data from CEDLAS and World Bank (2024) and World Bank (2025).

- While many countries in the region have expanded access to non-contributory social protection programs, the high prevalence of informality continues to limit both the coverage and long-term sustainability of contributory systems.

Graph 8
Informal employment rate by educational attainment (%)



Note: The graph shows the most recent available rate of informal employment by educational attainment for each country (2023 or 2024). OECD figures exclude LAC countries. Data corresponds to informal employment and total employment by educational attainment. Educational levels were regrouped to construct harmonized categories. Informality is defined using the ILO’s harmonized indicator, based on the employment status and characteristics of a worker’s main job. For the following countries, the latest available data refer to an earlier year: Bahamas (2019), Guyana (2019), Haiti (2012), Honduras (2017), Paraguay (2017), Suriname (2016), and Venezuela (2017).

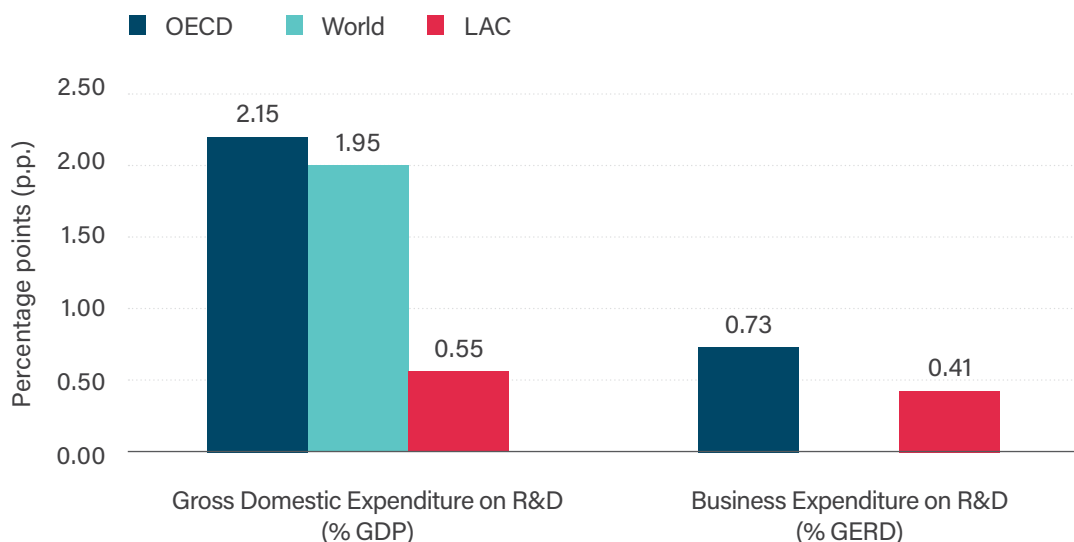
Source: Authors based on ILOSTAT data (ILO, 2025a, 2025b).

Innovation: Low inputs, poor outputs

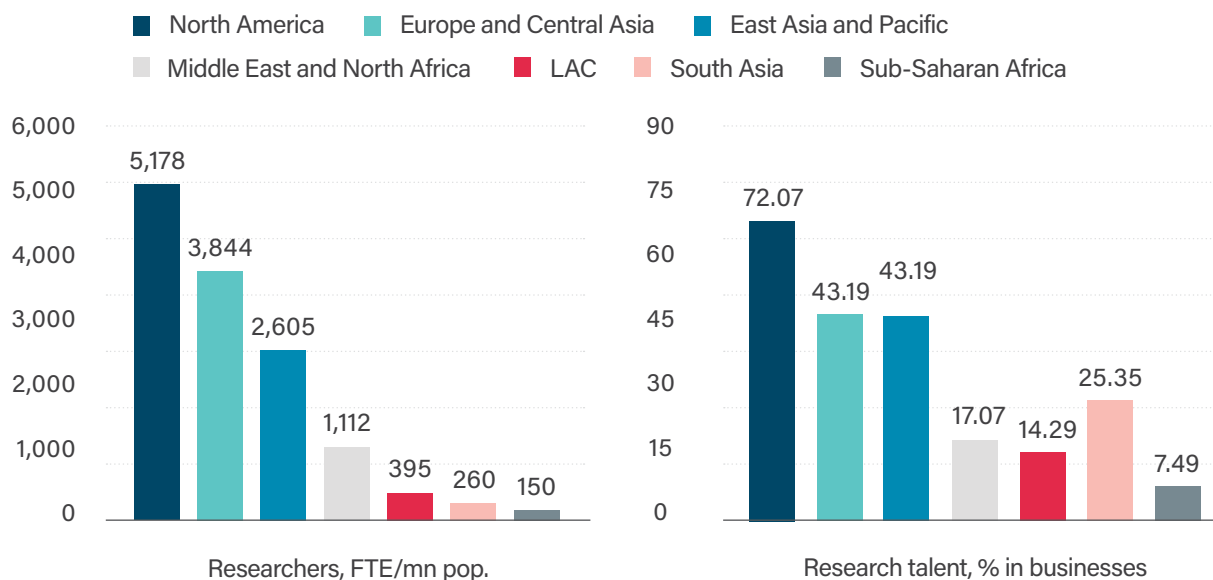
The region suffers from a dual deficit in the critical inputs for innovation: funding and specialized human capital (Graph 9). Investment in Research and Development (R&D) is strikingly low at 0.55% of GDP, far below the OECD average of 2.66%, and is financed predominantly by the public sector, often disconnected from market needs. Furthermore, the region also has significantly fewer researchers, and most are employed in academia rather than within firms (see Panel B in Graph 9).

Graph 9 Inputs for innovation

Panel A. Gross domestic expenditure and business expenditure on Research & Development (2022)



Panel B. Specialized human capital in Research & Development (2022)



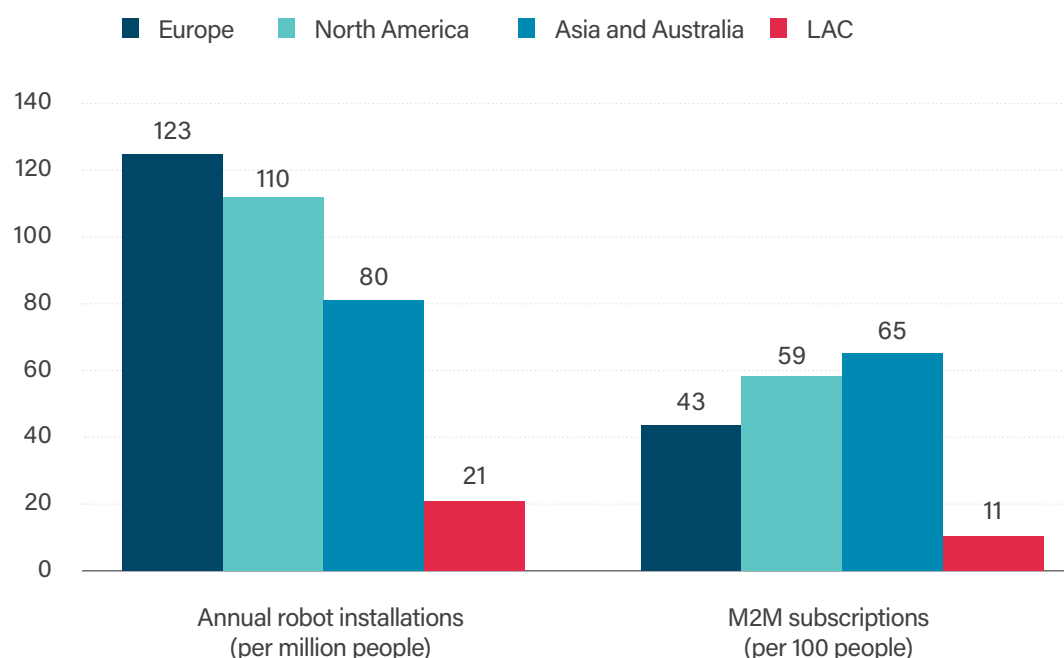
Note: In Panel A, business enterprise expenditure on R&D (BERD) comprises all expenditure on Research and Development (R&D) executed by the business enterprise sector, in a given territory. It is the subcomponent of Gross Domestic Expenditure on R&D (GERD) incurred by business enterprises. In Panel B, the left bars show the number of professionals engaged in the conception or creation of new knowledge, products, processes, methods, and systems per million inhabitants. The right bars show the share of researchers working in the business enterprise sector, measured in full-time equivalence (FTE).

Source: Authors based on Global Innovation Index Database (WIPO, 2024), UNESCO Institute for Statistics (UNESCO, 2025), and the OECD's Science, Technology and Innovation Scoreboard (OECD, 2025).

These fragile foundations translate into weak innovation outcomes. On the generation side, patent creation is minimal. On the absorption side, payments for external intellectual property are also low. This combination points to a "low-sophistication equilibrium," in which the region neither develops proprietary technology nor actively "imports" or licenses global knowledge from abroad.

This adoption gap is present in advanced digital technologies. While firms show moderate diffusion of basic tools (like ERP software), they lag severely in adopting more complex, sector-specific technologies (like IoT and robotics), where the largest productivity gains occur (Graph 10). A similar pattern emerges with artificial intelligence: according to the Digital Economy Observatory for LAC (Katz and Callorda, 2024), AI adoption among firms in the region is about 30% below the OECD level.

Graph 10
Adoption of advanced technologies: A regional comparison (2023)



Note: Industrial robots refer to an automatically controlled, reprogrammable multipurpose manipulator, programmable in three or more axes, which can be either fixed in place or fixed to a mobile platform for use in automation applications in an industrial environment. M2M subscriptions refer to the number of mobile-cellular machine-to-machine subscriptions that are assigned for use in machines and devices for the exchange of data between networked devices and are not part of a consumer subscription.

Source: Authors based on the International Telecommunication Union (2025) and the International Federation of Robotics (Müller, 2024).

Innovation and technological adoption are key drivers for economic growth, competitiveness, social inclusion, and sustainability. The lack of innovation and technology adoption is the primary cause of within-firm productivity stagnation. Without the tools and the culture for the continuous improvement of their processes and products, the region's firms simply cannot grow and compete. Secondly, this stagnation weakens the resource reallocation process. An ecosystem with few rapidly growing innovative firms and an insufficient number of disruptive start-ups lacks the "creative destruction" needed to displace inefficient firms and transfer capital and talent to more productive uses.

Integration: Shallow, far, and undiversified

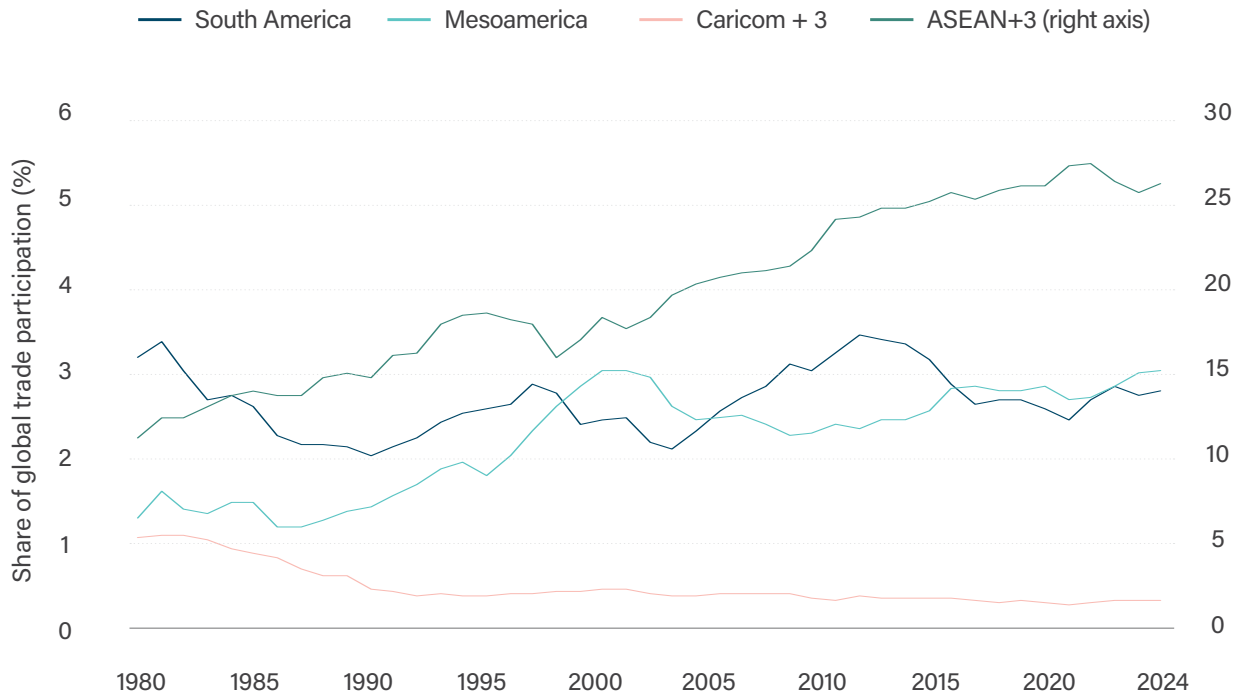
Despite significant liberalization efforts undertaken by LAC countries in the 1990s, the region's footprint in world trade has performed below expectations. Its share of global merchandise trade rose only modestly—from 5.4% in 1980 to 6% in 2024—with Mexico's deep integration into North American value chains accounting for virtually all of this increase. Over the same period, key economies in the ASEAN+3 group that also implemented major market-opening and trade-integration reforms increased their share of global trade by 15 percentage points, reaching 27% (Graph 11).⁷

Today, economies in the Caribbean and South America remain far less exposed to international trade than economies of similar size in other regions. Total trade, considering trade in goods and services, barely accounts for 50% of GDP, well below levels observed in Europe and East Asia (86%), the Middle East and North Africa (69%), and East Asia and the Pacific (56%).

The region's limited trade integration is even more evident in its intra-regional dimension: only 15% of LAC's merchandise trade takes place among the region's own countries, a stark contrast to the 60% in Europe or 50% in East Asia. From 1995 to 2023, the South American and Mesoamerican subregions showed an integration process biased to extra-regional trade. This stands in sharp contrast to Europe and ASEAN+3, the fastest-growing economies in that period, where intra-regional exchanges account for a much larger share of total trade (Graph 12).

7. Considering goods and services, participation in global trade is even smaller for LAC, due to smaller services exports.

Graph 11
Participation in global merchandise trade by region



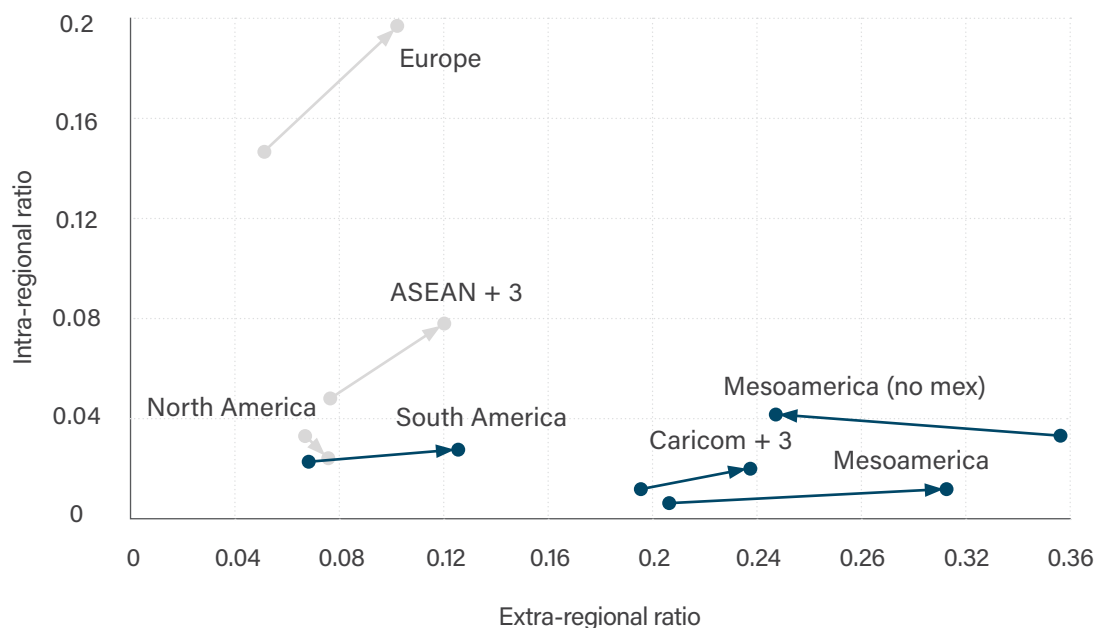
Note: Participation is measured as the sum of the region's imports and exports divided by the total imports and exports of the rest of the world. ASEAN + 3 includes the ASEAN countries (Association of Southeast Asian Nations), as well as China, Japan, and South Korea. CARICOM + 3 includes the CARICOM member countries (Caribbean Community), together with Aruba, the Dominican Republic, and Cuba.

Source: Own elaboration based on data from UNCTAD (2025).

Compared with other regions, subregions in LAC are structurally oriented toward trading with distant partners. While this pattern is not inherently negative, it helps explain the region's limited overall international integration. Evidence from East and Southeast Asia, North America, and Europe suggests that higher levels of integration and economic output are associated with greater exchange among neighboring countries, particularly because the trade of complex goods relies on productive integration into value chains that depend heavily on regional components (Allub et al., 2021)

Graph 12

Intra and extra-regional merchandise trade openness by region in 1995 and 2023



Note: Arrows start in 1995 and point towards 2023. Dots represent the level of intra- and extra-regional trade relative to GDP. ASEAN + 3 includes the ASEAN countries (Association of Southeast Asian Nations), as well as China, Japan, and South Korea. CARICOM + 3 includes the CARICOM member countries (Caribbean Community), together with Aruba, the Dominican Republic, and Cuba.

Source: Own elaboration based on data from UNCTAD, retrieved from The Growth Lab at Harvard University (2025).

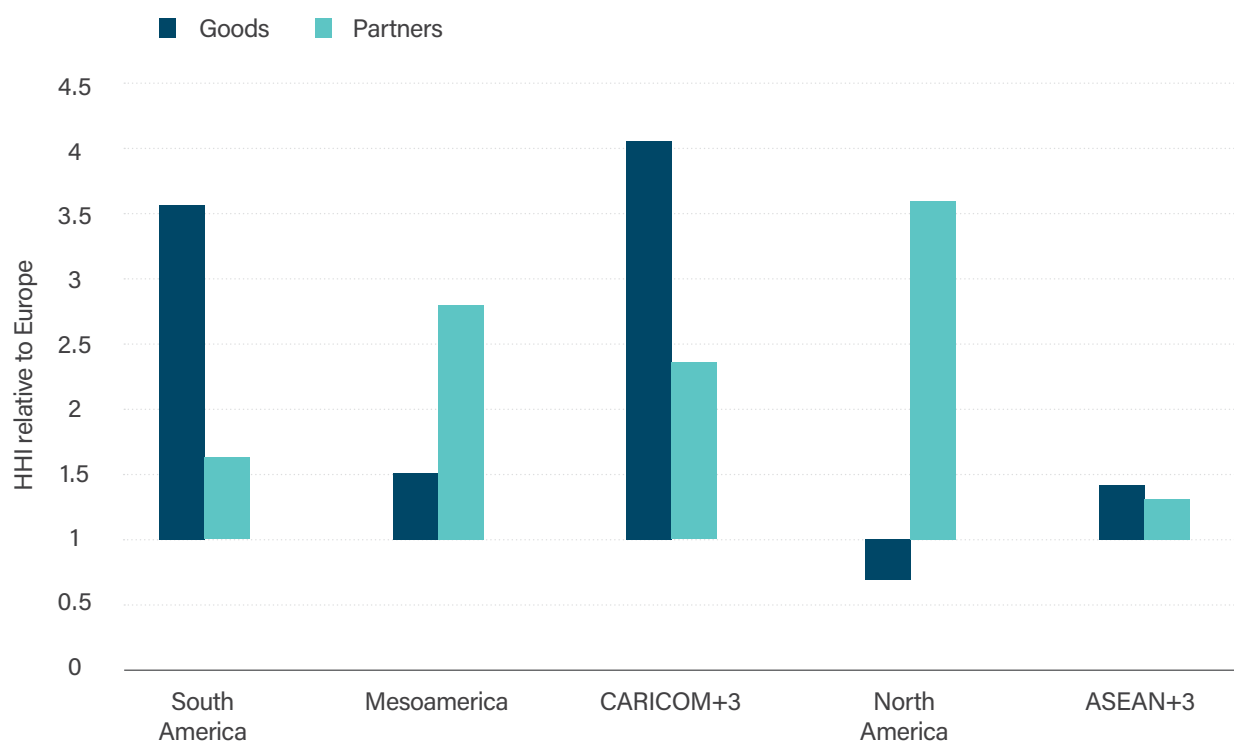
Trade in LAC is also marked by limited diversification. The region's economies exhibit a high concentration of exports across goods and markets. The Herfindahl-Hirschman Index (HHI)—a standard measure of market concentration⁸—is consistently higher across all LAC subregions than in continental Europe (Graph 13). This pattern is especially pronounced in South America and in CARICOM+3, where export concentration is roughly four times that of Europe.

A relative strength of South America is its comparatively more diversified export destinations, which reduces exposure to demand shocks in any single market/. Mesoamerican economies, by contrast, display the opposite pattern: their export baskets are less concentrated, reflecting more diversified manufacturing activity, yet their export destinations are unusually concentrated, largely because of the deep integration of El Salvador and Mexico into value chains linked to the US.

8. The Herfindahl-Hirschman index (HHI) is computed as the sum of the squared market shares that each category represents; in this case, the sum of the share of exports of each partner or good in a country's total exports.

Graph 13

Concentration index for merchandise exports across goods and partners relative to continental Europe



Note: Bars show the HHI calculated by goods and by partners, relative to the corresponding index for the average of countries in continental Europe. ASEAN + 3 includes the ASEAN countries (Association of Southeast Asian Nations), as well as China, Japan, and South Korea. CARICOM + 3 includes the CARICOM member countries (Caribbean Community), together with Aruba, the Dominican Republic, and Cuba.

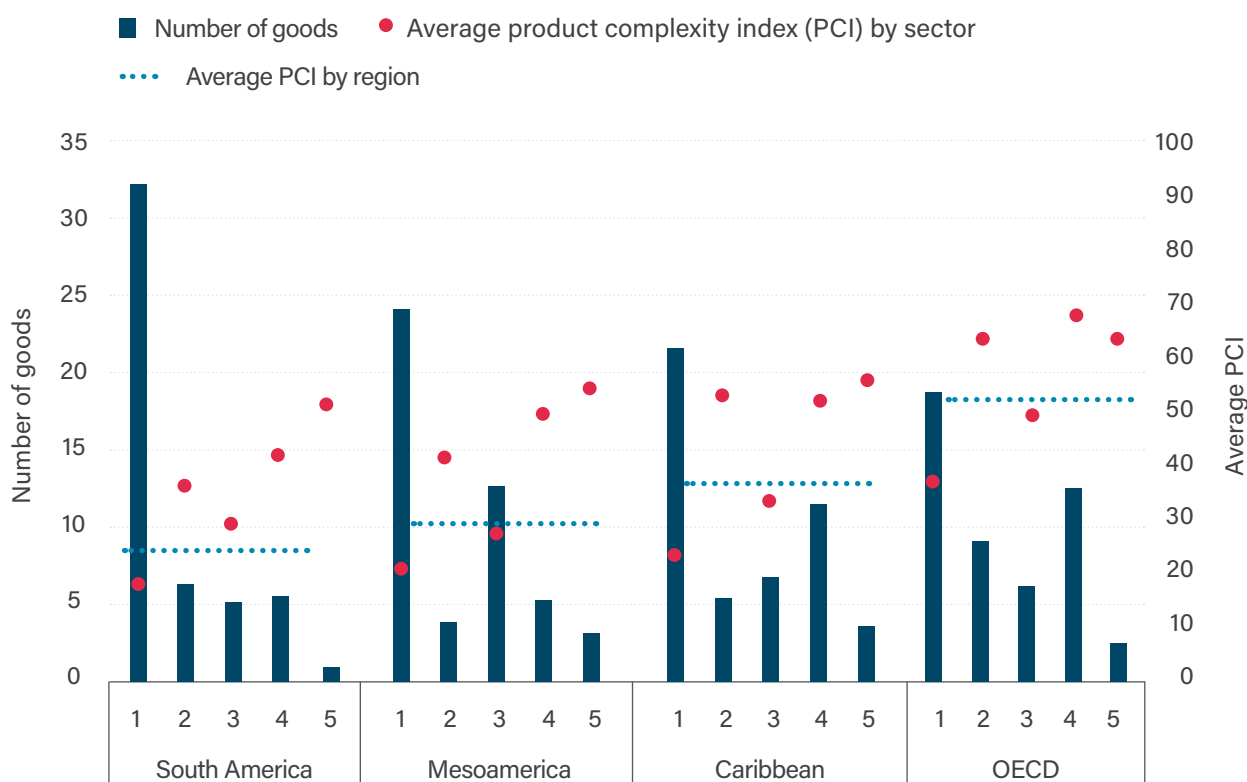
Source: Authors based on data from UNCTAD, retrieved from The Growth Lab at Harvard University (2025).

In addition to being highly concentrated by product, the region's export basket is heavily skewed toward the primary sector. According to the Atlas of Economic Complexity (The Growth Lab at Harvard University, 2025), more than 30 of the 50 products with the highest Revealed Comparative Advantage (RCA) in South America are agro-based or natural-resource products (compared with just under 20 in the OECD). Moreover, the region's export profile is not only biased toward natural-resource goods but also toward low-complexity goods.⁹ On average, LAC's economic complexity score is less than 40% of that of the world's top-performing economy. Most importantly, even within sectors, the region's complexity index is significantly below the OECD average (Graph 14).

9. According to the Atlas of Complexity, complex goods are defined as those with low ubiquity (exported by few countries) that are produced by countries with high diversity and complexity (economies capable of exporting a wide range of other complex products).

A diversified and complex economy is a fundamental engine of sustainable growth. First, diversification reduces vulnerability by acting as an insurance policy against commodity price volatility and shielding the economy from damaging boom-and-bust cycles. Second, economic complexity acts as a direct catalyst for productivity: producing sophisticated goods requires—and in turn strengthens—a dense ecosystem of capabilities, generating knowledge spillovers and pressuring firms to adopt global standards. In this sense, economic complexity is not simply an outcome of development: it is an active force that pushes the entire economy up the productivity ladder.

Graph 14
Number of goods in top RCA ranking and complexity index per sector and subregion



Note: The graph shows the sector composition of the top 50 products with the highest RCA index (left axis). This index measures the ratio of a good's participation in total exports of a country relative to that observed at the world level, so that an RCA value of 1 means that the participation of that good in total exports for a country is the same as for the average country. The horizontal line indicates the export value-weighted average of the product complexity index within each subregion and sector (right axis). Sectors on the horizontal axis are defined as follows: (1) agro-based and natural products: vegetables, animals, wood and paper, minerals, fuels, ores, salts, stone, glass, and ceramics; (2) chemicals and derivatives: chemicals and plastics; (3) light manufactures and consumer goods: textiles, garments, footwear, and furniture; (4) heavy manufactures and capital goods: machinery, instruments, and metals; and (5) technology and transport: electronics and vehicles. Export baskets vary across regions. Mesoamerica specializes in chemicals and selected machinery; South America combines industrial inputs and metal products; the Caribbean shows greater diversification; and OECD countries concentrate on technology-intensive goods. Across all regions, human and animal blood products, vaccines, and biological cultures are prominent.

Source: Authors based on The Growth Lab at Harvard University (2025).

Weak international integration deprives the region of powerful drivers of productivity. Competitive pressure from foreign markets, which pushes inefficient firms out and allows the most productive ones to expand by accessing new markets, is one of them. This competition, combined with greater access to markets and to higher-quality, more technologically advanced imported inputs, creates incentives for existing firms to innovate. Likewise, foreign direct investment (FDI) and the presence of multinational corporations accelerate technology diffusion through imitation, production linkages, and human capital formation. FDI and multinational enterprises (MNEs) can also have a meaningful impact on gender equality in host countries. This influence operates through two channels: directly through the employment practices of foreign affiliates and indirectly through spillovers into local labor markets (Davis and Poole, 2024; UNCTAD, 2021).

Strategic opportunities in a changing world

The pending agenda to reduce informality, foster innovation, and achieve meaningful global integration must unfold within a transitional and challenging global context. Today's world is shaped by the interaction of three powerful forces: an ever-accelerating digital revolution, driven by the mass adoption of general-purpose artificial intelligence, a sharp return to market interventionism and transactional diplomacy among major economies and blocs, and a growing urgency of advancing the green transition.

The capacity of AI models has multiplied exponentially in recent years. Widespread use of generative AI tools is deepening the impact of the technological revolution now underway. Digitalization offers opportunities for productive leapfrogging, market expansion, and sharp efficiency gains. Yet it also poses serious challenges for labor markets and equity. These AI systems have pushed the frontier of tasks that can be automated, increasingly encompassing non-routine cognitive tasks. This shift is transforming global and local labor markets—destroying some jobs, creating others—and its net effect remains uncertain.

The global geopolitical context has been marked by a steady resurgence of industrial policies and a marked rise in protectionist measures—a trend that began after the 2007 global financial crisis. In the last decade, the number of trade-distorting interventions has doubled in LAC and increased three- to four-fold in Europe and the US (Evanett et al., 2024). The most consequential shift came with the second Trump administration, which raised U.S. tariffs to levels not seen since before the 1930 economic crisis associated with the Tariff Act. These measures assign different tariff levels to different countries. Thus, they violate the Most-Favored-Nation (MFN) principle, which is at the core of the multilateral system embodied by the WTO. Several economies have responded by negotiating bilateral deals with the US and establishing preferential, ad hoc arrangements that

themselves deviate from multilateral trade rules. In the region, Argentina, Ecuador, El Salvador, and Guatemala have advanced “Joint Reference Frameworks” with the United States, granting the US preferential treatment while securing concessions for LAC countries on goods that the US does not produce or for which domestic supply is insufficient. This contagion effect risks accelerating the erosion of the WTO’s relevance.

As large economies move away from the global rules-based framework, smaller economies, including most of LAC, face a weaker negotiating position. For the region, there may be apparent gains that stem from diverted trade flows away from countries directly targeted by the US, as LAC economies have received a softer treatment. Some may see short-term gains from diverted trade flows, as LAC economies have largely avoided direct targeting by U.S. measures. However, even where short-term benefits emerge, the broader strategic environment becomes more uncertain and less favorable for small economies negotiating in an uncoordinated and isolated manner.

Finally, there is an urgent need to decarbonize the global economy. The decarbonization path requires a massive substitution of fossil fuels—which today account for about 80% of the world’s energy matrix—with clean energy sources. This will, in turn, trigger a surge in demand for critical minerals: it is estimated that by 2050, demand for lithium will increase tenfold, while demand for cobalt and nickel will triple and double, respectively. Finally, food systems will have to undergo a deep transformation, sharply halting deforestation and the loss of natural habitats, and meeting increases in nutrient demand solely through higher agricultural yields.

Within this context, two dimensions appear central to shaping LAC’s strategy for growth and global insertion. First, sectors such as tourism, health, agriculture, mining, and energy are undergoing profound transformation through high-precision agriculture, sustainable tourism models, and low-emission energy generation. These can serve as gateways for a more sophisticated, diversified, and resilient development path. Second, the current global environment underscores the importance of strategic international partnerships grounded in shared values and trust. In this regard, deeper and mutually beneficial integration with the EU should occupy a central place.

Strategic sectors

The confluence of digitalization and decarbonization policies offers an opportunity to redefine LAC’s economic future. The region can play a key role in the green economy. Its abundance of critical minerals offers the chance to integrate into clean energy value chains. Its immense potential for solar and wind power can attract energy-intensive industries and the development of an export industry for clean fuels, such as green hydrogen (Allub et al., 2024). The region’s vast and productive agricultural land, combined with strengthened adoption of sustainable production methods, can supply the world with high-quality and sustainable

sources of nutrition. Finally, its vast forests and grasslands provide key ecosystem services to the world by acting as a large climate mitigation mechanism, so that it is in the interest of the world to contribute to its preservation.

However, the opportunities that these global forces present are not limited to those closely related sectors. It extends to those linked by input-output relationships, and more importantly, to the development of goods and services in other sectors related through similar capabilities, a shared pool of knowledge, and technology. To seize these opportunities, the state can play an active and strategic role; one that recognizes the challenges and follows the best practices of industrial policy as a key tool to drive these engines of growth.

According to the Atlas of Economic Complexity, opportunity goods are those that lie close to the region's current export basket—proximity determined by the co-occurrence of these products in countries with similar export structures. These goods are either complex themselves or closely connected to other complex products, which makes them viable pathways for diversification. While opportunities remain in agriculture and mining, notable prospects also emerge in the chemical and machinery sectors (Graph 15).

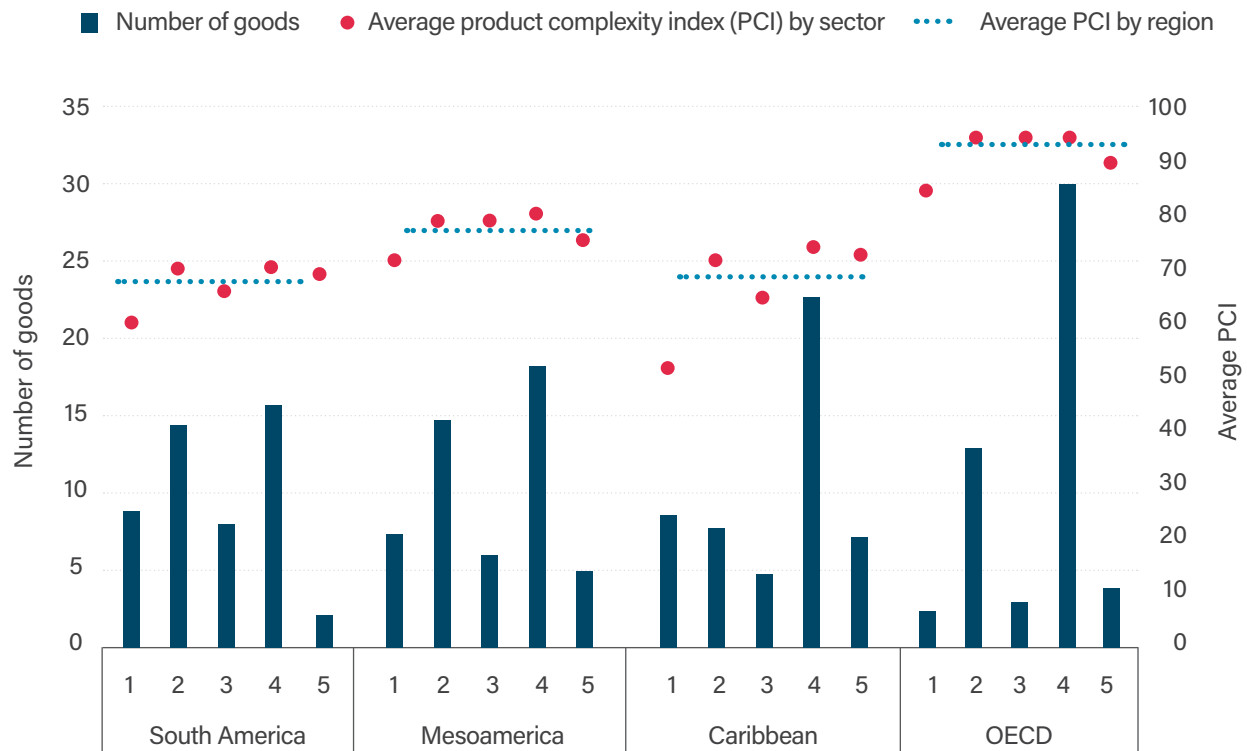
In other words, the region may *already* possess some of the necessary underlying capabilities to produce these more sophisticated goods: knowledge, skills, technology, and institutions. For example, a country that has mastered complex logistics and industrial chemistry for its modern agricultural sector (e.g., fertilizers, pesticides) already has many of the "building blocks" needed to move into adjacent, higher-value chemical products.

On the path toward development, growth, and diversification, services will also play a key role. As firms deepen their specialization and division of labor, tasks once performed internally are increasingly outsourced to specialized providers, expanding markets for services such as business consulting, marketing, and cloud computing.

Digitalization and technological change have reshaped the boundary between tradable and non-tradable sectors, making it possible for many services to be traded internationally. This gives the service sector characteristics for economic growth that were previously intrinsic to manufacturing: domestic no longer represents a ceiling for growth, and firms can tap into substantial learning opportunities through cross-border linkages.

Graph 15

Top opportunity goods among those close to the current export basket



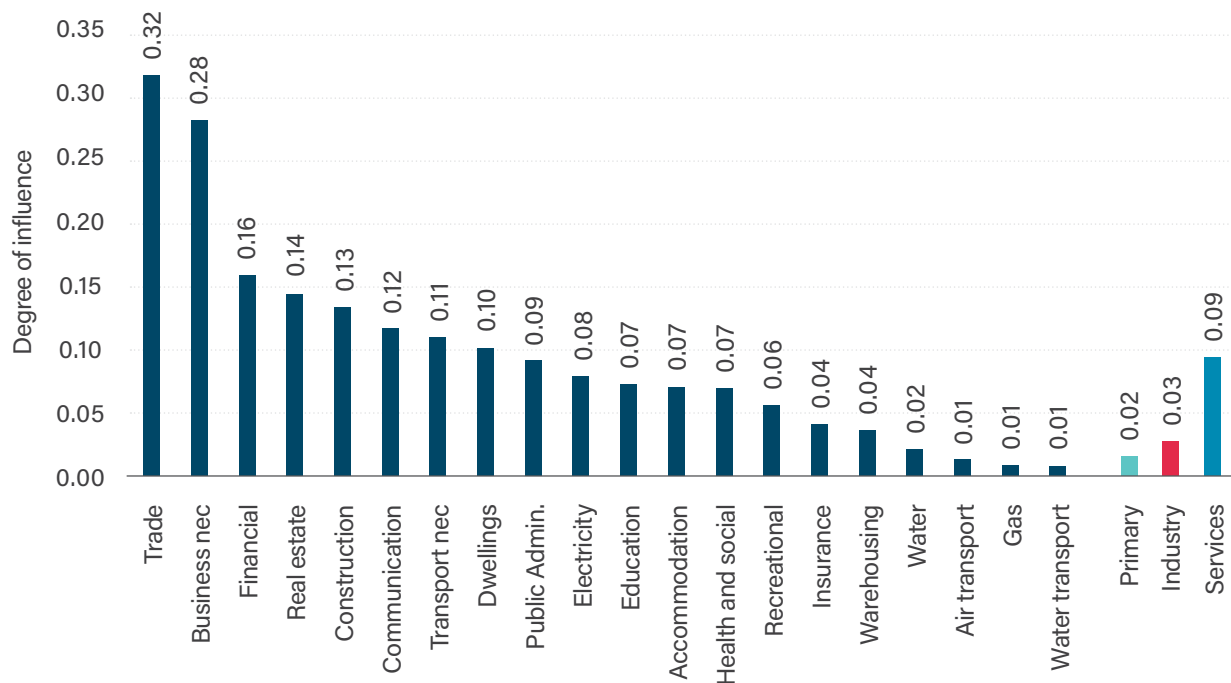
Note: The graph shows a description of the top 50 goods in terms of their Opportunity Gain Index for each country, among goods that are below the median distance from the current export basket in the product space. Sectors on the horizontal axis are defined as follows: (1) agro-based and natural products: vegetables, animals, wood and paper, minerals, fuels, ores, salts, stone, glass, and ceramics; (2) chemicals and derivatives: chemicals and plastics; (3) light manufactures and consumer goods: textiles, garments, footwear, and furniture; (4) heavy manufactures and capital goods: machinery, instruments, and metals; and (5) technology and transport: electronics and vehicles. Export baskets differ across regions. For details on the composition of goods in each region, see the note in Graph 14.

Source: Authors based on The Growth Lab at Harvard University (2025).

In addition, some service sectors are key inputs for other goods and services. Services have roughly three times greater influence—a measure of centrality as inputs—than manufacturing or primary activities. Within services, commerce and business services (accounting, finance, etc.) stand out, while communications and land transport also rank above average. This high degree of influence coexists with significant productivity gaps in these sectors relative to advanced economies, indicating considerable room for improvement (Graph 16).

Graph 16

Degree of influence of service subsectors and grouped sectors in LAC



Note: The bars in the figure represent the degree of influence for the three aggregate sectors and for each services subsectors in LAC. AC values are unweighted (simple) averages across the countries with available data. The degree of influence of a sector is computed as the weighted sum of its forward (row) coefficients in the Leontief inverse of the input-output table, where the weights are the economy's value-added shares across sectors.

Source: Authors based on *GGDC Productivity Level Database* (Inklaar et al., 2023)

Finally, services are expected to play a larger role in employment in LAC as automation, trade exposure, and the green transition drive significant labor reallocation. This strengthens the case for policies to raise productivity in labor-absorbing services. The central challenge is to boost productivity in typically non-tradable, informal, and low-skill-intensive activities—such as retail trade and care services—so they deliver better earnings and formality.

A mutually beneficial alliance between LAC and the EU

The current global context—marked by polarization, uncertainty, and rising protectionism—creates an opportunity for LAC to seek strategic alliances based on shared values and can offer a stable framework for sustainable development.

The EU stands out as a partner capable of forging enduring economic and political ties. As an ally, the EU can leverage LAC's strengths to channel capabilities and resources into key sectors that are essential to sustaining the region's growth and development. In addition, such a partnership can serve as a catalyst for regional leadership through collective efforts that enhance their joint negotiating power and promote greater autonomy in defending their strategic interests.

The EU is firmly committed to decarbonization, leading the adoption of instruments like the EU Emissions Trading System, the Carbon Border Adjustment Mechanism (CBAM), and the EU Deforestation Reduction Act (EUDR), among many other key tools. Although Europe is a leader in clean-tech innovation, its dependence on concentrated suppliers creates vulnerabilities (Draghi, 2025).

LAC holds assets that are central to Europe's long-term strategic priorities. The region is a global pillar of food security, a major exporter of energy and mineral commodities, and home to vast reserves of critical minerals—lithium, copper, nickel—that will determine the pace of the green and digital transitions. The region also has exceptional conditions for scaling solar, wind, hydro, and green hydrogen, making it one of the few global frontiers capable of producing clean energy at competitive cost.

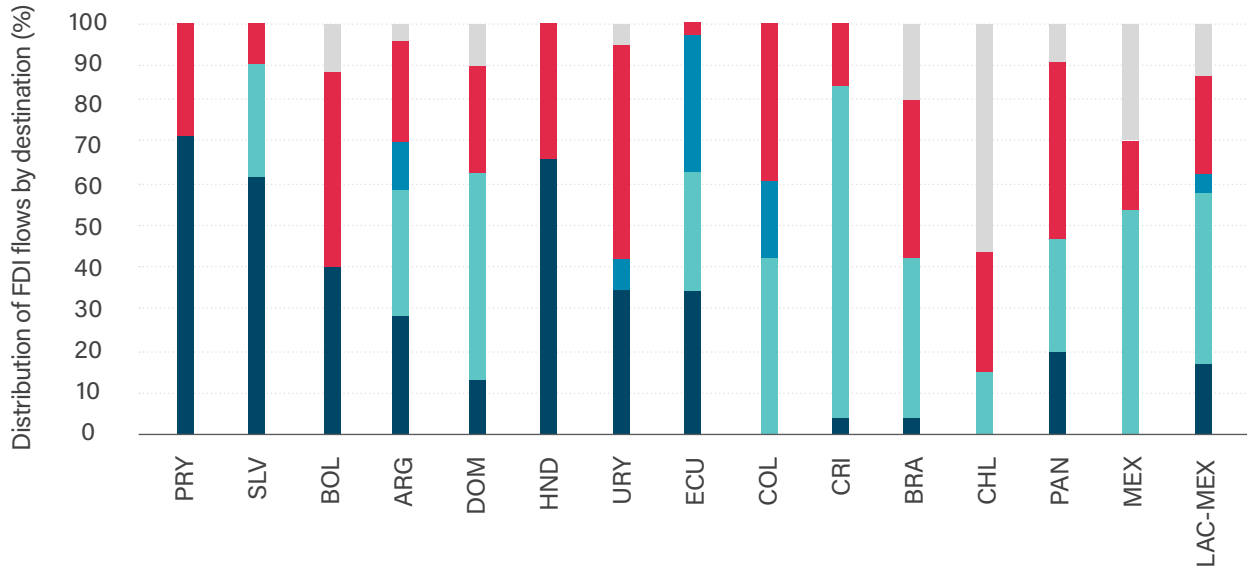
Despite these complementarities, LAC's integration with the EU remains limited. For instance, while 44% of LAC's total goods exports go to the US and 12% to China, only 9% go to the EU (Graph 17). In this regard, the EU remains a stable trading partner with clear expansion potential as a destination for LAC's exports. In contrast, LAC shows a more diversified profile of FDI sources, with the EU—the region's second-largest investor—already representing a core pillar of investment. This solid investment foundation, combined with the potential for trade growth, underscores the significant gains the region stands to achieve by strengthening this partnership in an uncertain global context.

Graph 17

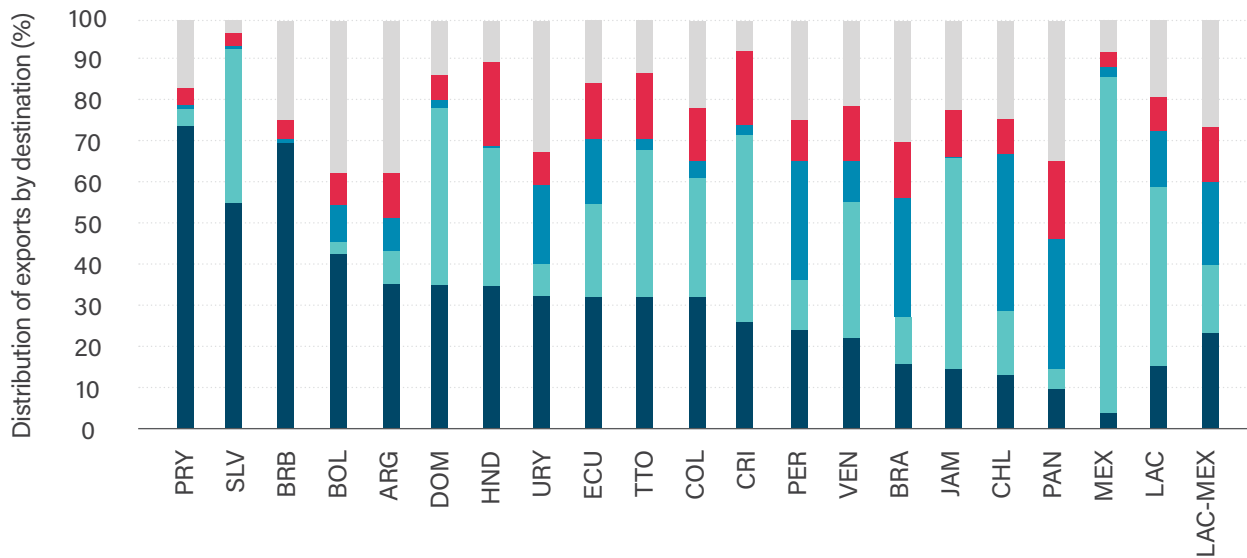
LAC countries: FDI flows and Export destinations

■ LAC ■ US ■ CHN ■ EU ■ Other

Panel A. FDI flows



Panel B. Export destinations



Note: LAC-Mex shows the aggregate of the countries presented in the graph, excluding Mexico.

Source: Authors based on ECLAC (2024).

A stronger partnership between LAC and the EU offers strategic advantages for the region. It provides broader and more stable access to external markets, supported by EU agreements that embed labor, environmental, and institutional standards, reinforcing high-quality integration and long-term investor confidence. It expands financing options for the green and digital transitions through instruments such as the Global Gateway, which aims to mobilize up to EUR 45 billion for LAC by 2027 to support infrastructure, renewable energy, digital connectivity, and climate-resilience projects. It strengthens FDI in key sectors where EU investment already plays a large role, like energy, telecommunications, financial services, and manufacturing. New “powershoring” opportunities—relocating energy-intensive production to renewable-rich regions like LAC—can further generate spillovers and high-quality jobs.

This mutually beneficial partnership extends far beyond the exchange of goods and investment; it is grounded in the shared creation of productive knowledge and in advancing a coordinated position on global challenges such as climate change, peace, security, and equity. For LAC, a central benefit lies in the opportunity to draw on the EU’s institutional expertise in designing comprehensive social policy models that balance efficiency with inclusiveness, which can help deliver more equitable development outcomes. The EU’s experience in navigating demographic transitions—such as population aging and rapid urbanization—along with its support for institutional reforms, can further strengthen governance and resilience across the region. Above all, EU investment in LAC can accelerate the modernization of key productive sectors, not only through the provision of finance but also through the transfer of embedded technical and managerial capabilities that accompany such investments.

Finally, a stronger partnership can contribute to LAC’s productive innovation and institutional capabilities. Innovation alliances drawing on Europe’s strengths in clean technologies, digital solutions, biotechnology, and advanced manufacturing can facilitate technology adoption and research collaborations.

Yet the region’s ability to translate these complementarities into a cohesive relationship with Europe is constrained by limited collective negotiation capacity. LAC often engages with external partners through fragmented bilateral channels, reducing its influence in multilateral forums and weakening its bargaining power. A critical bottleneck is the lack of strategic alignment between the region’s two largest economies, Mexico and Brazil. Without greater coordination between these actors—one oriented primarily toward North America, the other toward global markets—LAC cannot build a unified voice capable of advancing common priorities in global trade and climate negotiations.

Differences in interests with Europe also need to be acknowledged and managed. Agricultural protectionism in some EU member states complicates the negotiation of comprehensive agreements. Moreover, elements of the European Green Deal (EGD)—including the CBAM and the EUDR create adjustment pressures in LAC, particularly for exporters of coffee, cocoa, palm oil, and other commodities. Roughly 20% of LAC’s exports to the EU fall under the scope of the EUDR, with significant variation across countries.

Managing these tensions requires an institutionalized dialogue that balances environmental objectives, trade interests, and development needs. The LAC–EU partnership should advance along seven fronts:

Mutual Impact: both sides must engage in open and honest dialogue, establishing clear, realistic contributions that each can bring to the partnership. Effective cooperation requires both sides to align in technical, regulatory, and administrative terms, recognizing the level of institutional and managerial capacity of each country.

Focus on Sustainable Development: Joint initiatives should be consistent with the UN Sustainable Development Goals (SDG), the Paris Agreement, and emerging climate and digital agendas. LAC should harness the significant growth opportunities in the green economy.

Flexibility: Given rapid geopolitical and technological change, cooperation mechanisms must allow for periodic adjustments and the incorporation of stakeholders from governments, the private sector, civil society, and academia.

Productive Investment: EU financing and FDI should target infrastructure, renewable energy, digital platforms, and climate-resilient production—areas with high social and economic returns

Innovation and Technology Transfer: Joint research centers, technology-transfer mechanisms, and cross-regional networks can boost innovation in renewable energy, sustainable agriculture, circular manufacturing, and smart cities.

Social equity, human rights, and inclusion: Cooperation should reinforce policies in education, health, gender equality, and Indigenous rights, ensuring that the benefits of integration translate into broader social gains.

Trust: building and maintaining long-term trust through institutionalized cooperation is paramount. This entails deepening political dialogue, enhancing technical cooperation, and developing social welfare programs that integrate efforts at the national level.

Table 1 presents an analysis of key interregional projects that build upon these desirable theoretical traits in a renewed alliance. The table outlines specific, tangible examples of flagship initiatives, highlighting the key contributions each region might bring as well as the relevant EU–LAC framework to ensure the viability of these projects. In light of the urgency of adopting sustainability policies, the Global Gateway initiative plays a fundamental role in this bi-regional relationship.

Table 1

Seven pathways to deepen LAC–EU collaboration: A few concrete examples

Pathway	Example LAC–EU Project	LAC Contribution	EU Contribution	Relevant EU–LAC Framework / Program
Mutual Impact	Joint initiative to export sustainably produced agricultural goods to European markets with recognized sustainability certifications.	Sustainable production methods, local know-how, producer networks.	Market access, certification processes, marketing and distribution expertise.	AL-Invest Verde, Global Gateway – Sustainable Trade Pillar.
Focus on Sustainable Development	Development of large-scale renewable energy projects in LAC with financing linked to green standards.	Access to project sites, local permits, operation & maintenance capabilities, and skilled labor.	Capital investment, clean technology, and advanced environmental and safety standards.	Global Gateway – Green Transition, EU–LAC Green Alliance.
Flexibility	Creation of a bi-regional climate resilience fund to support communities facing environmental shocks.	Local knowledge of vulnerabilities, cultural adaptation of solutions, and community engagement.	Flexible financing instruments, risk management tools, and expertise in adaptive planning.	EU–LAC Global Gateway Investment Agenda, Latin America and Caribbean Climate Adaptation Facility.
Productive Investment	Establishment of sustainable industrial facilities to process raw materials into higher-value products for global supply chains.	Resource access, labor force, supportive policy environment.	Investment in infrastructure, ESG compliance frameworks, and integration into European and global markets.	Global Gateway – Sustainable Value Chains, Horizon Europe – Industry Partnerships.

Pathway	Example LAC-EU Project	LAC Contribution	EU Contribution	Relevant EU-LAC Framework / Program
Innovation and Technology Transfer	Deployment of smart systems (e.g., digital platforms, sensors, AI) to improve productivity in key sectors such as agriculture, manufacturing, or logistics.	Local data and operational context, pilot sites, sector expertise.	Technology solutions, technical training, and intellectual property protection frameworks.	EU-LAC Digital Alliance, Horizon Europe – Research and Innovation.
Social equity, human rights, and inclusion	Bi-regional policy dialogue to promote social inclusion, foster equality, and strengthen social cohesion.	Local implementation, partner engagement, policy execution, and leveraging regional networks	Financial resources, technical assistance, and policy support.	Global Gateway - Inclusive Societies Programme, which includes the Inclusive Societies Regional Programme and the Social Accelerator.
Trust	Bi-regional observatory to track and report on the social, environmental, and economic impacts of joint projects.	Access to field data, engagement with communities and stakeholders, and local institutional networks.	Transparent monitoring tools, funding for independent evaluations, and methodologies for participatory governance.	EU-LAC Foundation, Global Gateway – Governance and Rule of Law Pillar.

Note: This table is not an exhaustive list of all current and future lines of action. The relationship between the two regions can and must continue to deepen and strengthen.

Policy pillars for productive transformation

The preceding analysis yields clear messages. Closing development gaps in the region requires a growth model driven not only by factor accumulation but, fundamentally, by productivity. While growth must be broad-based, the current context highlights strategic opportunities in specific sectors. Additionally, the global context points to

the potential benefits of pursuing a carefully crafted partnership between LAC and the EU, based on strategic complementarities and mutual gains. Capitalizing on these opportunities is key to driving growth, diversification, and economic complexity.

Achieving robust, broad-based growth and capturing sector-specific opportunities requires a comprehensive policy agenda focused on three core levers: reducing informality, fostering innovation, and deepening international integration. This agenda should also pursue a balanced approach that combines horizontal, cross-cutting policies with targeted vertical interventions focused on strategic priorities.

The following section presents a set of relevant policy options for the region across these three domains. These range from broad instruments—such as adjustments to hiring and firing costs or minimum wages—to more targeted interventions, including cluster initiatives or innovation grants that can be deployed in a sector-specific manner (e.g., mining clusters or green hydrogen funding).

Sector-specific policies must be approached while mitigating well-known risks: informational failures (governments "picking winners" without real potential) and political capture (policy distortions caused by lobbying and corruption). Mitigating these risks requires, first and foremost, establishing strong horizontal foundations. Its success depends on macroeconomic stability, robust competition, citizen security, legal certainty, and transparent regulations to lower entry barriers. Furthermore, vertical interventions should prioritize the provision of low-risk public goods—such as certification labs and specialized Technical and Vocational Education and Training (TVET) programs—over high-risk and costly market interventions like subsidies and tariffs. When high-risk tools are employed, they must be transparent, tied to performance targets, and subject to clear sunset clauses that specify, in advance, the conditions under which support would be withdrawn.

Lower informality

Reducing informality requires a comprehensive agenda that combines incentives, enforcement, and capability development, all adapted to the new realities of digitalization.

An effective agenda must recognize that informal firms are not homogeneous (Ulyssea, 2018). *Resource-constrained firms* are productive enough to be formal but are blocked by high entry costs (a minority, according to evidence). *Survival firms* are so unproductive that they can only stay in business by evading regulations. Finally, *parasite firms* are productive enough to afford formal costs but strategically choose informality.

While all three types may contribute to the productivity costs of informality, they do so through different channels and to varying degrees. Moreover, the most effective policy tools to tackle them differ.

Policies to incentivize formalization

Policies seeking to alter the incentives and the relative cost-benefit of formality generally fall into three main categories:

The first seeks to reduce the costs of entering and operating formally. These initiatives may target distinct stages of firm activity. First, lowering entry costs—through simplified registration, counseling, and fee reductions—remains a common approach. However, these policies have only modest effects on formalization, as they only target the small fraction of "resource-constrained" firms. A second approach targets ongoing operational costs through tax reductions. While potentially more impactful, these raise concerns regarding cost-effectiveness due to the negative fiscal impact of foregone revenue. Finally, regulatory costs, such as minimum wages and Employment Protection Legislation (EPL), require careful calibration; overly strict rules can inadvertently raise the cost of formal hiring, incentivizing firms to remain informal.

The second category involves reshaping incentives via social protection. Enhancing benefits directly tied to formal employment can effectively attract workers, as demonstrated by Uruguay's 2008 health reform. Conversely, non-contributory programs, while essential for poverty reduction, can generate unintended consequences by lowering the relative value of formal jobs if they are not carefully designed. Evidence highlights this tension: in Uruguay, a conditional cash transfer program led to a 13% drop in formal employment among beneficiaries (Bergolo and Cruces, 2021), and in Argentina, the *Asignación Universal por Hijo* reduced the likelihood of holding a formal job by 40% (Garganta and Gasparini, 2015). The evidence on non-contributory health programs is more mixed, with some studies finding increased informality (Bosch and Campos-Vazquez, 2014) while others found no significant negative effects (Azuara and Marinescu, 2013; Campos-Vázquez, 2013).

Acknowledging these trade-offs does not negate the necessity of these programs; social protection and inclusion remain paramount development goals. The policy challenge is to balance inclusion with formalization incentives. The objective is to design a comprehensive safety net that meets the basic health and income needs of vulnerable groups (e.g., the unemployed, children, the elderly) without significant effects on the motivation to participate in the formal labor market.¹⁰ Finally, the third group of policies to foster formalization focuses on strengthening regulatory enforcement. Effective enforcement can raise aggregate productivity by forcing the exit of low-productivity "survival" firms and reallocating resources to more efficient ones. However, these policies need to be well-calibrated in each country as they may carry short-term unemployment risks. Stricter enforcement targeting registered firms (to reduce the intensive margin) can reduce informal workers at these firms but may unintentionally push some firms into informality to remain entirely off the authorities' radar.

Strengthening compliance could also open doors to global markets. Conversely, the prospect of accessing these high-value markets acts as a powerful incentive

10. Sound design is essential to strike the right balance between social protection and incentives. Naturally, the appropriate design depends on the specific instrument (e.g., unemployment insurance or conditional cash transfers) as well as the underlying economic structure. However, a general principle applies: to incentivize formalization, the value of a formal job must exceed that of an informal one. Meeting this condition can be potentially challenging for workers entering the formal sector at low wages if the transition triggers a sudden withdrawal of non-contributory benefits.

to comply with regulations, driving formalization to meet international labor and environmental standards.

A structural challenge is that enforcement is often biased against larger, easier-to-monitor firms. This creates a de facto “tax on size” that discourages growth and distorts competition. Digitalization is a key ally in correcting this imbalance. By enabling states to cross-reference tax and labor databases and use predictive analytics, authorities can detect evasion more effectively across all firm sizes, improving the selection of operating firms and ensuring a level playing field.

Active labor market and skill policies

Active Labor Market Policies (ALMPs) play a vital role in helping individuals acquire the skills needed for formal employment, improving job search efficiency, and shortening unemployment spells that often lead to informality.

First, vocational training programs are designed to equip individuals with the technical skills required for specific occupations. These programs are among the most effective ALMPs for improving long-term formal employment. Yet, the magnitude of these gains varies widely across programs, underscoring the importance of program design, implementation quality, target population, and context for determining effectiveness (Yeyati et al., 2025). Programs targeting youth (e.g., *Jóvenes en Acción* in Colombia), in particular, show positive outcomes.

Another key initiative is skills certification programs, which provide workers with a credible signal of their competencies to employers. These programs can either complement training courses or certify pre-existing skills through competency assessments. They are particularly valuable for groups whose abilities are hard to signal, like informal workers, migrants, and young people who lack prior employment experience.

Job intermediation services offer a mechanism to reduce search frictions. These programs include a broad range of interventions, such as job vacancy databases, labor market information portals, job fairs with private employers, résumé-building workshops, job search and interview training, and individualized counseling or mentoring throughout the job search process. These services are highly cost-effective and have been transformed by digital job portals.

Finally, financial incentives like wage subsidies for first jobs have proven effective in generating employment gains for young entrants. The magnitude and duration of the subsidy appear to be key determinants of a program’s impact. For example, Berniell and de la Mata (2017) find large gains in formal employment five years after participation in the *Programa Primer Paso* in Cordoba, Argentina.

Beyond these specific interventions, addressing the structural link between education and informality is essential. As mentioned, informality is significantly more prevalent among less-educated workers. Increasing overall educational attainment—particularly

tertiary completion—serves a dual purpose: it fosters growth by boosting productivity across all job types and structurally reduces the prevalence of informality.

To enhance human capital, a qualitative leap is required. Policy actions should begin in early childhood with investments in health, nutrition, parenting, and high-quality universal pre-primary education. In basic and secondary education, priorities should focus on improving learning and reducing dropouts, updating curricula to include 21st-century skills, and strengthening teacher policy (selection, career, and competitive pay) and providing critical infrastructure. Finally, in the tertiary and technical stage, key actions should include strategically expanding public capacity, improving quality assurance, and fostering employer linkages, often through short-cycle technical programs. Integrating digital skills across all levels is a crucial cross-cutting action.

Sectoral policies and the future of employment

The impact of digitalization and the green transformation on the labor market deserves special attention, particularly regarding its potential effects on informality. These transitions will trigger significant labor reallocation. Estimates suggest that 70% of workers currently hold "gray" jobs and will require new skills to transition to the growing segment of green Jobs (Allub et al., 2024). Simultaneously, automation will substitute human activities in specific tasks. If this reallocation is not managed effectively, the displacement of workers could inadvertently drive an increase in informality.

Several service sectors, particularly with high informality prevalence, will likely absorb a significant portion of the labor displaced by automation and the green transition. Therefore, raising productivity and fostering formalization within services is strategic. In this context, digitalization can act as a powerful ally. New technologies have the potential to complement low- and medium-skill service workers and raise their productivity—for instance, when generative AI assists customer service agents or logistics platforms expand the capabilities of small merchants. Policy efforts must therefore focus on accelerating the adoption of these complementary technologies in non-tradable sectors.

However, capitalizing on this opportunity requires overcoming a critical barrier. PIAAC data reveal that informal workers suffer from a massive deficit in basic digital skills. Without addressing this gap, digitalization risks deepening inequality and further entrenching informality. Consequently, public policy must place an urgent priority on digital literacy to ensure the workforce can adapt to these structural shifts.

Smarter innovation

Escaping the low-innovation trap requires an active public policy that strengthens both the incentives and the capabilities of firms to innovate and cooperate. This section organizes the policy toolkit into four categories: instruments for financial support, tools for building internal firm capacities, initiatives for knowledge exchange and co-creation, and actions to strengthen critical enablers. The design of this policy portfolio must be contingent on the level of development and the sophistication of the local innovation ecosystem (Maloney et al., 2025).

For developing economies, technology adoption is a priority. However, adoption alone is not enough; the region must also build R&D capabilities. Frontier innovations, for instance, in agriculture, are rarely transferable "off-the-shelf" to the region's unique climates, soils, or disease profiles. Consequently, local scientific capabilities are essential, not only for the complex task of selecting, evaluating, and adapting global technologies to local realities, but also for building the foundation to eventually generate frontier innovations targeted at the region's most urgent challenges. Within this agenda, the adoption of advanced digital technologies is also paramount.

Digital transformation is a cross-cutting force reshaping business models, value chains, and competitive dynamics. However, digitalization also poses profound challenges. The widespread adoption of digital tools fundamentally alters task composition and skill requirements, triggering intense labor reallocation that risks exacerbating inequality and informality. Mitigating these disruptions requires robust complementary social policies. The region's strategy to strengthen its innovation ecosystem can be leveraged by its relationship with Europe, a global leader in innovation, particularly in renewable energy, clean tech, and digitalization. As a key source of FDI to the region, the EU also has the potential to complement these flows with knowledge transfer and spillovers to the entire local ecosystem.

Furthermore, there are concrete initiatives within the EU's strategy toward LAC. A prime example is the EU–LAC Digital Alliance, launched in March 2023, which is a core element of the Global Gateway Initiative and a key pillar of the partnership to promote inclusive digital transformation. It aims to foster public-private collaboration in areas such as regulation, connectivity, data flows, digital ecosystems, and space services. Key projects include expanding the BELLA cable—a direct high-speed fiber-optic link between Europe and LAC—to create a secure regional digital backbone and establishing a regional EU–LAC Digital Accelerator to boost innovation among startups and firms. The pipeline of initiatives also highlights projects linked to the energy transition, such as the renewable hydrogen fund in Chile or the electrification of public transport in Costa Rica.

Initiative for financial support for firms

Innovation and technological adoption require patient, risk-tolerant capital that private markets often fail to provide. To correct this underprovision, governments have a toolkit of instruments that can be grouped into three categories: direct support, debt instruments, and equity mechanisms.

Direct support instruments reduce the cost of innovation through explicit or implicit transfers. Common initiatives include *R&D grants*, which are competitive funds used to co-finance specific, complex projects in firms that typically already possess some internal R&D capabilities. They allow for the strategic funding of areas with high positive externalities but usually entail high administrative costs. *Vouchers* offer a more agile alternative for SMEs to purchase services. They are effective at initiating short-term collaborations, but their long-term impact depends on complementary support (Kleine et al., 2022). Finally, *tax incentives*, which reduce tax burdens based on company R&D expenditure, seem to have a faster and more robust effect on private

investment than direct subsidies (Beck et al., 2017; Jaumotte and Pain, 2005) but face the risk of firms merely relabeling existing expenses.

Debt instruments aim to unlock credit, particularly for SMEs. *Credit guarantee schemes* mobilize private lending by assuming a portion of the loan risk. Their main challenge is managing moral hazard, where banks may relax their due diligence. Penalizing banks with high default rates and rewarding high-performing portfolios mitigates this problem. Well-designed programs, such as Chile's FOGAPE, have demonstrated both financial and economic additionality. Similarly, *public direct credit programs* address liquidity constraints but risk crowding out private lenders or falling prey to political capture. Hence, targeting credit-constrained firms is key, as these programs otherwise carry the risk of financing firms that were not credit-constrained (Lazzarini et al., 2015). The *second-tier credit model*, where a development bank operates through commercial banks, is often superior as it leverages the knowledge of private intermediaries.

Finally, equity instruments provide essential capital for startups. Governments may use direct public capital funds to finance disruptive deep tech or employ a Fund of Funds model to invest in private venture capital funds. The evidence highlights that public equity is most effective when co-invested with the private sector (Berger et al., 2024). A final tool in this category is *tax incentives for investors* investing in qualifying startups. These help to mobilize venture capital. An effective design for such incentives includes minimum holding periods to encourage patient, long-term capital (European Commission, 2017).

Initiatives for building innovation capacities

Financial capital is necessary but insufficient for innovation. Firms, particularly SMEs, face a critical "capability gap"—lacking the internal knowledge and managerial skills to transform funds into productivity. Consequently, non-financial support is essential. Three instruments are commonly used for this purpose:

Technology Extension Services assist firms in identifying and adopting existing technologies and management practices. An analysis of the work carried out by Start-Up Chile found that while basic funding and co-working spaces alone had no significant effect, bundling these services with structured training and mentorship significantly boosted venture performance (Gonzalez-Uribe and Leatherbee, 2017).

Business advisory and training services strengthen strategic planning, financial management, and marketing. These tools directly address managerial failures, a significant obstacle to innovation. Finally, incubation and acceleration offer startups intensive support packages, including mentorship and network access. Incubators focus on early-stage ideas, while accelerators target the growth phase. Evidence from Start-Up Chile highlights that bundling these services with structured training is crucial (Gonzalez-Uribe and Leatherbee, 2017).

A critical challenge of this group of tools is cost-effectiveness. High-impact interventions like consulting are costly. Effective programs address this via a tiered approach: offering light-touch digital tools for broad outreach while reserving intensive

support for high-potential firms. Furthermore, requiring co-financing acts as a necessary filtering mechanism, ensuring firm commitment. Finally, rigorous evaluation is key to quantifying both impact and costs.

Initiatives for knowledge exchange and co-creation

Modern policy aims to create ecosystems that turn isolated actors into interconnected networks to maximize knowledge spillovers and address coordination failures. Unfortunately, innovation surveys reveal a scarcity of collaborative R&D projects and limited cluster formation for LAC (WIPO, 2024). To bridge these gaps, governments may employ instruments like clusters and collaborative R&D grants.

Cluster development programs foster agglomeration externalities through strategic direction, technical assistance, and shared public goods. Evidence confirms their potential: Brazil's *Arranjos Produtivos Locais* increased SME employment by 17% (Figal Garone et al., 2015). To navigate challenges like mis-targeting and governance capture, best practices suggest a staged approach: starting with rigorous diagnostics to identify latent comparative advantages—rather than political preferences—and gradually shifting governance to the private sector.

Public-private R&D partnerships are a cornerstone of modern innovation policy, designed to bridge the gap between the scientific and business communities. Instruments like collaborative R&D grants and research consortia explicitly aim for the co-creation of knowledge, combining industry's market know-how with academic expertise to produce commercially relevant innovations. These partnerships favor knowledge externalities: a Chilean study found that while individual grants improved recipient productivity, only collaborative grants generated positive spillovers for other firms (Crespi et al., 2020).

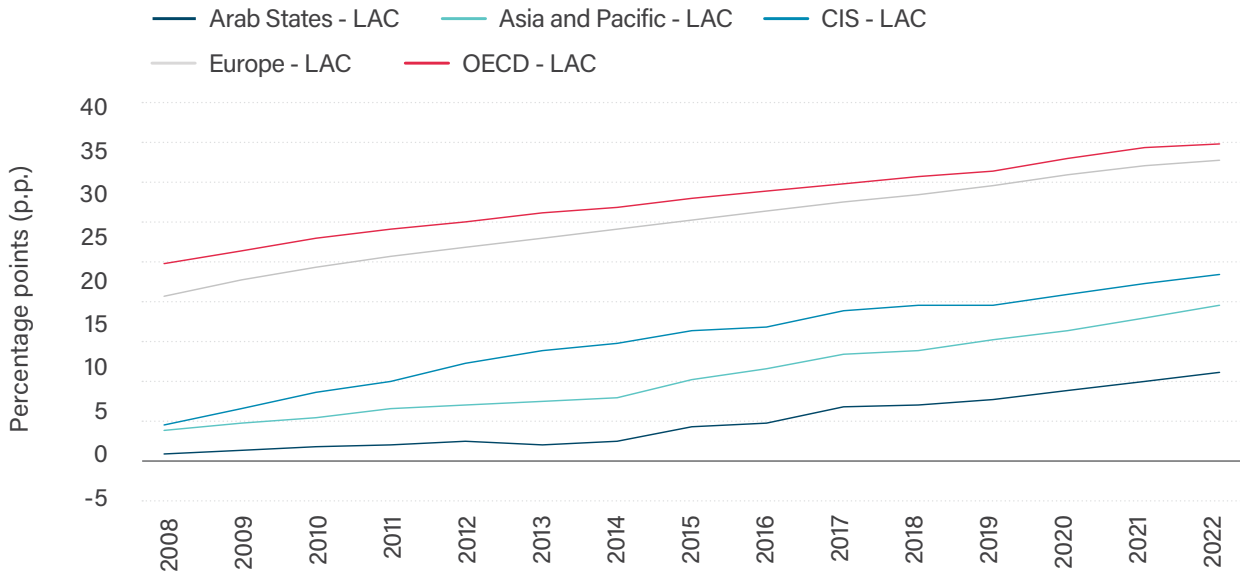
Actions for key innovation enablers

The effectiveness of direct support and collaboration policies is severely limited without a solid foundation of enabling conditions. While the full spectrum of enablers is broad, the focus here is on two that are intrinsically linked to the innovation policy agenda: digital connectivity and public research systems.

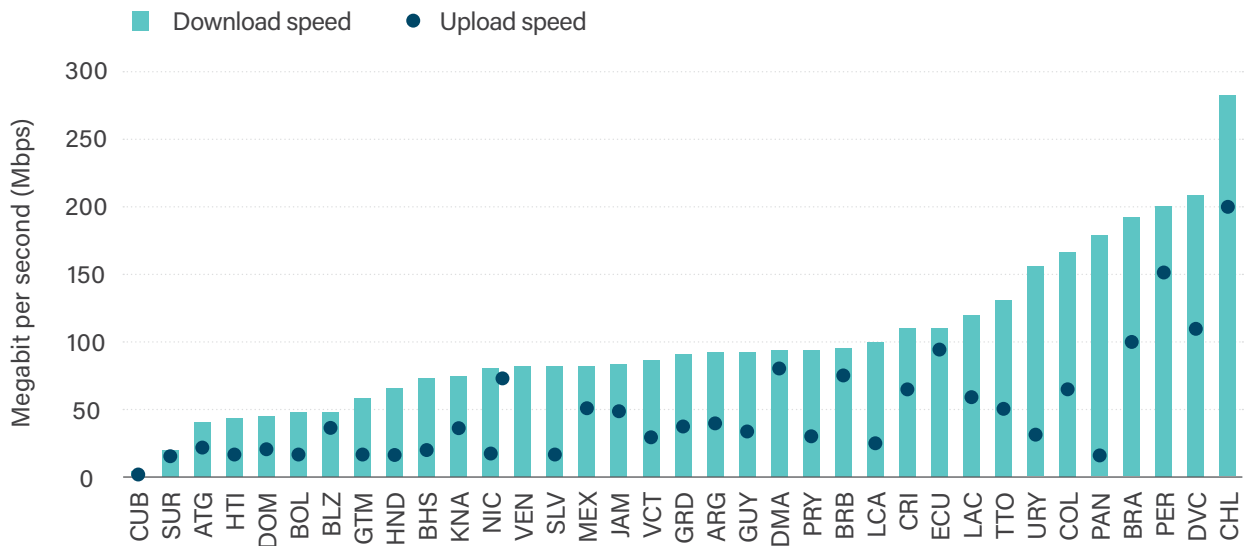
The region faces a critical digital connectivity gap, which acts as a fundamental bottleneck for digital transformation. Although 73% of the population has internet access, penetration still lags behind the developed world (90%). While the gap in broadband penetration is growing, the quality gap is even more severe: average download speeds in high-income countries are 75% faster than the regional average, and stark urban-rural divides persist (Graph 18). To close this gap, the report recommends four concrete actions: (1) promote public and private investment to expand high-quality broadband access, especially in underserved areas; (2) modernize regulatory frameworks to foster competition and investment in the telecommunications sector; (3) strengthen institutional infrastructure, establishing clear frameworks for cybersecurity and data protection to build trust; and (4) invest in digital skills among the population to foster digital adoption.

Graph 18
Gaps in digital infrastructure

Panel A. Connectivity gap, fixed broadband (2008-2022)



Panel B. Maximum download speed of Internet service on fixed connections by country



Note: The connectivity gap refers to the difference in fixed broadband penetration between the different regions of the world and LAC, subtracting the penetration results in percentage points (p.p.). Download speed measures how quickly data can be transferred from an internet server to a device, while upload speed measures how quickly data is sent from a device to the internet. Speed, measured in megabits per second, corresponds to the median speeds recorded during December 2024. DVC stands for the simple mean of the available developed countries: France, Italy, Japan, Korea, Portugal, Spain, UK, and US.

Source: Authors based on the Observatorio de Desarrollo Digital (2025a, 2025b).

In addition to improving digital connectivity, a vibrant innovation ecosystem relies on a strong public research system. Such a system is fundamental for generating knowledge and advanced human capital relevant to the productive sector. To move forward, the report recommends: (1) utilizing a balanced funding portfolio that combines competitive grants (to promote excellence) with institutional funding (to provide stability); (2) investing in modern scientific infrastructure and actively promoting public-private partnerships to close the academia-industry gap; and (3) reforming researcher performance evaluation systems to value not only academic publications but also technology transfer, patenting, and social impact.

Better integration

Despite the liberalization efforts undertaken by LAC, most evident in tariff reductions, trade costs remain high. However, the current global protectionist environment does not call for swift unilateral liberalization. Large economies are deeply engaged in transactional negotiations driven by their own strategic interests. In this context, remaining trade-protective measures in LAC are better addressed through negotiations that seek concessions from the other side, ideally coordinated at the regional level to increase bargaining power.

At the same time, there is an outstanding integration agenda that can move forward largely independent of global trade dynamics. Priority should be given to policies that enhance the efficiency of trade transactions. This includes improving transport markets and infrastructure, reassessing non-tariff measures, and facilitating trade. In addition, diplomacy plays a crucial role in reducing information barriers and solving coordination failures by identifying mutually beneficial opportunities with trading partners and in connecting domestic producers with foreign demand.

Tariffs

Most economies in the region maintain tariff levels above global levels, with high dispersion across goods and origins. While a unilateral reduction of tariffs in the current context is generally not advisable, there is scope for reducing distortions.

Tariff schedules in some cases reach extreme values—above 180% for certain good–origin–destination combinations in CARICOM and over 240% in parts of Mesoamerica—creating distortions and efficiency losses. In some sectors, tariff structures even generate *negative protection*, where the tariff structure inadvertently targets a sector’s inputs with a higher average tariff level than its output, which undermines its competitiveness.¹¹ High dispersion also creates incentives for tax evasion and corruption: misclassifying imports or reorganizing production enables firms to evade a significant portion of the tariffs they owe.

11. For instance, estimates for Brazil show that effective tariffs in 2015 were negative for seven of the 41 sectors in the sectoral partition of the economy used (Bloch, Soares, 2019).

The flipside is that enforcement becomes more costly and demanding, and these distortions result in efficiency losses and resource misallocation. A pragmatic approach is to simplify tariff schedules by gradually reducing the most protected categories until they converge toward the sector's average tariff level.

LAC's trading partners levy relatively higher tariffs on sectors central to the region's export basket. Agricultural raw products and agricultural manufactures are the sectors with the highest MFN tariffs in the EU, the US, and ASEAN+3, with maximum rates exceeding 200%. Reducing these tariffs remains a priority in trade negotiations and is one of the contentious domains in the Mercosur-UE trade agreement currently under review.

Finally, there is significant scope to lower intra-regional tariffs to strengthen integration within LAC. For example, Mercosur and the Andean Community impose tariff levels on the Common Central American Market and CARICOM that are as high as those for developed and high-productivity regions like the EU.

Non-tariff measures and trade facilitation

Customs administrative procedures and non-tariff measures (NTMs), including technical standards, sanitary and phytosanitary rules, and non-technical trade-protective measures, often impose higher barriers than tariffs themselves.

Technical measures are necessary components of trade policy and can have positive effects by increasing the available information, facilitating comparison, and signaling that products are safe for consumers. They are particularly relevant for agricultural and food products, particularly sanitary and phytosanitary requirements. However, a comparatively large prevalence may also be an indication of hidden protectionism. Additionally, regulatory differences between partners significantly reduce trade: a 10% increase in regulatory divergence lowers the probability of trading by about 1.2 percentage points and reduces trade volumes by 3.5%, with even stronger effects in agriculture (Blyde, 2024).

UNCTAD data indicate that technical measures in the region are less numerous than in the EU or the US, especially for animal and food products, yet the diversity of national standards and the absence of mutual-recognition mechanisms make compliance burdensome for firms. In contrast, the use of non-technical measures is more prevalent in LAC. Environmental protection frameworks like the EUDR are apparent in the number of technical measures affecting sectors in agriculture and agricultural manufactures. State support in establishing collaborations for overcoming such barriers is of central importance for strengthening ties with the EU.

Addressing this challenge requires a dual agenda of regulatory convergence and digital modernization. Convergence involves aligning technical and sanitary standards with those of key markets and among regional partners to avoid duplicated controls and the need for product variants tailored to different

regulations; likewise, harmonizing customs procedures—particularly through mutual recognition and simplified rules of origin—would strengthen regional value chains.

Digital technologies can dramatically improve efficiency: AI-based tools can screen technical product descriptions to flag risks, while digitalization and IoT sensors enhance traceability and facilitate compliance with safety and environmental requirements. Single-window systems enable firms to submit documentation once and share it automatically with customs, health, and tax authorities. Successful regional examples, such as Brazil’s Portal Único de Comércio Exterior and Uruguay’s electronic phytosanitary certificates, have halved clearance times and reduced compliance costs by double-digit percentages.

Because administrative modernization and regulatory reform are strongly complementary to technological adoption, customs procedures must be redesigned to leverage the available digital technologies. An integrated approach of this kind can shorten border delays, reduce uncertainty, and make the region’s trade environment more transparent and predictable.

Transport costs

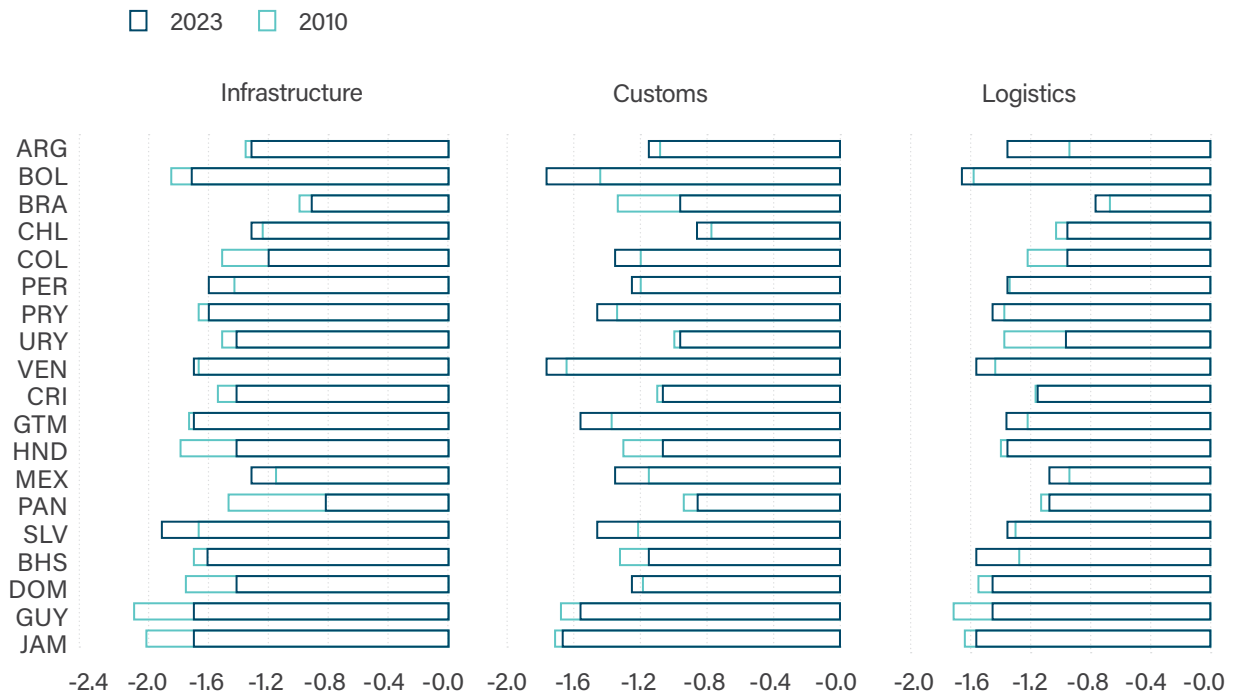
Transport infrastructure and logistics performance are decisive determinants of trade costs. LAC’s geography, combined with underinvestment and fragmented networks, raises costs and limits intra-regional flows.

An analysis of CIF-FOB margins (the ratio of the price of goods after transport and insurance costs have been paid relative to the price at the port of origin) shows that, on average, transport costs for intra-regional exports in South America are the highest among major world regions—well above those in North America or Europe. The region’s trade relies heavily on maritime routes, even for short distances, reflecting inadequate land connectivity.

The World Bank’s Logistics Performance Index shows that all LAC countries lag North American standards by about 1.3 points in logistics competence and customs efficiency and by 1.5 in infrastructure quality, on a scale of 0 to 5. Panama, Brazil, Uruguay, and Chile perform best in the region, but gaps remain large. Finally, while infrastructure shows some improvements for most countries since 2010, especially Panama, Guyana, and Honduras, improvements have been modest at best in customs and logistics (Graph 19).

Graph 19

LPI scores gap respect to north america, by countries and benchmarks, 2010 and 2023



Note: The graph shows the gap in the respective components of the Logistic Performance Index for each country, as a gap relative to the value for the Canada-US average, for years 2010 and 2023. Countries are ordered alphabetically within the subregions: South America, Mesoamerica, and CARICOM+3. The index and its components can take values from 0 to 5. Levels for the Canada-US average for the infrastructure, logistics, and customs are 4.09, 3.95, and 3.69 for 2010, and 4.10, 4.05, and 3.85 for 2023.

Source: Authors based on World Bank (2025).

Reducing transport costs requires both significant and continued investment in infrastructure, complemented by market reforms. Within this context, expansions and upgrades to transport infrastructure must place resilience at the forefront. This is particularly critical for the Caribbean, where extreme climate exposure makes it one of the world’s most vulnerable regions. Hurricanes, flooding, and sea-level rise repeatedly damage road, port, and airport networks, disrupting connectivity and imposing persistent economic losses. Recent analysis comparing standard and resilient infrastructure across Barbados, Jamaica, and Dominica—countries with varying levels of climate risk—shows that resilient designs consistently offset the negative economic impacts of extreme weather events and generate net gains that exceed their higher upfront costs (Brichetti et al., 2025).

A sound transport infrastructure strategy begins with long-term strategic planning to guide investment decisions, secure the required resources for continued investments, and adequately balance infrastructure expansion with maintenance works. Regarding

transport markets, in competitive segments—such as air and road transport—opening markets can lower prices, while sectors that exhibit natural-monopoly characteristics, including ports, airports, and railways, require strong regulatory capacity or direct public provision.

Mobilizing private capital through public-private partnerships is also essential to close persistent investment gaps. At the same time, governments must balance spending on new construction with adequate maintenance budgets, taking advantage of digital technologies to monitor infrastructure conditions and allocate resources efficiently. Transport planning needs to be aligned with productive development and trade strategies so that infrastructure supports diversification and export growth. Finally, coordination between neighboring countries is indispensable for bi- or plurinational projects, ensuring that cross-border investments reduce bottlenecks and facilitate deeper regional integration.

Export promotion and sectoral opportunities for integration

To unlock the full potential for integration, governments can actively catalyze trade by supplying sector-specific public goods, lowering information frictions, and solving coordination failures to help new exporters enter and stay in foreign markets.

Smart diplomacy aligns political leadership, technical negotiations, and private-sector action to open foreign markets through sectoral advocacy, high-level support, and synchronized technical missions. Its main mechanism is to reduce information gaps that affect first-time exporters and exports to new destinations. These micro trade policies complement broader reforms and are especially powerful when paired with preferential market access, trade facilitation, and “export roundtables” that coordinate agencies and firms.

Evidence from programs like *Exporta Fácil*,¹² which significantly streamlined procedures for exporting small parcels, shows strong effects on the extensive margin—more firms and products exporting—highlighting that bottlenecks are concentrated at the entry stage. R&D support further enables product adaptation, quality upgrading, and differentiation, raising the value added in exports.

A strategic integration agenda also requires local public goods that enable deeper links with the EU. Europe operates under regulatory standards in labor, inclusion, and environmental protection that rank among the most ambitious globally. For firms in LAC to maintain and expand access to the EU market, they must be able to demonstrate compliance with these high standards. This, in turn, demands key public goods—such as robust traceability systems for agricultural and livestock products—

12. The *Exporta Fácil* program is a cooperative initiative between government agencies, customs authorities, and national postal services that significantly reduces the cost and bureaucracy of exporting small parcels valued up to a set limit (USD 10,000 initially, later raised to USD 50,000). The program reduced the number of documents required to export, avoided the need for a customs operator, and relied on the postal service, removing the need for SMEs to travel to capital or port cities for an export operation. This program has been implemented in Brasil, Colombia, Ecuador, Perú y Uruguay.

that allow producers to certify that their goods are not linked to deforestation or other environmental harms, in compliance with the EUDR.

Finally, beyond trade policies, the integration agenda must also address a set of concurrent trade barriers prevalent in the region: uneven state capacity and the presence of illegal activities. First, institutional quality varies widely across LAC. For trade-related institutions and agencies, this means that sanitary and technical standards that are formally identical or harmonized across countries are not enforced with comparable capacity. As a result, controls must often be duplicated even within customs unions, undermining the value of new trade agreements.

In addition, corruption, organized crime, and other illegal activities remain legitimate concerns for trading partners in other regions. Addressing these challenges domestically is therefore a critical, complementary lever with significant potential gains for regional integration.

Enabling factors

The success of the growth agenda outlined above requires three foundational pillars: an agile state capable of strategic facilitation, sound public finances to ensure stability and financing, and broad social consensus to guarantee the political viability of reforms. This, in turn, calls for a phased rollout of interventions and proactive coalition-building, together with policies to support vulnerable groups affected in the short term.

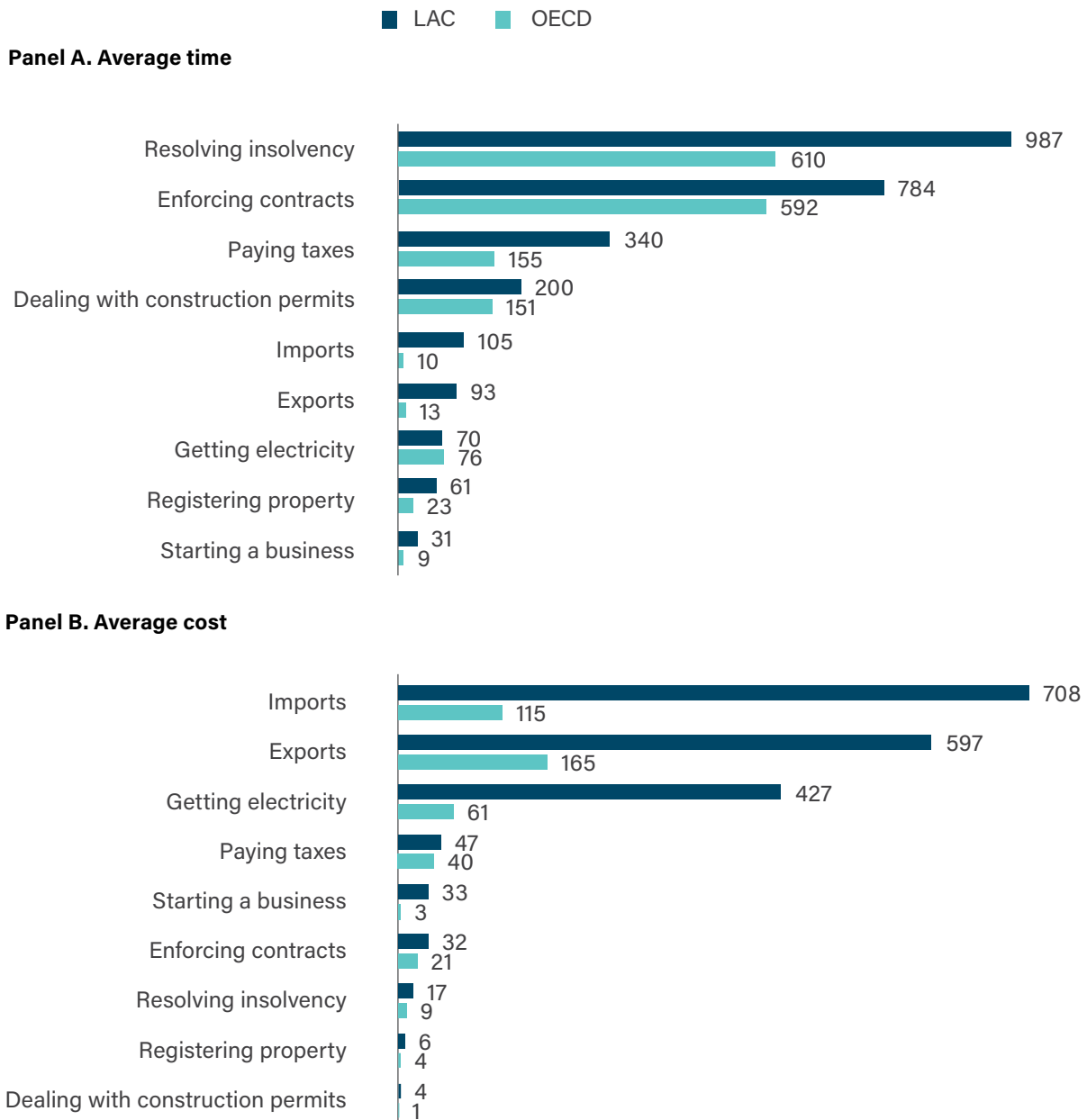
The State: From a tollbooth to a strategic facilitator

Unlocking growth requires a state with strong institutional capabilities and an agile regulatory framework. When these capabilities are weak, regulations and state activities become “tollbooths” that discourage investment, distort resource allocation, promote informality, and ultimately undermine productivity. High state capacity is also essential for designing and implementing the diverse instruments and initiatives required by the development agenda, as well as for improving tax collection and public spending efficiency.

Although LAC has made progress in simplifying bureaucracy, the administrative burden remains disproportionately high. For example, opening a business costs ten times more, and the time to trade across borders is nine to ten times longer than in OECD economies (Graph 15). Likewise, data from the World Bank's new *Business Ready (B-Ready)* program confirms this gap, highlighting a disconnect between de jure laws and de facto reality: the region scores relatively well on the Regulatory Frameworks pillar (the law on the books) but performs significantly worse on the Public Services (implementation) and Operational Efficiency (firm perception) pillars.

Graph 20

Regulatory burden: LAC and OECD



Note: Panel A: Time is measured as follows: taxes in hours per year; imports and exports in hours. Panel B: Costs are measured as follows: starting a business and getting electricity as a percentage of income per capita; dealing with construction permits as a percentage of warehouse value; registering property as a percentage of property value; paying taxes as a percentage of profit; enforcing contracts as a percentage of claim; Resolving insolvency as a percentage of estate; and exports and imports in USD.

Source: Authors based on the *Doing Business Report* (World Bank, 2020).

The problem runs deeper than mere red tape; it stems from weak bureaucratic skills and incentives, compounded by poor regulatory governance. This governance deficit is evident in the inconsistent use of *Regulatory Impact Assessments (RIA)*—which prevents proper cost-benefit analysis—and a prevailing "regulate and forget" culture that lacks ex-post evaluation, leading to an accumulation of obsolete rules. Furthermore, stakeholder engagement is often superficial and opaque, increasing the risk of capture, while weak coordination between government levels frequently results in costly duplication and regulatory contradictions.

Transforming the state into a strategic facilitator requires institutionalizing deep reforms. First, the regulatory cycle must operate on the logic of prevent (ex-ante) and cure (ex-post). An agile state needs to institutionalize RIAs and enhance transparency to control quality before new rules are created; simultaneously, it must reassess and streamline the existing stock of regulations through ex-post evaluations and systematic simplification programs to eliminate obsolete norms. This shift also demands flexible, risk-based regulations that are well-suited to the context and that are proportional to risks. For instance, general banking regulations may be ill-suited to fintech startups, which are relatively small and pose less systemic risk. Regulatory sandboxes can allow testing and the proper calibration of new regulations. To operationalize this agility, digitalization for redesign is the central lever to make government interactions faster, cheaper, and more transparent. However, the goal is to simplify processes first, ensuring the state does not merely "digitize existing bureaucracy." This is achieved through single windows that allow citizens to fulfill all procedures for a task that may involve multiple government agencies, like registering a firm, and data interoperability (the "collect once, use many times" principle) to eliminate redundant procedures.

Finally, the sustainability of these reforms depends on strengthening capabilities and coordination. Reforms fail without the human capital to implement them, making investments in the skills of public officials and creating formal multi-level coordination mechanisms crucial. Success hinges on political leadership and the fight against capture. Regulatory reform requires strong, sustained leadership at the highest level to overcome bureaucratic inertia, along with full transparency to dismantle resistance from vested interest groups.

Financing development under fiscal stress

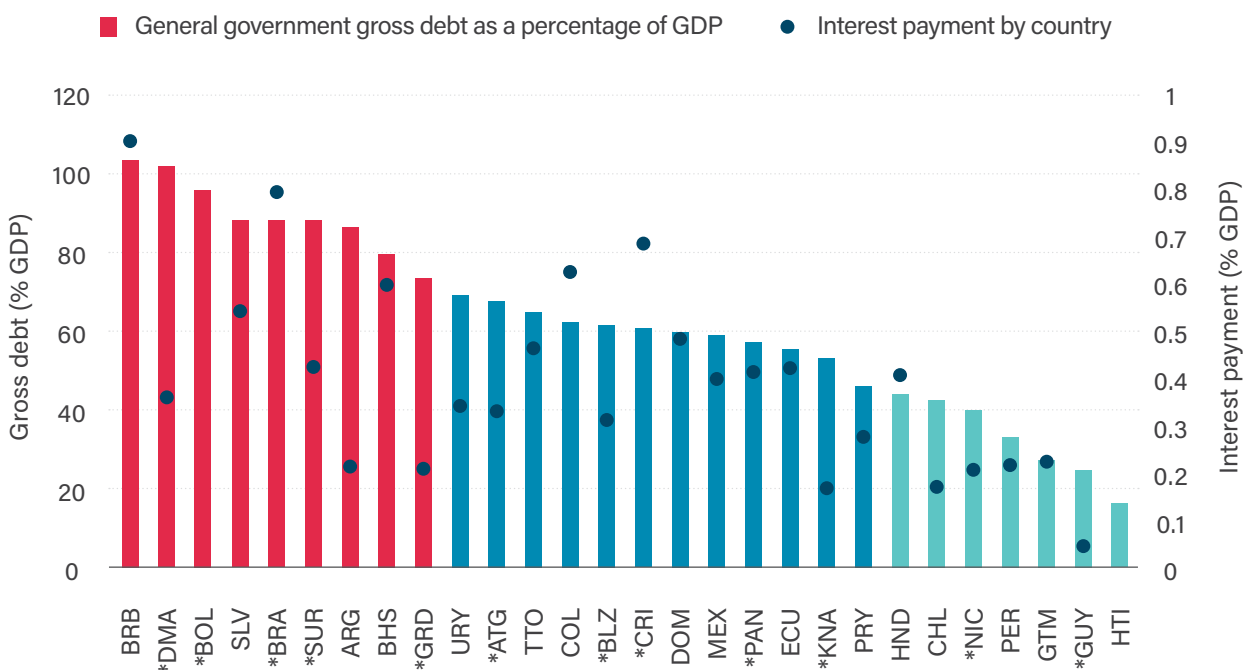
Sound public finances are essential for growth. A lack of fiscal space limits the state's capacity to make productivity-enhancing investments, while fiscal imbalances exacerbate macroeconomic vulnerabilities. Unfortunately, the region's public finances show structural weaknesses and face growing pressure.

Between 2017 and 2024, government spending remained stable at 20%–21% of GDP, peaking at 23.8% in 2020 due to the pandemic. This spending is dominated by current expenditures (82% of the total in 2023), standing in stark contrast to persistently low capital investment. This imbalance is compounded by large inefficiencies in public spending for the region.

Most countries display fiscal deficits (i.e., primary plus debt service), although approximately half maintain primary surpluses. As a result of persistent deficits and pandemic-related measures, average gross public debt in LAC reached 74% of GDP in 2023. However, there is wide heterogeneity across the region, with ratios ranging from below 40% to nearly 100%.

A growing concern is the rising cost of debt service. The regional average for interest payments rose from 2.3% of GDP in 2017 to 2.8% in 2024. In some countries, these payments crowd out development spending.

Graph 21
General government gross debt and interest payments in LAC



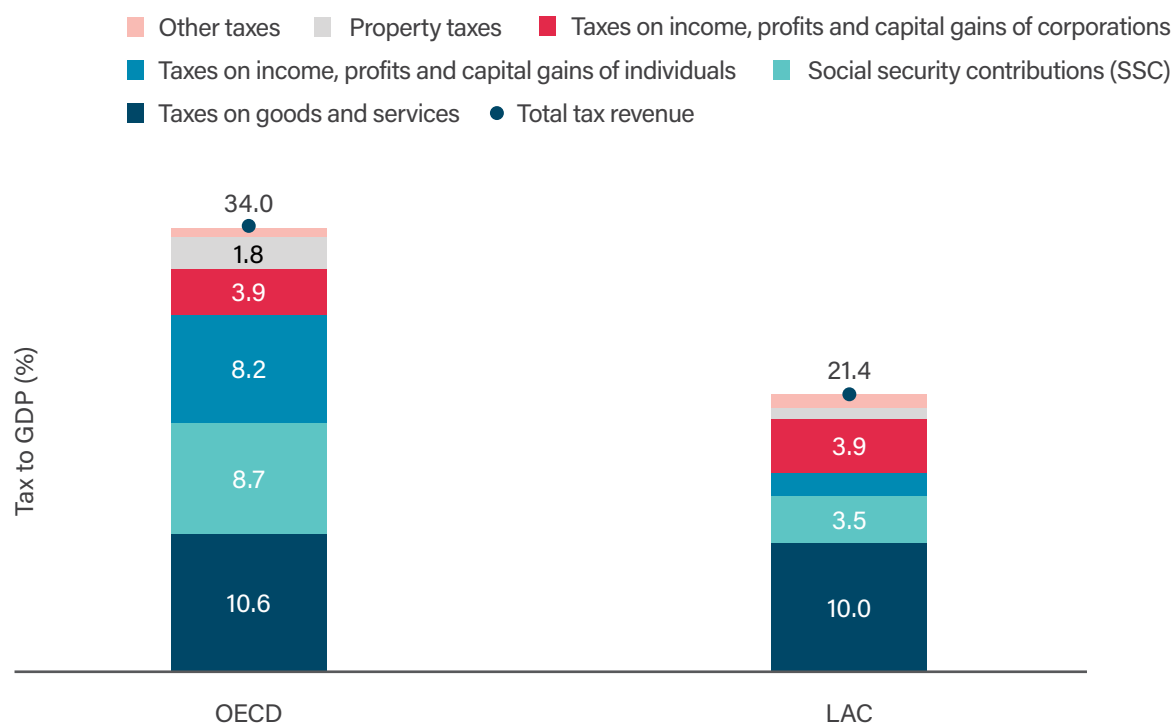
Note: The bars show general government gross debt as a percentage of GDP. Values marked with (*) correspond to 2024 estimates. Red indicates countries with gross debt above 70% of GDP; dark blue indicates countries with debt between 45% and 70% of GDP; and light blue indicates countries with debt below 45% of GDP. Data points represent interest payments by country in 2024. For Antigua and Barbuda, Barbados, Belize, Dominica, Grenada, Guyana, Jamaica, Saint Kitts and Nevis, and Suriname, the latest available data refer to 2023.

Source: Authors based on data from World Economic Outlook (IMF, 2025) and ECLAC (2024).

Looking ahead, this situation is compounded by new pressures from population aging, which drives up pension and health spending; the energy transition, which demands new public investment in mitigation while simultaneously eroding revenues for hydrocarbon-rich countries; and global warming, which demands investment in adaptation and measures to overcome the social and economic effects of natural disasters. Addressing this scenario requires a multi-pronged strategy: implementing domestic fiscal reforms, improving spending efficiency, and leveraging international cooperation.

A critical priority is strengthening tax systems. In 2023, LAC's average tax revenue stood at 21.3% of GDP, significantly below the OECD average of 33.9%. Regional tax structures remain dominated by indirect taxes (accounting for 47% of total revenue), while personal income tax remains a "missing pillar," contributing barely 2% of GDP compared to 8.2% in the OECD (Graph 22).

Graph 22
Tax-to-GDP ratios, LAC and OECD averages, 2022



Note: Tax revenue as a percentage of GDP.

Source: Authors based on data from OECD (2024).

The needed increase in tax collection will therefore have to rely, in part, on personal taxation. The challenge is not only the level of rates but the breadth of the tax base. In LAC, individuals become liable for income tax only once their earnings exceed 1.4 times GDP per capita, compared to just 0.31 times in Europe. Consequently, reforms should focus on broadening the tax base, curtailing exemptions, and revising thresholds. Because informality and tax evasion remain major barriers, these efforts require both stronger enforcement and policies that reinforce “tax morale.”

Countries should also explore other revenue sources, including property, green, and mining taxes, though the latter require transparent stabilization funds to manage commodity volatility.

A second strategy involves leveraging multilateral development banks (MDBs) and thematic bonds. MDBs act as catalysts to attract private capital; evidence shows that MDB involvement can yield a multiplier of 4.4, meaning every dollar invested mobilizes four additional dollars from third parties. At the same time, thematic (GSSS) bonds have become a fundamental financing source for LAC. In 2023, they accounted for 35% of all international bonds issued in the region, up significantly from 9.3% in 2020.

Strengthening links with Europe also offers critical mechanisms for improving the region's public finances and debt sustainability. The EU's Global Gateway initiative uses a blended finance approach, combining loans, grants, and guarantees to de-risk investments and mobilize private capital without overburdening state budgets. In the realm of thematic financing, the alliance is already delivering results linked to energy transition projects (such as the hydrogen fund in Chile). More broadly speaking, attracting additional European FDI can help ease fiscal constraints: by channeling private capital into strategic infrastructure—such as renewable energy and digital backbones—the region can narrow its development financing gap and ease the burden on public debt, preserving limited fiscal space for other priorities.

Finally, enhancing efficiency through digitalization is crucial. Digitalizing tax processes improves compliance, while digital technologies raise the quality of public services by enabling new delivery models, improving targeting, and reducing corruption.

Reaching consensus: Overcoming implementation challenges

Implementing structural reforms and pursuing the development agenda face formidable political-economy challenges. A central dilemma lies in the distribution of costs and benefits: the costs of reforms tend to be immediate and concentrated among well-organized groups, while the benefits are diffuse and often materialize in the long term.

Navigating these challenges requires a multifaceted approach. First, success depends on rigor, communication, and leadership: reforms must be anchored in solid technical work that quantifies the costs of inaction. Yet evidence alone is not enough; it must

be championed by clear political leadership capable of communicating the need for change to build consensus. Second, gradualism and compensation are critical to reducing resistance. Transition mechanisms can smooth economic adjustments and defuse opposition, making well-designed compensation schemes for those adversely affected an essential ingredient for political viability.

Finally, bundling policies and instruments helps spread the costs of reforms, reducing opposition/helps distribute the costs of reform and reduce opposition. One example is combining different tax instruments instead of putting all the effort into a single one. Another strategy is to link reforms with visible benefits, for example, pairing a fiscal adjustment with an increase in the quality of public services.

Ultimately, the success of reforms depends not only on their technical design but also on a sophisticated political strategy capable of managing these tensions, compensating those who stand to lose, and articulating a credible long-term vision for society.

A particularly important source of tension will arise in the labor market. The green and digital transitions, alongside trade shocks and industrial policies, will trigger significant labor reallocation. If not managed properly, this process could increase informality, unemployment, and inequality—a particularly acute problem for low-skilled workers. However, these negative effects can be mitigated through complementary policies. Therefore, strengthening social protection and scaling ALMPs—focused on training and inclusion—are crucial to ensure that the technological revolution, the green transition, and the implementation of the growth agenda narrow, rather than deepen, existing social gaps.

Finally, it is crucial to emphasize that the sustainable development agenda—and productive development in particular—is an inherently long-term endeavor. It requires a perspective that transcends electoral cycles and prioritizes strategic continuity. In this context, National Development Plans could provide governments with an anchor to shield economic strategy from short-term political volatility. By codifying goals and fostering broad societal consensus, these plans may help transform transient government initiatives into enduring state policies, providing the certainty and direction needed to guide public and private investment across different administrations. Furthermore, engagement with the multilateral system—through adherence to the UN Sustainable Development Goals (SDGs) and partnerships with regional development banks—provides an external layer of continuity. By anchoring national goals in international commitments and long-term financing, countries can better insulate their development strategies from domestic political turnover.

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Average income per capita in Latin America and the Caribbean amounts to barely one quarter of that of the United States, a gap that has remained virtually unchanged for more than six decades. This persistent divergence has profound implications for the well-being of the population. The report identifies low productivity as the fundamental driver of the income gap, not only because of its direct effects, but also because it indirectly underpins the region's low investment in physical and human capital.

Sustained, broad-based economic growth is both a necessary condition and an essential instrument for advancing toward comprehensive development. Against this backdrop, the report presents a policy agenda structured around three core constraints on productivity: high levels of informality, weak innovation capacity, and limited international integration.

These reforms must be pursued in a global context marked by rising geopolitical tensions, a resurgence of protectionism, accelerating technological change, and the urgency of adapting economic systems to the climate crisis. While these dynamics impose constraints, they also create new opportunities. In response, the report proposes a strategic approach that combines horizontal policies with a targeted focus on strategic sectors, and highlights strengthening ties with the European Union as a key lever to foster growth, raise productivity, and deepen Latin America and the Caribbean's international integration in global markets.