Latin American Economic Outlook 2018

RETHINKING INSTITUTIONS FOR DEVELOPMENT

OECD DEVELOPMENT CENTRE

DEVELOPMENT BANK OF LATIN AMERICA

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Latin American Economic Outlook 2018

RETHINKING INSTITUTIONS FOR DEVELOPMENT

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Foreword

The *Latin American Economic Outlook* analyses issues related to economic and social development in the Latin America and the Caribbean (LAC) region. Each year, since the launch of the first edition in November 2007, the report compares LAC's performance with that of other countries and regions around the world, analysing the main development challenges of the region, and putting forward policy recommendations, experiences and good practices.

Since 2011, the report has been published in conjunction with the United Nations Economic Commission for Latin America and the Caribbean (ECLAC). It has also incorporated the economic theme of the annual Ibero-American Summit organised by the Ibero-American governments and Ibero-American General Secretariat (SEGIB). In 2013, CAF – Development Bank of Latin America –joined the team of authors, followed by the European Commission, who joined the report in 2017 as one of its main partners.

This eleventh edition *Rethinking Institutions for Development* focuses on the analysis of the increasing disconnect between citizens and public institutions in LAC, illustrated by a decline of trust, the lack of good jobs and the decreasing satisfaction with key public services such as health and education. The report argues that this growing divide is weakening the social contract in the region, and that a new state-citizens-market nexus must be built, by rethinking institutions to boost inclusive growth and to build states that deliver and respond to citizens' demands by being more reliable, more efficient and effective, and more forward-looking.

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Acronyms and abbreviations

ALADI Latin American Integration Association
ALMPs Active Labour Market Policies
APEC Asia-Pacific Economic Cooperation
API Application Programming Interfaces
ASEAN Association of Southeast Asian Nations
BTI The Bertelsmann Stiftung's Transformation Index
CAF Development Bank of Latin America
CAFTA Central America Free Trade Agreement
CAFTA-DR The Dominican Republic–Central America Free Trade Agreement
CEQ Commitment to Equity Institute
CIT Corporate Income Tax
CoG Centre of Government
CPBs Central Purchasing Bodies
CPI Corruption Perception Index
DUs Delivery Units
ECLAC Economic Commission for Latin America and the Caribbean
EGDI E-government Index
EU European Union
FDI Foreign Direct Investment
GDP Gross domestic product
GVC Global Value Chains
ICT's Information Communication Technologies
UHC Universal Health Coverage
IDB Inter-American Development Bank
IMF International Monetary Fund
IoT Internet of Things
IREG Indicators of Regulatory Policy and Governance
LAC Latin America and the Caribbean
LAPOP Latin America Public Opinion Project
M&E Monitoring and evaluation
M2M Machine-to-Machine
MfDR Managing for Development Results
MIT Middle-Income Trap
MNEs Multinational Enterprises
NAFTA North American Free Trade Agreement
NGOs Non-Governmental Organisations
NPPA National Public Procurement Agency
NSE Non-Standard Forms of Employment
NTM Non-Tariff Measures
OECD Organisation for Economic Co-operation and Development
OGD Open Government Data
OPEC Organisation of the Petroleum Exporting Countries
OGI Open Government Index
OSH Occupational Safety and Health
PDPs Productive Development Policies
PISA Programme for International Student Assessment

PIT Personal income Tax
PPPs Public-Private Partnerships
PSI Public Sector Information
PTA Preferential Trade Agreements
QoG Quality of Government
R&D Research and Development
RoR Rules of Origin
SDGs Sustainable Development Goals
SDP State Development Plan
SEDLAC Socio-Economic Database for Latin America and the Caribbean
SIB Social Impact Bonds
SME Small medium enterprise
TFI Trade Facilitation Indicators
TiVA Trade in Value-Added
TSU Technical Support Unit
UNCTAD United Nations Conference on Trade and Development
USD United State Dollar
VAT Value-Added Taxes
WB World Bank
WEF World Economic Forum
WHO World Health Organisation
WTO World Trade Organisation
WVS World Value Survey

Editorial

The Latin America and the Caribbean (LAC) region has been experiencing a growing disconnect between citizens and public institutions in recent years. Indeed, the latest *Latinobarómetro* survey shows that 75% of Latin Americans showed little or no confidence in national governments in 2017, up from around 55% in 2010. Trust in other institutions like the judicial system or elections also deteriorated as dissatisfaction with the quality of public services grew.

This growing disconnect is not specific to Latin America, as it is also gaining ground in other regions of the world, and stems from several factors, some of them particular to Latin American countries. On the positive side, a more demanding society calls for more and better public services, notably in health and education. It also asks for more efficient, trustworthy, open and innovative public institutions. This shift has been largely driven by the expansion of the middle class, one of the greatest socio-economic transformations in the region, which represents today more than a third of LAC's population. For the first time in decades, the middle class is more numerous than the population living in poverty. The implications are significant for public policies and for the functioning of democracy itself.

The *Latin American Economic Outlook 2018 (LEO 2018): Rethinking Institutions for Development* argues that reconnecting public institutions with citizens and better responding to their demands is critical for well-being and the sustainable development of the region. Indeed, it is a vital step to guarantee a new period of economic growth, social progress, political stability and greater well-being for all in LAC. The policy debate, therefore, must devote greater focus to rethinking institutions.

But the growing divide between citizens and institutions reflects some persistent socio-economic challenges, documented in previous editions of the *Latin American Economic Outlook* – including for example the persistence of large inequalities related to socio-economic background, gender, or geographical location, low access to education and skills, and the predominance of low quality, informal jobs. In addition, emerging concerns related to the international trade system and the possible implications of technological progress on the future of work also increase uncertainty. On the domestic front, low levels of productivity and the stagnation of incomes at middle-income levels – what is often called "the *middle-income trap*" – remain critical challenges for greater well-being in LAC. Despite progress, 25% of Latin Americans still live in poverty, while around 40% have escaped poverty during the last 15 years, but only to join a vast and vulnerable social group of mostly informal workers that could easily fall back into poverty. This means that close to 65% of Latin Americans still live in poverty or vulnerability.

The disconnect between society and institutions in LAC thus derives from a combination of rising aspirations and unmet demands as well as persistent and emerging socio-economic challenges that erode trust and the foundations of the social contract. Trust is a cornerstone of public governance, and critical for the success of public policy. Without trust, citizens disengage from their civic duties and find few incentives to participate in politics and to pay taxes. Eventually, this damages the legitimacy of governments and their capacity to finance and deliver good quality public services resulting in a negative spiral that further erodes the social contract.

These economic, social and political challenges are being confronted with a macroeconomic performance that is improving, but not good enough. After five years of economic slowdown and a two-year recession in 2015-16, a modest recovery is now

underway. Gross domestic product grew at a rate of 1.3% in 2017, and is projected to grow between 2-2.5% in 2018. The macroeconomic outlook still points to different "Americas Latinas", with significant heterogeneity across countries. A stronger recovery is expected in the Southern cone than in the Andean countries and Mexico, with a more mixed outlook for Central America. Increased global trade, a moderate recovery in commodity prices and the gradual monetary normalisation in advanced economies – still supportive of financial flows – underpin the cyclical recovery in the region. Short-term risks look more balanced, but increased uncertainty about the progress of globalisation may dampen trade and foreign direct investment flows. In addition, a series of global megatrends, affecting Latin America and many other economies, is intensifying. These include weaker productivity, technological change, an ageing population, urbanisation and climate change. All of them challenge the status quo, and require more courageous and innovative policy action to embrace and deliver a future of greater well-being.

LEO 2018 highlights two areas of policy recommendations. *First*, institutions must be rethought to boost inclusive growth. The objective of achieving strong growth should go hand-in-hand with the provision of better job opportunities, greater macroeconomic stability and better prospects of socio-economic progress for citizens. Here the specific focus is on the institutional transformations needed to achieve greater levels of trade, trade integration, production diversification and value-addition. LAC needs to shift towards further regional and global integration; to that effect, persistent barriers, mainly non-tariff, need to be removed. This must be accompanied by policies to support investments in skills, technology and R&D. At the same time, the region should progress towards a stronger negotiating position in the international arena. *Second*, institutions must be rethought to build states that deliver and respond to citizens' demands. They need to be more reliable, building a culture of integrity and transparency that leads to regaining citizens' trust; they need to be more efficient and effective, to improve the delivery of services to citizens and make better use of existing resources; and they need to be more forward-looking, to anticipate change, adapt to emerging challenges and demands, and find innovative responses to them. Corruption, weak state capacities and lack of effective interaction channels with society all contribute to push public administrations away from citizens' demands.

LEO 2018 presents a comprehensive analysis on the drivers of these issues in LAC and provides policy recommendations and examples of best practices that can illustrate ways forward. These practices include spreading a culture of integrity and trust across the public administration, and improving state capacities by increasing fiscal resources and administrative capabilities. They also include adopting technologies to embrace change, innovate in policy making and create spaces for citizen engagement and participation. These are all critical elements of the agenda for the coming years in the region.

We hope this joint effort by the Development Bank of Latin America (CAF), the Economic Commission for Latin America and the Caribbean (ECLAC), the European Commision and the Development Centre of the Organisation for Economic Co-operation and Development (OECD) will contribute to policy discussions on these issues. We aim to stimulate the debate to rethink institutions in LAC and adapt them to the new challenges of a rapidly changing world. Our citizens demand this, and for good reasons.

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Executive summary

Citizens in Latin America and the Caribbean (LAC) are increasingly dissatisfied with their governments and public institutions at large. The growing disconnect between society and public institutions has emerged as a common feature across LAC in recent years. Citizens' trust in institutions, traditionally low in LAC, has deteriorated further. The share of the population having little or no trust at all in governments reached 75% in 2017, 20 percentage points (p.p.) higher than in 2010. Satisfaction with public services has also deteriorated. Over 2006-16, the share of the population satisfied with the quality of healthcare services fell from 57% to 41%, well below levels in the OECD (stable at around 70%). Likewise, satisfaction with the education system fell from 63% to 56% over the same period.

The growing dissatisfaction has been largely driven by the rise of the middle class, which has boosted aspirations. The expansion of the middle class has been one of the major socio-economic transformations of recent times in LAC. In 2015, around 34.5% of the population could be considered "consolidated middle class" (living on USD 10-50 expressed at constant 2005 prices in purchasing power-parity (PPP) a day), up from 21% in 2001. This expansion has been accompanied by higher aspirations and evolving demands and values, as middle-class citizens are believed to be strong supporters of democracy. Additionally, there is a large vulnerable class (living on USD 410 (2005 PPP) a day). This represented around 40% of the population in 2015, up from 34% in 2000. This socio-economic group lives with the uncertainty of falling back into poverty as a result of negative shocks. Altogether, the increased (and oftentimes unmet) expectations of the consolidated middle class, and the instability of the vulnerable middle class, co-exist with the threats of those many Latin Americans still living in poverty.

The disconnect between society and institutions is also driven by insufficient growth and high inequality, compounded by an uncertain domestic and global context. Public policies and institutions in LAC still battle to overcome persistent challenges, including the prevalence of the so-called middle-income trap and the large gaps across socio-economic groups. Those unresolved difficulties can be further aggravated in a context where LAC economies experienced a two-year contraction in 2015-16. A modest recovery is now underway, and gross domestic product (GDP) grew at 1.3% in 2017 and is expected to grow between 2-2.5% in 2018. The global economic outlook is also improving, but is still far from the dynamism of the previous growth cycle that boosted demand and provided much needed tailwinds to the region. It is negatively influenced by lower international commodity prices, stagnant trade expansion and still tight financial conditions. Meanwhile, global trade and investment flows are decelerating, and rhetoric on protectionism and retracting from globalisation is increasing. New challenges such as technological change, an ageing population, migration and climate change are intensifying. Confronted with this context, citizens are disoriented and uncertain about the capacity of institutions to guarantee further progress.

The social contract is weakening in LAC owing to the decline of trust in public institutions and the rising dissatisfaction with public services. The social contract is understood as a tacit pact between the state and citizens. When citizens perceive that public institutions are unable to respond to their demands, they have lower incentives to fulfil their obligations. High- and middle-class Latin Americans usually channel their dissatisfaction by "opting out", moving away from mediocre public services towards better quality private services. But they still have to pay taxes for public services that they do not necessarily use. Those from the vulnerable middle class and poor households

are also dissatisfied, but do not have the means to opt-out and pay these services for themselves. In fact, the willingness to pay taxes – i.e. "tax morale" – has been falling in LAC since 2011: in 2015, 52% of Latin Americans were willing to evade taxes if possible (46% in 2011). Tax evasion undermines the state's capacity to provide quality public goods and services effectively. This, in turn, has a negative impact on citizens' lives, as shown by the deterioration of well-being indicators in recent years, and risks perpetuating a negative spiral.

LAC can largely benefit from rethinking its institutions, building a renewed *state-citizens-markets nexus*, to better respond to citizens' needs and demands. The *Latin American Economic Outlook 2018: Rethinking Institutions for Development* calls for rethinking institutions in ways that build a new *state-citizens-market* nexus. This can be achieved by exploring interactions in the nexus, promoting synergies, and placing citizens' demands and well-being at the centre. Reforms should focus on institutions (policies and organisations) to support an economy (the market) that provides increasing opportunities for all, in particular better income and jobs; and on public institutions (the state) that provide good services and deliver their functions efficiently, reliably and innovatively.

Institutions must be rethought to support more and better trade integration and raise productivity to overcome the middle-income trap. Economies that overcame the middle-income trap in recent decades, many of them from the OECD, showed a strong rule of law and democracy, sufficient tax revenues, high-quality education and skills, strong investment levels and developed capital markets. Another critical area to transition from middle to high income is trade, but LAC has been unable to reap all its benefits. The share of LAC in world exports has stagnated since 1970, averaging 5% annually. Regional integration has been modest, with just 16% of total LAC exports destined for the regional market. Meanwhile, integration into global value chains remains weak. The trade scenario has also turned increasingly complex, with some deglobalisation and protectionist forces in place. In this context, one effective policy response for LAC countries is *regional integration*. The convergence of the Pacific Alliance and Mercosur offers a promising path. These two groups account for 90% or more of LAC's GDP, trade and foreign direct investment flows, touching such areas as customs cooperation, trade facilitation, and cumulation and digital certification of origin. LAC should also focus on removing distortionary *non-tariff* (regulatory) *barriers*, promote harmonisation and strengthen capacities of national authorities and firms to comply with necessary and legitimate technical, sanitary and phytosanitary standards. Further, it should improve infrastructure, logistics and customs procedures to reduce high-trade costs.

Institutions must support enabling states that deliver and respond to citizens' demands by being more reliable, more efficient and effective, and more forward-looking. States in LAC face inter-related barriers that limit and in some cases prevent a response to citizens' demands and fulfilling their objectives. First, private groups and interests often divert the state from serving the public interest. Second, institutional capacities are generally weak in LAC, limiting implementation of policies. And third, states often lack effective channels of interaction with society, making it difficult to understand citizens' real demands and adapt to them. This is why new or rethought institutions should focus on making states more trustworthy, more efficient and effective, and more open, transparent and innovative.

Moving towards trustworthy states requires strengthening rule of law promoting a coherent integrity system, and regulatory systems that foster accountability. The perception of state compliance with the rule of law is low in LAC, with an average score of -0.5 in 2016 (on a scale from -2.5 to 2.5), well below the OECD's 1.2. To ensure

compliance with rule of law, a *broad strategy to foster independent and effective legal institutions* is a priority. Weak legal enforcement in LAC makes policy capture, crime and corruption more likely. In 2016, 80% of Latin Americans claimed their government was corrupt, a significant increase from 2010 (65%). To fight corruption, *a strong and cross-cutting integrity system* across all levels of government is crucial. Implementing international standards is equally important in this regard. The OECD *Recommendation of the Council on Public Integrity,* for example, identifies lines of action in this direction, including anti-corruption. The *use of information and communication technologies, big data analytics and open governments* are also effective ways of limiting corruption. These tools help building transparent, accountable and more participatory states. And *regulatory frameworks* should promote fair competition and limit harmful practices that diminish the quality of goods and services provided to citizens though mechanisms like central purchasing bodies.

Building more efficient and effective states requires stronger fiscal and administrative capacities. Improving state capacities requires *strengthening its fiscal muscle.* This means making public spending more efficient and mobilising more tax revenues, which represented 22.8% of GDP on average in 2016 (OECD average of 34.3% of GDP). To improve administrative capacities, *better equipped and empowered Centres of Government* (CoGs) are critical as they can strengthen coordination and policy coherence and advance whole-of-governments reform agendas. Where they exist, LAC CoGs often lag behind. Explicit coordination exists at the level of ministers in 70% of LAC countries, for example, compared to 84% for the OECD. *Merit-based civil service recruitment systems* in LAC are needed to address low levels of impartiality and low capabilities of public servants. Most countries lack a formal professional civil service and experience a high proportion of political appointments among public servants. Some useful steps have been taken, delivering some improvement that should be further strengthened. Between 2004-15, however, the region's overall civil merit score went up by 12 units, from 33 to 45 on a scale from 0 to 100. *Improving public management cycles* – results-oriented planning and budgeting, public financial management, project and programme management, and monitoring and evaluation – is critical to improve service delivery for citizens. Progress has been made (e.g. the *Sistema Nacional de Evaluación de Resultados* in Colombia, or the monitoring (MIDE) and evaluation (EVALÚA) systems in Jalisco (Mexico). However, most countries still have to undertake significant steps to enhance their public management and evaluation systems, and to align incentives with institutional objectives. Finally, *developing digital tools* is a priority for modern governments for improved policy making and cost-effective service delivery.

Fostering open, participatory and innovative states is necessary to build a new connection with citizens. *Open government strategies* enable a culture of transparency, accountability and access to information as a means to fight and prevent corruption. Mass social media platforms offer a relatively cost-effective way to open spaces for citizens to communicate with public institutions and participate in policy making. Some LAC countries have created local citizens' councils to make governance more inclusive and participatory. *Innovation labs* promote collaboration and citizen engagement within core public institutions to design cost-effective, risk-taking small pilot projects that respond to citizens' needs. Good examples include engagement platforms like *mi Quito*, *mi Medellín*, *Bogotá Abierta* or Ágora Rio, or the social innovation lab in Uruguay. These seek to make all administrative procedures and public services available on line. A more intense *use of big data* could improve government effectiveness in LAC. As an example, big data analytics reduced the incidence of dengue fever in Brazil by 98% in 2014. The use of hospital information helped identify hotspots that were later prioritised through geo-referencing.

Latin American institutions must be rethought, adopting a forward-looking perspective, so they can adapt to and embrace the future. To make the most of emerging opportunities and to face new challenges, LAC needs to rethink its institutional frameworks. These must be designed to anticipate change and to adapt to a rapidly evolving and increasingly complex global context. Various megatrends are shaping an era of uncertainty, where citizens demand innovative policy responses, in Latin America and elsewhere. In particular, the impact of technological change on the world of work is a major transformational force. Thus, it is critical to focus on *productive development policies* to create good quality jobs, *education and skills policies* to favour employability, and *labour market institutional arrangements* to guarantee good job conditions.

Overview – Rethinking institutions for development: Towards a new state-citizens-market nexus

In recent years, the growing disconnect between society and public institutions has become a common feature throughout Latin America and the Caribbean (LAC). Well-being and recent socio-economic gains, which have been extraordinary in the last 15 years, are at risk because of this divide that undermines the social contract. Demands from citizens for greater transparency and integrity, higher quality of key public services such as education and health, and more government openness are not being fully met. This results in decreasing levels of trust in institutions and erodes the social contract.

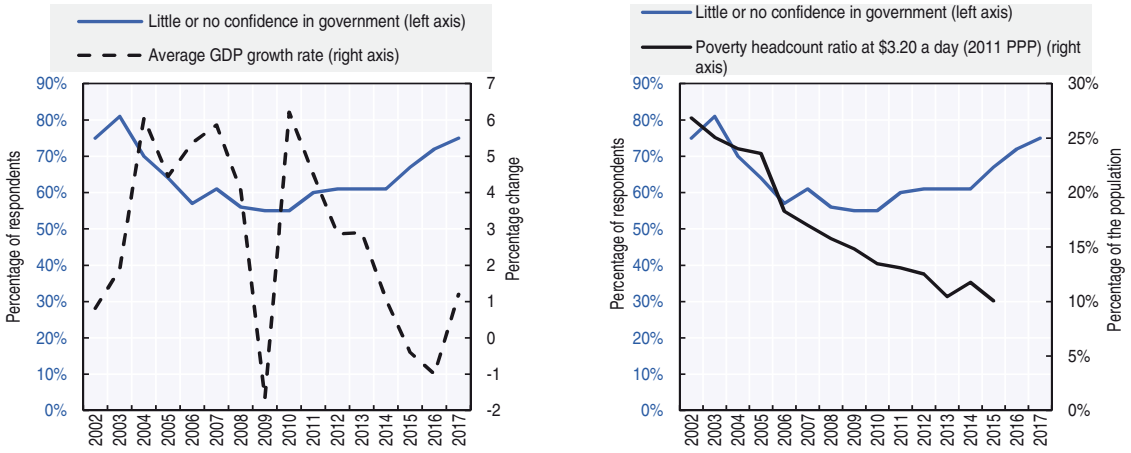
Two factors help explain this disconnect: the rising aspirations of a larger middle class and the difficulties for public institutions to address existing and new challenges. LAC's remarkable socio-economic progress and improved standards of living have raised expectations and aspirations. At the same time, institutions still battle to overcome some persistent challenges. These include the prevalence of the so-called m*iddle-income trap* or the vulnerability of large segments of the population, who could revert into poverty. Globally, new challenges are emerging in a context of rapid change, leaving citizens uncertain about the capacity of institutions to respond and to guarantee further progress.

The *Latin American Economic Outlook 2018: Rethinking Institutions for Development* (LEO 2018) analyses the drivers of this disconnect and examines their impact on the social contract and on citizens' well-being. It argues that the region confronts a critical moment: now is the time to rethink and strengthen institutions in LAC if we do not want to witness a reversal in the many recent gains. To that end, the report provides specific recommendations. Stronger institutions should support a new *state-citizens-market nexus* that can address existing and emerging economic, social and political challenges, reconnect with society and guarantee sustained and inclusive growth for the well-being of all Latin Americans.

Trust and citizen satisfaction, a defining moment in Latin America

Citizens' trust in public institutions, traditionally low in LAC, has deteriorated still further in recent years. Lack of trust has deepened since the global financial crisis, with the share of the Latin American population having little or no trust at all in governments reaching levels of around 75% in 2017. This is a drop in confidence of almost 20 percentage points from 2006 according to Latinobarometro (Figure 1). In 2016, only 23% of Latin Americans said they were confident in the honesty of elections (compared with 46% in OECD countries); barely 15% did not believe that corruption was widespread in government (28% in the OECD); just 34% had confidence in the national judicial system (49% in the OECD); and 29% had confidence in the national government (37% in the OECD). Most indicators worsened between 2006 and 2016 in LAC, with the exception of confidence in the judicial system, which remained fairly stable (Gallup World Poll, 2016).

Figure 1. **Trust in governments vs. growth and poverty rates in Latin America**



Note: Unweighted average for all variables for Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, the Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, Uruguay and Venezuela. Figures in USD.

Source: OECD/ECLAC/CAF, own elaboration based on CEPALSTAT (2017), *World Bank Development Indicators* (2017) and Latinobarometro (2017).

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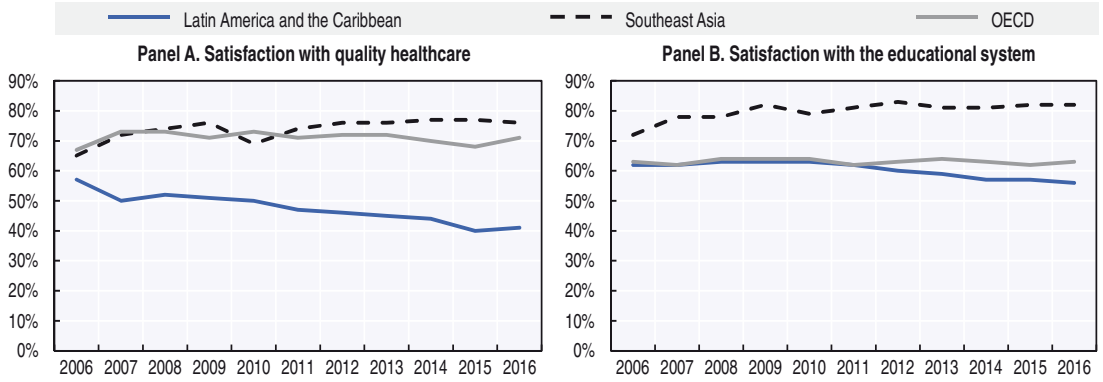
Satisfaction with public services has also deteriorated. Over 2006-16, the share of the population satisfied with the quality of healthcare services fell from 57% to 41%, well below levels in OECD member countries (stable at around 70%) (Figure 2, Panel A). Likewise, satisfaction with the quality of the education system fell from 63% to 56% over the same period (Figure 2, Panel B).

Figure 2. **Satisfaction with public services in Latin America, Southeast Asia and OECD**

Percentage of population



Source: OECD/ECLAC/CAF, own elaboration based on Gallup World Poll (2016).

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Throughout a long period of economic and social progress in LAC, poverty rates declined sharply, inequalities fell and living standards improved. However, despite these positive trends, trust in public institutions and citizen satisfaction declined. There are two forces behind this apparent discrepancy. First, higher aspirations and evolving demands have accompanied the expansion of the middle class. This is particularly true for LAC, a region where 25% of the population is between 15 and 29 years old and almost 90% live in cities (OECD/CAF/ECLAC, 2016). Second, after experiencing a period of quick progress and continued improvement in living standards, the economic slowdown that

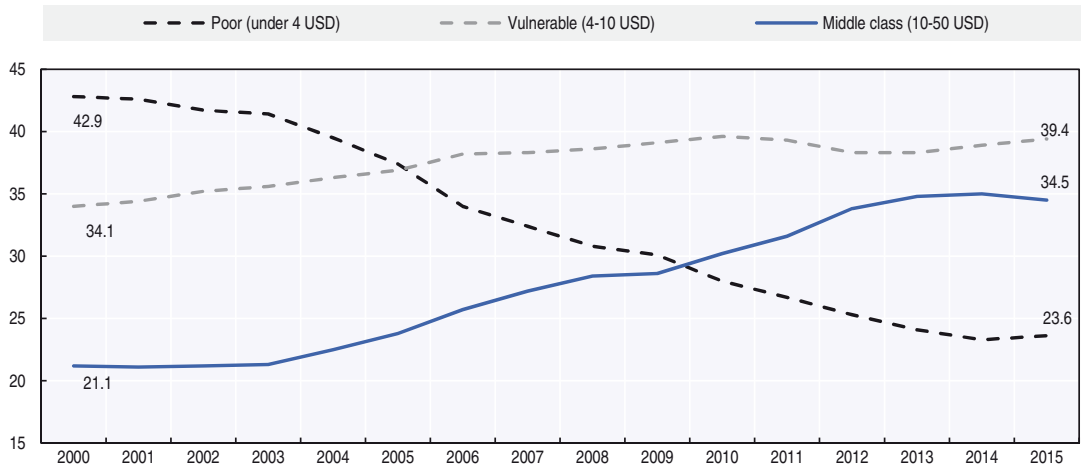
started in the mid-2010s made many segments of society feel insecure, with the sense that the previous socio-economic gains could be at risk. At the very least, they fear it will be difficult to continue with a similar pace of progress. Both factors interact with a number of global trends, such as rapid technological change, ageing populations, migration and climate change, that add up to a sense of insecurity and complexity, as well as the growing uncertainty regarding the ability of existing institutions to provide effective responses.

A larger middle class is driving up aspirations and demands for good

The expansion of the middle class is one of the major positive socio-economic transformations of recent times in LAC. In 2015, around 34.5% of the population could be considered "consolidated middle class", up from 21% in 2001. This group earns USD 10-50 (2005 purchasing power parity [PPP]) a day (Ferreira et al., 2013). Almost 40% of the population are "vulnerable" (living with USD 4-10 [2005 PPP] a day). Some 24% of the population is considered "poor", living on less than USD 4 [2005 PPP] a day (Figure 3). As is often the case, subjective measures of social class belonging suggest that an even larger share of the population considers itself as "middle class" (40% according to Latinobarometro, 2015; 53% according to Penfold and Rodriguez, 2014). Some people have middle-class aspirations even when their levels of income are not necessarily those attributed to middle-class groups. In this sense, the influence of the middle class as a group that shapes the political agenda may be greater than expected by only looking at its size by income measures.

Figure 3. **Latin American population by socio-economic groups**

Percentage of total population



Source: OECD/ECLAC/CAF, own elaboration based on LAC Equity Lab tabulations of SEDLAC (CEDLAS and the World Bank, 2017).

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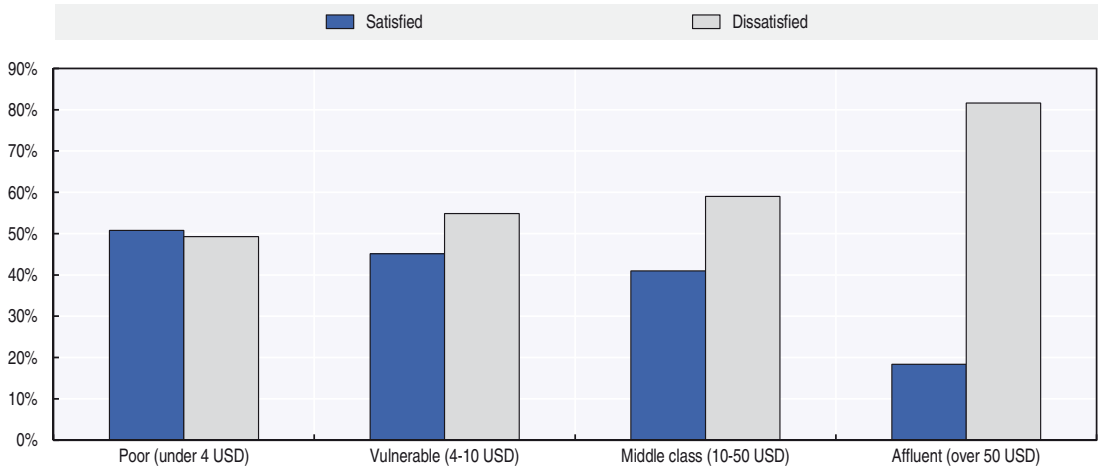
The expansion of the middle class has brought with it a change in values that may partly explain the decreasing levels of citizens' trust and satisfaction in LAC. Middle-class citizens are believed to be strong supporters of democracy, while at the same time being critical of how it functions (OECD, 2010). In fact, some authors argue that when the middle class reaches at least 30% of the population its members attain a collective power to demand better public goods and services more effectively (Birdsall, 2016). Empirical analyses have found that an increase in the size of the middle class is associated with greater spending on public health and education, decreases in corruption and better quality of governance in terms of democratic participation (Loayza, Rigolini and

Llorente, 2012). However, these dynamics may be more prominent for members of the consolidated middle class. The large vulnerable middle class lives with the uncertainty of falling back into poverty in cases of negative shocks.

The increased expectations of the consolidated middle class and the sense of instability of the vulnerable class add up as relevant drivers of the surge in social dissatisfaction witnessed in LAC in recent years. The healthcare sector illustrates how discontent with public services rises with income. As much as 55% of the vulnerable and 60% in the consolidated middle class report dissatisfaction with public health services in LAC. The dissatisfaction surpasses more than 80% in the affluent group (Figure 4). Dissatisfaction with public education, water and sanitation, and public security reach similar levels.

Figure 4. **Satisfaction with public medical and health services in Latin America, 2015**

Percentage



Note: The figure shows answers to the question: "Are you very satisfied, satisfied, dissatisfied, or very dissatisfied with the quality of public medical and health services?". Satisfied represents the sum of those who answered to be "very satisfied" and "satisfied" with the public medical and health services, while dissatisfied is the sum of the "dissatisfied" and "very dissatisfied". "Poor" refers to individuals whose daily per capita income is USD 2.5-4; "vulnerable" have a daily per capita income of USD 4-10; "middle class" have income between USD 10-50; "affluent" have an income above USD 50. 2005 USD PPP per day. PPP = purchasing power parity.

Source: OECD/ECLAC/CAF, own elaboration based on *The Americas-Barometer 2015* by the Latin American Public Opinion Project (LAPOP 2015), www.LapopSurveys.org.

StatLink http://dx.doi.org/10.1787/888933649563

Latin American economies are recovering at a modest pace in a highly uncertain domestic and global context

The region is undergoing a subdued recovery after a decline in economic activity. The modest recovery and the global context may weaken citizens' confidence in a better future and in the ability of governments to contribute to it. Following a two-year contraction, activity bottomed in 2016. Gross domestic product (GDP) grew by 1.3% 2017. It is then projected to recover between 2-2.5% in 2018 (ECLAC, 2017; IMF, 2017). The global economic outlook is improving, but still below the dynamism of the previous growth cycle. Given lower international commodity prices and trade expansion, the forces that favoured economic expansion in LAC in recent years are no longer sufficient drivers of high rates of growth (OECD, 2017a). This is already having an impact on social conditions, prolonging the region's protracted stay in the *middle-income trap* (Melguizo, Nieto-Parra, Perea and Perez, 2017).

Globalisation and technological change create new challenges and opportunities, as well as uncertainties among citizens. After three decades of increased openness, global trade and investment flows decelerated. World trade growth in 2016 remained at a particularly low level of 2.4%. Forecasts of above 4% for 2017 and 2018 are still below the average of 7% growth since 1980 (IMF, 2017; OECD, 2017a). Meanwhile, the rhetoric on protectionism is increasing, driven mainly by rising discontent from those who have not benefited much from globalisation. These are mostly segments of the middle classes of developed countries who are worse-off today (OECD, 2017b). A shift towards nationalistic and populist policies is being observed all over the world. Over 1996-2000, global support for populist parties remained at around 10% of vote share. In 2011-15, the share has risen to almost 25% (Rodrik, 2017). This could have direct consequences for LAC in terms of trade, finance and restrictions on migratory flows, thus adding to a sense of uncertainty. Technological progress, too, is advancing at a very fast pace. The advent of the so-called "fourth industrial revolution" is expected to transform the world of work and the global economy. The process of automation is already underway and intensifying. It could lead to large shifts in employment from some sectors to others, a rearrangement in skills demand, and the destruction and creation of jobs. Results are uncertain and, most importantly, there is a growing concern about the effects of new technologies and their distributional impact on our economies, as well as who wins and who loses from these transformations.

The social contract is weakening in Latin America and challenging global and domestic contexts are fuelling citizens' discontent

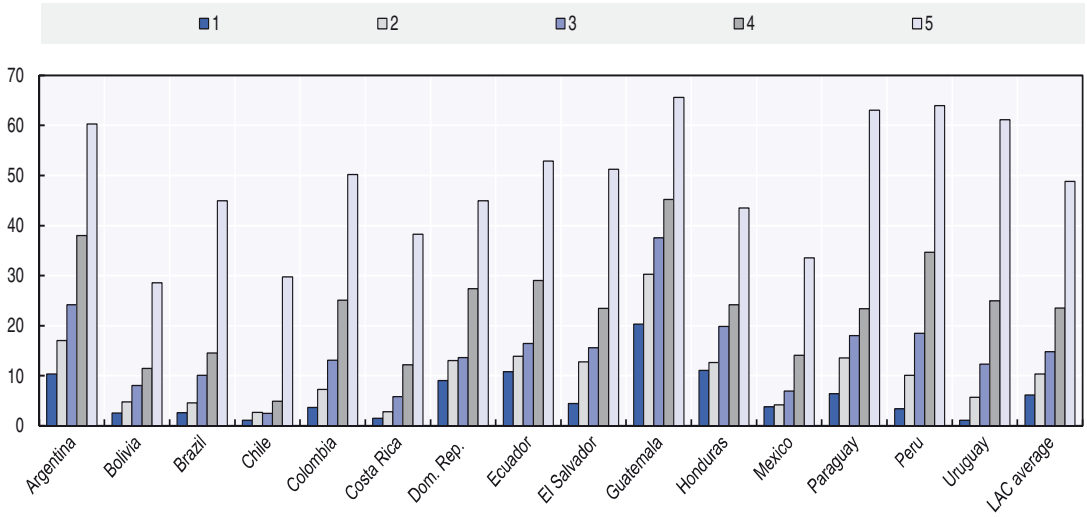
The social contract, understood as a tacit pact between the state and citizens, is weakening in LAC owing to high dissatisfaction with public services and lower perceptions of well-being. The concept of the state is used in this report in a broad sense and includes all bodies of public administration. The state enables people to make the most of their lives by guaranteeing fundamental rights and by providing public goods and services that ensure a certain standard of material conditions and quality of life. Citizens, for their part, fulfil certain duties and obligations, such as voting and paying taxes that underpin the effective functioning of democratic societies (Rousseau, 1762).

Social contracts are generally characterised by explicit and implicit agreements that determine what each socio-economic group gives to the state and receives in return. Citizens engage firmly in these agreements with three conditions. First, they must believe the agreements are reliable (i.e. they trust state institutions). Second, they must see these agreements as beneficial (i.e. their satisfaction with what they receive leads to social engagement) (Estefania and Martinez-Lillo, 2016). Third, they must perceive the pact as fair (no one is favoured over others or benefits at their expense). In LAC, the decline of trust in public institutions and the rising dissatisfaction with public services suggest these foundations of the social contract are weakening. As incentives are lacking to engage in the social contract, citizens find it increasingly justifiable, for instance, to avoid paying taxes and opt out of public services.

Dissatisfaction with public services creates incentives not to engage in the social contract

High levels of dissatisfaction with public services may explain why a large share of Latin Americans with sufficient income choose private education and health over universal public services. For instance, the share of secondary students enrolled in private schools is strongly linked to household income, with a drastic increase for the fourth- and fifth-income quintile (Figure 5).

Figure 5. **Enrolment in private schools in Latin America, 2014**
Share of secondary students in private schools, by income quintiles



Source: OECD/ECLAC/CAF, own elaboration based on SEDLAC (CEDLAS and the World Bank, 2017).
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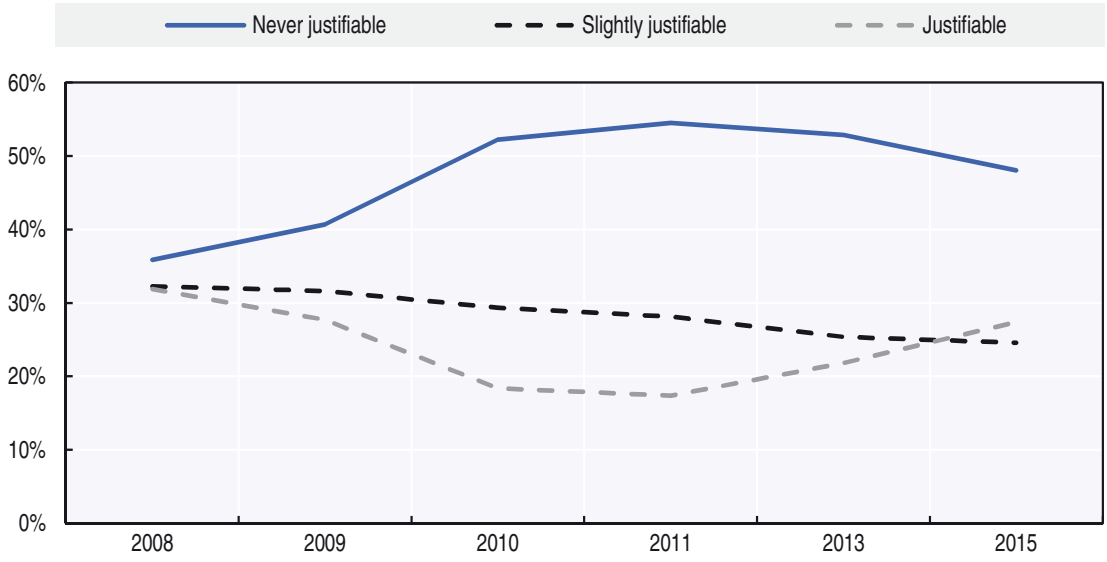
Dissatisfaction with public services and the subsequent opting out of those with sufficient resources create a dynamic that weakens the social contract. On the one hand, individuals from high- and middle-class households usually channel their dissatisfaction with public services by *opting out*, moving towards better quality private services they can afford. On the other hand, individuals from the vulnerable middle class and poor households are also dissatisfied with the quality of public services. However, since they do not necessarily have the income to opt out, they continue using low-quality public services. This creates a risk of fracture and a vicious circle. Consolidated middle classes pay via their taxes for the cost of public services that they do not necessarily use and also for the cost of private services that they eventually use. Meanwhile, vulnerable middle classes are dissatisfied with them (and are unable to afford higher quality options). These groups, which together represent around 70% of the population, are dissatisfied for different reasons, and find few incentives to firmly engage in the social contract. This can have an impact on their willingness to pay taxes and eventually deteriorate the capacity of the state to finance good quality public services (Daude, Lustig, Melguizo and Perea, 2017).

The willingness to pay taxes has decreased

Citizens' willingness to pay taxes – known as "tax morale" – has been falling in LAC since 2011, after a period of significant improvement. In 2015, 52% of Latin Americans were willing to evade taxes if possible, with 27% strongly justifying evading taxes and 25% slightly justifying it, an increase from 46% in 2011 (Figure 6). In fact, the decline in tax compliance and the fall in trust in institutions and satisfaction with public services go hand in hand. The "fiscal pact" is understood as the agreement that citizens pay taxes to the state in exchange for certain public services and goods. It is one of the main components of the social contract. In this respect, decreasing tax morale suggests that Latin Americans are dissatisfied with their government and the services it provides. Consequently, they are more likely to justify cheating on taxes and potentially avoiding paying them.

Figure 6. **Tax morale in Latin America**

Do Latin Americans find it justifiable not to pay taxes?



Notes: Unweighted average for Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, the Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, Uruguay and Venezuela. The specific question is: "Please tell me for each of the following statements whether you think it can always be justified to cheat on taxes, never be justified, or something in between". For practical purposes, we classify those as "never justifiable" to the share of respondents that answered 10 (the highest note); "slightly justifiable" is the fraction of respondents who answered between 9 and 6; and "justifiable" is the fraction of answers between 1 (the minimum possible) and 5.

Source: OECD/ECLAC/CAF, own elaboration based on Latinobarometro 2015.

StatLink http://dx.doi.org/10.1787/888933649601

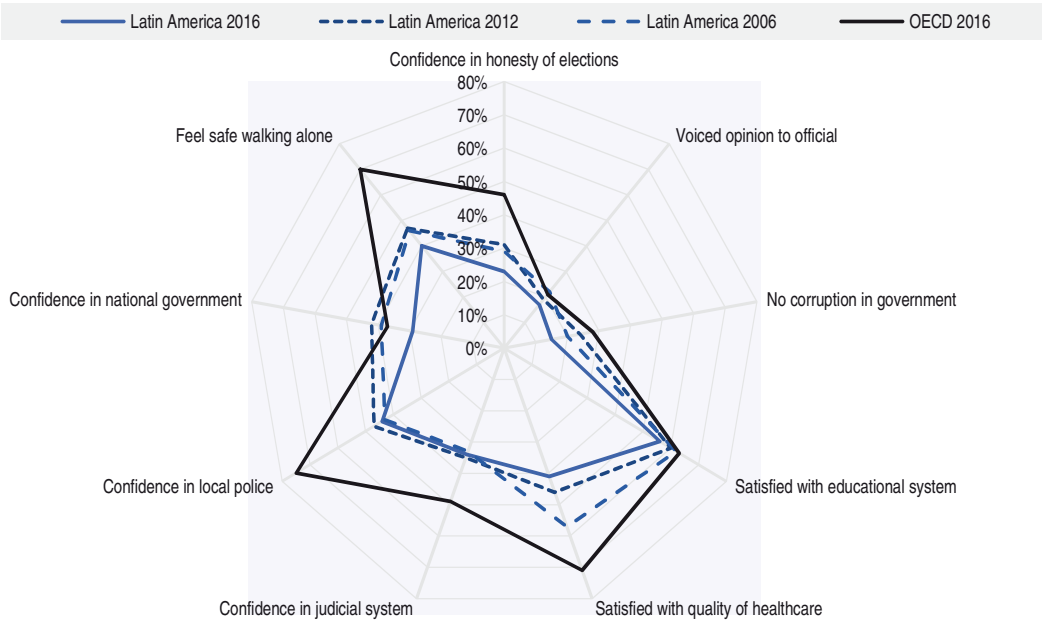
The redistributive function of fiscal policy appears to be less clear for Latin Americans than for citizens in other regions. According to the *World Value Survey*, in LAC in the mid-2010s almost 20% of the population believes that taxing the rich and subsidising the poor is not an essential characteristic of democracy. This result is much higher than in Africa (11%), Asia (10%) or OECD economies (9%). This may be a source of weakness of the fiscal pact in LAC. If a sizeable share of Latin Americans does not clearly perceive the main objective and destination of their taxes, then they may find more reasons to justify cheating on them when possible (Melguizo, Olate and Orozco, forthcoming).

Perceptions on well-being have deteriorated

Perceptions on well-being have also deteriorated in LAC in recent years, driven by falling confidence in public institutions and decreasing satisfaction with public services (OECD, 2017c). Confidence in public institutions and satisfaction with public services are core elements of people's well-being, as shown by the *OECD How's Life?* framework (OECD, 2011; Boarini, Kolev and McGregor, 2014). This framework includes people's satisfaction with democracy (confidence in the honesty of elections) and political engagement (having voiced an opinion to an official). It also covers corruption in public services (perceptions of widespread corruption in government and business), satisfaction with services (such as education and health care), and trust in public institutions (confidence in the national government, the judicial system and local police) (Gallup World Poll, 2016). The share of people replying positively to all these questions decreased in LAC over 2006-16, and notably since 2012. And it remains significantly below the OECD (Figure 7).

Figure 7. **Selected indicators of governance and well-being in Latin America and OECD**

Percentage of respondents replying positively to each question



Source: OECD/CAF/ECLAC, own elaboration based on Gallup World Poll 2016.

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A strong social contract is critical to foster well-being, and, at the same time, greater well-being would support a stronger social contract. When citizens perceive that public institutions are unable to respond to their demands, as is the case in LAC, they find few incentives to fulfil their obligations in the social contract. This, in turn, undermines the state's capacity to provide quality public goods and services effectively, which has a negative impact on citizens' well-being. The overall result is a negative spiral that further fuels citizen disengagement from public institutions. Ultimately, a weak social contract affects well-being. Therefore, policies must improve the institutional framework to better respond to citizens' demands and rebuild trust. While there are different categories of trust – trust of citizens in governments; trust of governments in citizens; and trust among citizens – LEO 2018 focuses on the trust of citizens in governments and in public institutions.

Rethinking institutions for greater well-being: Towards a new *state-citizens-market nexus*

Rising aspirations and evolving demands, together with uncertainties created by domestic structural weaknesses and the global scenario, are weakening the social contract in LAC. People's current and future well-being is at stake. In this context, LAC can largely benefit from rethinking its institutional design. This is necessary to embrace upcoming opportunities, shield against emerging risks and build the pillars of sustained social and economic progress that can meet citizens' demands.

LEO 2018 calls for rethinking institutions in ways that build a new *state-citizens-market* nexus. Institutions in this context represent "the rules of the game" in society. This theoretical approach, initiated by North (1991), developed in LAC by Acuña and Tommasi (1999) considers institutions "as sets of rules that structure interactions in

particular ways" (see also World Bank, 2017). In this respect, institutions can be grouped in three categories:

- *Policies* refer to concrete plans and/or sets of actions directed towards a specific social, economic or political outcome.
- *Organisations* are understood as the bodies or structures within which some people act, or are designated to act, towards some purpose.
- *High-level rules,* which usually take a legal or normative form, are formal arrangements that enable the adoption of organisational or policy changes.

While acknowledging the importance of the high-level laws, LEO 2018 focuses on policies and organisations, and will refer to these two when talking about institutions.

Institutions must be rethought in a way that reinforces the *state-citizens-market nexus* by exploring interactions among its three core parts, promoting synergies, and placing citizens' demands and well-being at the centre. What seems to matter most for citizens are economic concerns (jobs and income), the quality of goods and services (especially to combat crime and violence, and provide good health and education) and political issues (notably corruption), according to Latinobarometro (2017). Citizen searches via the Internet, a source of information that provides higher anonymity, sincerity and frequency than traditional surveys, suggest that citizens' perceptions about economic problems, public insecurity, corruption or public services are directly linked to presidential approval rates in LAC. And they can be used as a proxy of citizens' overall satisfaction and potentially of their willingness to engage firmly in the social contract (Montoya, Nieto-Parra, Orozco and Vazquez, forthcoming).

To support a *state-citizens-market nexus* that puts society's demands at the centre, reforms should focus on institutions linked to the main sources of discontent of *citizens:* the *market* and the *state.* Citizens expect an economy – *the market* – to provide increasing opportunities to thrive in life, and in particular through certainty in terms of income and jobs. Similarly, they expect public institutions – *the state* – to provide good services and deliver their functions in an efficient, reliable and innovative manner.

Recommendations in LEO 2018 focus on three areas where rethinking institutions will be crucial for LAC to meet citizens' expectations:

- Institutions must boost inclusive growth in a challenging global economy. The focus is on institutions to support trade and productivity and to overcome the middle-income trap.
- Institutions must build enabling states that deliver and respond to citizens' demands. The three goals here are: greater trust and reliability through strengthened rule of law, integrity and transparency; higher effectiveness and efficiency through strengthened fiscal capacity, administrative capacities and management; and more openness and innovation to better understand and respond to citizens' evolving demands.
- Given that the *state-citizens-market nexus* evolves rapidly, the previously mentioned institutions must be forward-looking, flexible and ready to adapt to embrace the future, make the most of emerging opportunities and face increasing complexity.

The recommendations in these three areas are interconnected, and clear interactions exist among them that hold great potential.

Institutions to boost inclusive growth in a challenging global economy

The short-term outlook remains uncertain and heterogeneous across LAC countries, with a key role for fiscal policy

The economic slowdown in LAC that began in 2011 led to a two-year recession in 2015 and 2016, from which the region is resurfacing. LAC will benefit from the mild improvement of global activity and the stabilisation of commodity prices. However, political uncertainty and in particular delays in large infrastructure projects will dent investment and increase risks.

Heterogeneity continues to be the norm in the region. Activity in net commodity exporters in South America bottomed in 2016; in most countries, output gaps are closing. Growth momentum will benefit from Argentina and Brazil coming out of recession. In contrast, expectations are deteriorating for Mexico and Central America, but their growth will still outpace South American economies. Apart from that, the scope for demand policies to stimulate growth remains limited. The space for monetary policy is opening up for South America, but higher prices in Mexico and Central America may call for some tightening. Fiscal space remains constrained, though heterogeneous across LAC countries. A "smart fiscal adjustment" should be put in place, combining taxes, debt and reallocation of expenditures in different degrees depending on each country's particular situation. Such policy approaches should aim to strengthen fiscal positions, while fostering public investment in physical and human capital to spur long-term growth and social inclusion (OECD/CAF/ECLAC, 2016).

Institutions would help overcome the middle-income trap

Medium-term growth projections suggest that potential output in Latin America is close to 3%, much lower than the 5% average annual growth rate of the mid-2000s (OECD/CAF/ECLAC, 2016). This is largely associated with low productivity levels owing to the absence of structural changes towards innovation and more knowledge-intensive production in the region.

The middle-income trap (MIT) has affected the majority of the region's economies, with only Chile, Trinidad and Tobago and Uruguay managing to escape from it. As LAC countries reached middle-income levels, growth experienced a long-lasting slowdown. This was due to the need for new engines of economic growth based on capital- and skill-intensive manufacturing and service industries (Kharas and Kohli, 2011; Felipe, Kumar and Galope, 2017).

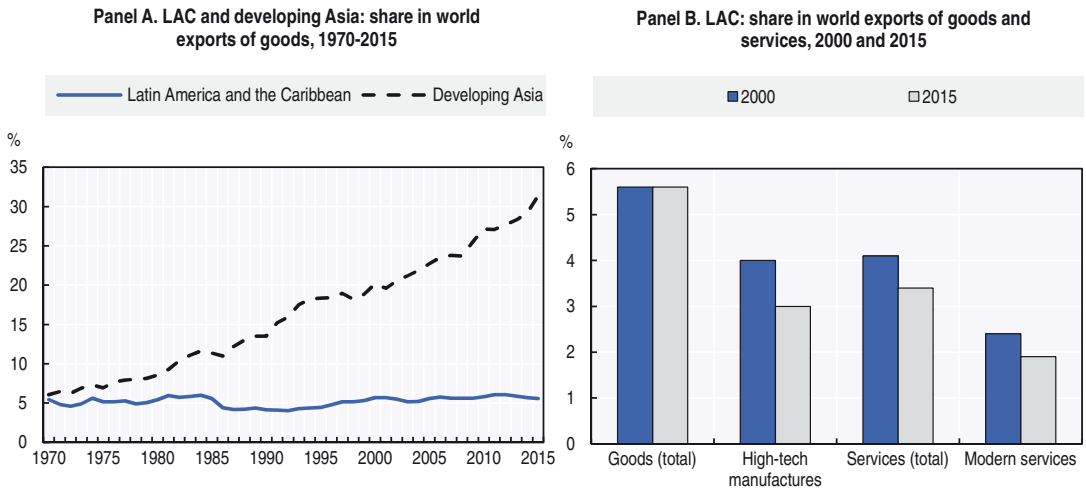
The quality of public institutions and trade openness play a key role in overcoming the middle-income trap. Weak institutions might not have an impact at low-income levels, but could dampen growth in middle-income economies (World Bank, 2017). Evidence suggests that economies that overcome the MIT have strong rule of law, strong democracy and solid tax revenues. Similarly, more open economies and those able to export high added-value goods are more likely to transition from middle to high income. Countries that have evaded the MIT also have better quality education, an adequate supply of skills, adequate investment levels and developed capital markets (Melguizo, Nieto-Parra, Perea and Perez, 2017).

Institutions to navigate a challenging global trading environment and boost inclusive growth

Trade is critical to boost inclusive growth and can play a powerful role in contributing to accessing technology, rising incomes and creating jobs (OECD, 2012). However, LAC has been unable to reap all the gains trade can bring. The share of LAC in world

merchandise exports has stagnated since 1970, averaging 5.2% since that year with minimal variations (Figure 8, Panel A). Such stagnation contrasts with the performance of developing Asia, whose share of world merchandise exports was similar to LAC levels in 1970 but has grown steadily to 31% in 2015. Moreover, since 2000, the LAC region has lost ground in high technology manufactures and services exports. This includes such services as legal, information technology and business (Figure 8, Panel B).

Figure 8. **Latin American exports as share in world exports**



Note: Developing Asia excludes Western and Central Asia.

Source: OECD/CAF/ECLAC, own elaboration. Panel A based on data from UNCTAD, UNCTADSTAT database. Panel B based on UN Comtrade (2017) database (goods) and WTO (services).

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For decades, LAC has experienced too few changes in the structure of trade, while regional economic integration remains far from its potential. In the last 15 years, more than 70% of total exports and imports have been concentrated in five economies: Argentina, Brazil, Chile, Mexico and the Bolivarian Republic of Venezuela. The region continues to trade with the same partners, but new relationships are emerging and trade patterns differ across the region. Over the same period, the United States has remained the region's top trade partner for both exports and imports. Recently, the People's Republic of China has emerged as a key partner (OECD/CAF/ECLAC, 2015). Regional integration remains low, with just 16% of total LAC exports destined for the regional market. This is well below the intra-regional trade of the world's three major trading blocs in 2015: European Union (63.2%), the North American Free Trade Agreement (50.4%) and the Association of Southeast Asian Nations (46.5%) (UN Comtrade, 2017).

Imports are equally important as they can favour the acquisition of key inputs and technology, and boost firms' productivity, export competitiveness and growth. This has become even more apparent with the emergence of global value chains (GVC) and "the intertwining of trade in intermediates, the movement of capital and ideas, and demand for services to coordinate the dispersed production and distribution of goods and services" (OECD/WBG/WTO, 2014). LAC's integration into GVCs is weak. The region's participation as a source of foreign value-added in world exports (forward linkages) remains negligible. Meanwhile, the share of foreign value-added in Latin American exports (backward linkages) is considerably lower than that of other regions. Data for seven LAC countries (Argentina, Brazil, Chile, Colombia, Costa Rica, Mexico and Peru) shows that the joint participation of these countries in the origin of the foreign value-added embodied in world exports marginally increased from 3% to 4% between 1995 and 2015 (OECD/WTO, 2015).

The trade scenario for LAC has also turned increasingly complex. Although global trade started to revive in 2017, it remains less robust than in pre-crisis decades. Furthermore, trade and globalisation have been under pressure, with growing worldwide concerns that benefits are not shared by all (OECD, 2017b). Overall, fear is growing that these concerns might lead to a rise in protectionism.

In the face of a challenging global trading environment, one effective policy response for LAC countries is *regional integration*. With the advantages offered by geographical proximity, language and cultural affinities, the region is a natural space for LAC countries to enter GVCs. Also, despite representing just 16% of the region's total exports, LAC accounts for much larger shares of manufacturing exports than most countries. Regional markets are also a path towards export diversification. And a more integrated regional market would enhance LAC's position in trade negotiations with other partners.

The convergence between the region's two largest integration agreements, the Pacific Alliance and Mercosur, offers a promising path. Combined, these two integration agreements account for more than 80% of the region's population and over 90% or more of its GDP, trade and foreign direct investment flows. This means that any agreements between them could act as a powerful catalyst of region-wide integration. Convergence is still at an early stage and not expected to lead to any formal trade negotiations in the short term. Still, it will proceed incrementally, starting with work on customs co-operation, trade facilitation for goods and services, cumulation of origin and digital certification of origin.

While the region has progressed in removing tariffs to intra-regional trade, it now faces the challenge of removing *non-tariff (regulatory) barriers*. These include inconsistent technical, sanitary and phytosanitary standards; discrimination against regional suppliers in government procurement; and cumbersome customs procedures. These obstacles may be greater to the formation of regional value chains than tariffs (Cadestin, Gourdon and Kowalski, 2016; Bown, Lederman and Robertson, 2017). Similarly, the region needs to further harmonise rules of origin and regulatory frameworks for the exchange of goods, services and endowments for production (e.g. electricity) (Powell, 2017). It also requires adoption of international standards and export certifications, particularly in agro-food. High-trade costs remain a challenge for regional integration. Thus improvements in infrastructure, logistics and customs procedures are critical as well (OECD/CAF/ECLAC, 2013).

Institutions to support a state that delivers: Towards enabling and empowering states

Responding to citizens' demands requires a state that delivers its functions. Public administrations in LAC face inter-related barriers that reduce and in some cases prevent them from responding to citizens' demands and fulfilling their objectives. This hinders their transition towards *enabling states*. First, groups and private interests interfere with the functioning of the state, often diverting it from serving the public interest. Second, institutional capacities are generally weak in LAC, limiting the implementation of policies. And third, states often lack effective channels of interaction with society, making it difficult to understand citizens' real demands and to adapt. New or "rethought" institutions can make states more trustworthy, based on rule of law, a coherent integrity system and improved regulations; more efficient and effective, based on stronger fiscal and administrative capacities; and more open, transparent and innovative, based on open government strategies and the use of new sources of data. The state should be a catalyst for citizens to access opportunities in order to deliver their full potential and achieve their aspirations.

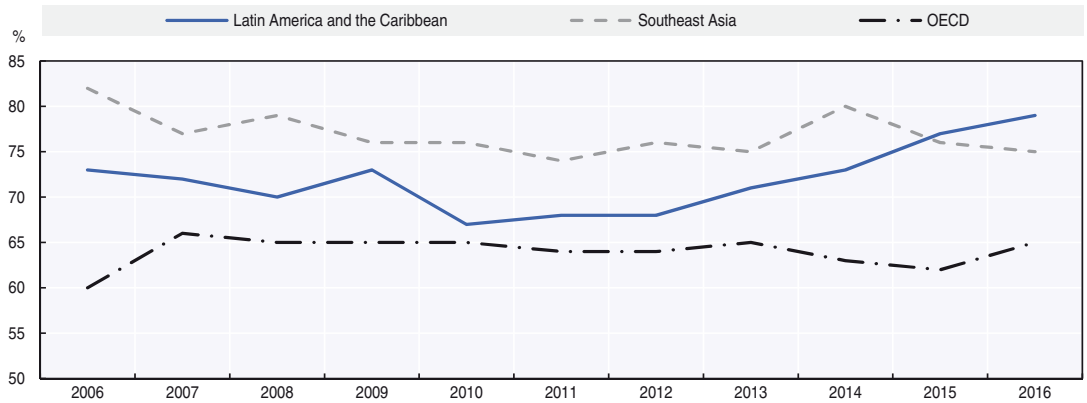
Towards trustworthy states: Strengthening the rule of law and regulatory systems

The perception of compliance with rule of law is low in LAC. A majority of LAC countries score below zero on World Bank indicators (on a scale from -2.5 to 2.5). The LAC average of -0.50 is well below the OECD's 1.2 in 2016 (World Bank, 2016). Only Chile, Uruguay, Costa Rica and the Dominican Republic score positively.

To ensure compliance with rule of law, a *broad strategy to foster independent and effective legal institutions* is a priority. This would increase certainty, raise citizens' trust and improve the business climate by ensuring adequate contract enforcements and protection of property rights. A good example is the *Lava Jato* case in Brazil. This investigation has been possible because of widespread judicial reform in the late 1980s that created an independent prosecutor's office, lifetime tenure and protection against political retaliation (Ambrus, 2017).

Weak legal enforcement in LAC makes policy capture, crime and corruption more likely. In 2016, eight out of ten Latin Americans claimed their government was corrupt, according to Gallup data (Figure 9). Perceptions of corruption have significantly increased since 2010, surpassing the average of Southeast Asia for the first time in a decade and well above the OECD levels. On a scale from 0 to 100, the region scores 55 points on the 2016 *Corruption Perception Index*, much higher than average OECD member countries that score 31 (Transparency International, 2016). However, the increased perception of corruption does not necessarily reflect a rise in the number of corruption cases, but rather that more efforts are being made to fight it, thus making it more visible. In fact, though still insufficient, progress in legal and institutional reforms in LAC has paved the way for more effective prosecutorial agencies, while citizen oversight and protest has been facilitated by increased transparency and connectivity (Casas-Zamora and Carter, 2017).

Figure 9. **Perception of corruption in government in Latin America, Southeast Asia and OECD**



Source: OECD/ECLAC/CAF's own elaboration based on data from Gallup World Poll (2017).
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To fight corruption, *a strong and cross-cutting integrity system* across all levels of government, involving the private sector and the society, is crucial. Most LAC countries have already prioritised anti-corruption policies. Yet enforcing policies and promoting a broader culture of integrity within public and private institutions remains challenging. Further, evidence on the success of anti-corruption initiatives remains mixed at the international level (Hanna et al., 2011). The OECD *Recommendation of the Council on Public Integrity* sets forward different lines of action in this direction, including for anti-corruption. For instance, Mexico and Colombia could achieve a stronger culture of integrity by integrating anti-corruption policies into the National Development Plan

and strengthening the internal control system within public institutions, respectively (OECD, 2017d; OECD, 2017e).

The *use of information and communication technologies (ICTs), big data analytics and open governments* are also effective ways of limiting corruption. These tools build transparent, accountable and more participatory states. Available data on budget and public finances in government transparency portals proved effective in uncovering some recent corruption scandals in LAC. The *Panama Papers scandal* illustrated the potential of ICTs and big data to fight corruption in the region (Santiso and Roseth, 2017). Similarly, open data had an important role in the investigations of Odebrecht and its corruption network in LAC.

Regulatory frameworks should promote fair competition and limit harmful practices that diminish the quality of goods provided to citizens. In particular, public procurement is crucial for delivering citizen services, but it can be captured by private interests. This, in turn, prevents the state from serving the public. The creation of central purchasing bodies (CPBs) as centres of procurement expertise and the development of e-procurement solutions are transforming traditional measures in LAC to combat price rigging. CPBs have considerably improved in the past years, such as *Colombia Compra Eficiente* or *Chile Compra*, though challenges remain to increase their effectiveness (OECD, 2017d, 2017f).

Towards stronger state capacities: Public sector reform to ensure good governance

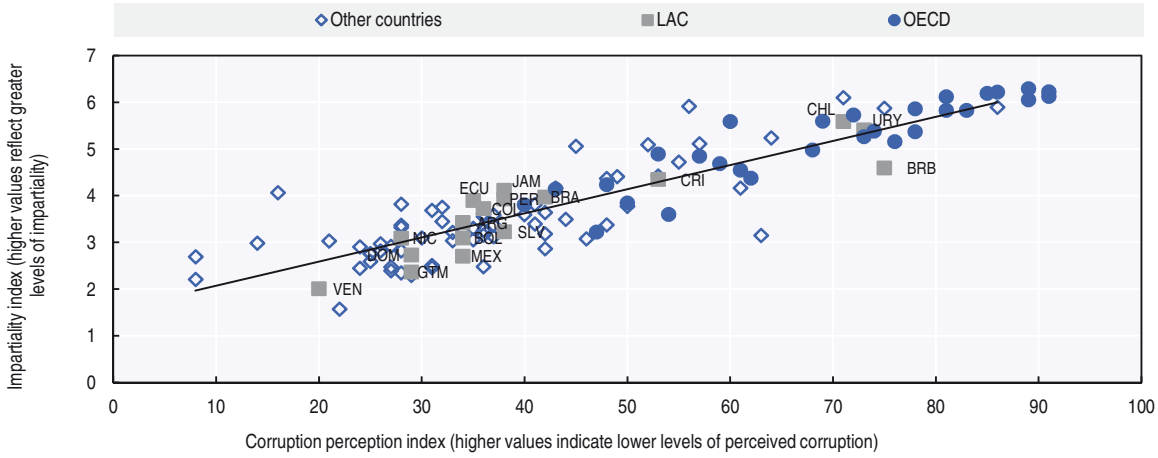
Improving a state's capacities requires *strengthening its fiscal muscle,* both by improving the efficiency in public spending and mobilising more tax revenues. Spending more efficiently and rationalising subsidies by improving targeting mechanisms are critical. On average, this process could deliver 3% of GDP in savings in LAC countries (IDB, 2016). Some LAC countries will also require mobilising more revenues to finance their development, as average tax revenues in LAC are 22.8% of GDP, relative to an average of 34.3% in OECD member countries (OECD/CIAT/ECLAC/IDB, 2017). Tax reforms should streamline tax expenditures that are inefficient and not cost effective. Strengthening direct taxation can mobilise resources and contribute to improving the tax system's redistribution capacities. At the same time, environmental taxes can provide a double dividend as they will increase revenue and improve environmental outcomes.

Better equipped and empowered Centres of Government would strengthen coordination and policy coherence. The Centre of Government (CoG) refers to organisational units that provide support – in coordination, management or monitoring – to heads of government. It promotes horizontal and vertical coordination that improves decision making and policy coherence throughout different government institutions and levels. Where they exist, LAC CoGs often lag behind OECD experiences. For example, explicit coordination exists at the level of ministers in 70% of LAC countries as opposed to 84% for the OECD, at the level of deputy ministers in 59% (72% in the OECD) and at the civil service level in only 23% (38% in the OECD) (OECD/IDB, 2016; Alessandro, Lafuente and Santiso, 2014).

Merit-based civil service recruitment systems in LAC are needed to address low levels of impartiality and low capabilities of public servants. These will also encourage a move towards professional, competent and accountable public institutions. Merit-based recruited public servants are more motivated to work and more transparent in the management of public funds and less likely to participate in the electoral efforts of the government of the day than appointed employees (Oliveros and Schuster, 2017). They also guarantee continuity and greater policy coherence across different administrations. These capabilities are critical for successfully implementing public policies and coping with the volatility and shocks that affect open economies (Chuaire, Scartascini and Tommasi, 2017).

Most LAC countries lack a formal professional civil service and experience a high proportion of political appointments among public servants. Between 2004 and 2015, however, LAC countries made significant progress towards merit-based processes: on average, LAC increased its merit score by 12 units, from 33 to 45 on a scale from 0 to 100, in the *Civil Service Merit Index*. Only Mexico and the Plurianational State of Bolivia show deterioration in their recruitment processes. Brazil, Costa Rica and Uruguay scored the highest (OECD/IDB, 2016). Impartiality is crucial to support citizens' perceptions, as it is positively and significantly correlated with lower levels of corruption. Impartiality levels in public administrations, with the exceptions of Chile and Uruguay, are low in LAC countries. On a scale from 1 to 7, LAC scores an average of 3.6 on the impartiality index as opposed to an average of 5.1 for OECD member countries (Figure 10).

Figure 10. **Public administration impartiality and corruption perception, 2017**



Note: Level of correlation is 0.90, significant at a 0.05% level. The indicator for corruption is the Corruption Perception Index calculated by Transparency International. It ranges from 0 to 100, with lower values showing more corruption. The correlation is calculated at a global scale including all countries for which data are available. For Latin American countries, the correlation remains significant at a 0.05% level with a value of 0.92.

Source: OECD/CAF/ECLAC, own elaboration based on the *Quality of Governance Database*, Quality of Government Institute, Cross-section data, 2017.

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Improving public management cycles – results-oriented planning, results-based budgeting, public financial management, project and programme management, and monitoring and evaluation systems – are critical to improve service delivery for citizens. Most countries in LAC require significant steps to enhance their public management systems, align incentives with institutional objectives and implement evaluation systems. In fact, Belize, Guyana, Jamaica, Nicaragua, Paraguay, and Trinidad and Tobago scored below 1.5 in 2007 on the *Management for Development Results Index* (the index is based on a scale from 0 to 5 in which 5 is optimal, according to Kaufmann, Sangines and Garcia Moreno, 2015). However, many efforts have been taken in recent years. Colombia has developed one of the region's most advanced monitoring and evaluation systems, the *Sistema Nacional de Evaluación de Resultados* (SINERGIA). For its part, the state of Jalisco in Mexico has established a monitoring system (MIDE) and the evaluation system EVALÚA. Together, these have improved the institutional capacity for policy evaluation, for government action based on quantitative evidence and for accountability and citizen participation.

Developing digital tools is a core component of modern governments and a strategic asset for policy making and improved cost-effective service delivery. Yet LAC countries struggle to manage and monitor digital government strategies. In their quest to adopt

digital tools, governments should continue to redesign good processes and promote inter-governmental co-ordination. In 2012, the European Commission estimated that all European Union (EU) public administrations using e-procurement procedures could save at least EUR 100 billion per year and that e-government could reduce costs by 15-20%. Digitisation of public services is already a common practice within OECD member countries, which have agreed on a set of recommendations on digital government strategies. Yet online government service supply and citizen demand have been asymmetrical. "Once-only" strategies or "digital-by-default" have had positive impacts. Digital-by-default services are designed from the beginning to be so compelling that everyone who can use them will choose to do so. This means the vast majority of transactions will be handled electronically. At the EU level, a "digital-by-default" strategy could save EUR 6 500 million annually, 0.04% of the EU-28 GDP (European Parliament, 2015).

Towards a new connection with citizens: Fostering open, participatory and innovative states

Open government strategies would improve democratic governance since they enable a culture of transparency, accountability and access to information as a means to fight and prevent corruption. Mass social media platforms offer a relatively cost-effective way to open spaces for citizens to directly communicate with public institutions and participate in policy making. Extensive data disclosure, measured by the *Open Budget Index,* and public participation in the budget process are positively associated with government effectiveness and corruption perceptions (Schmidthuber, 2015). A number of LAC countries including Brazil, Colombia, Guatemala, Mexico, Paraguay and Peru have created local citizens' councils to make governance more inclusive and participatory. These local spaces bring together representatives of civil society, academia and the private sector to discuss and make decisions about local development issues.

Innovation labs offer a viable alternative to capitalise on technology and social sciences. Such labs usually promote collaboration and citizen engagement within core public institutions to design cost-effective, risk-taking small pilot projects that respond to citizens' needs. Most are created as a special component of open government agendas, resulting in engagement platforms such as *mi Quito*, *mi Medellín*, *Bogotá Abierta* or Ágora *Rio*. In Uruguay, the social innovation lab supports the objective of making all administrative procedures and public services available on line.

A more intense *use of big data* could improve government effectiveness in the LAC region. Big data are a collection of structured and unstructured, large and complex datasets generated at great speeds. It requires advanced database management tools and data processing applications for analyses (OECD, 2015). In Brazil, big data analytics reduced the incidence of dengue fever by 98% in 2014 as the use of hospital information had helped identify hotspots that were later prioritised through geo-referencing (ECLAC, 2014). Applications of big data can also improve the government's spending efficiency and combat tax evasion. In Argentina, the design and implementation of an algorithm to identify individuals based on their most salient characteristics produced savings close to USD 120 million (around 0.06% of total tax revenues in 2015) in 2014-15 on transportation and energy subsidies (Pessino, 2017).

Institutions to embrace the future

Institutions to boost inclusive growth and support a state that delivers must be designed to anticipate change and to adapt to a rapidly evolving and increasingly complex global context. Various megatrends are shaping an era of uncertainty where

citizens perceive new challenges and risks that demand innovative policy responses. This context also requires a sustainable fiscal framework to underpin the capacity of financing more and better public goods and services to respond to them. In particular, the impact of technological change on the world of work and on economic activity is one of the major expected shifts (ECLAC, 2016).

Institutions must be rethought to guarantee economic opportunities in the context of technological change. This includes supply-side institutions, which are critical drivers of development and have a strong potential in Latin America (Pérez Caldentey and Vernengo, 2017). Thus, it is critical to focus on productive development policies to create good quality jobs, education and skills policies to favour employability, and labour market institutional arrangements to guarantee good job conditions; all backed by sound fiscal accounts to finance these institutional transformations.

Productive development policies (PDPs) are critical to help LAC countries transit towards knowledge-based, innovation-led economies. This productive transformation entails expanding high-value added activities, creating value chains and removing obstacles to competitiveness (ECLAC, 2012). The *OECD Productive Transformation* framework aims at providing guidance to promote structural change. In a context of uncertainty and complexity, more sophisticated policy approaches are needed based on five main capacities: forward-looking, flexibility, engendering self-discovery processes, ability to deal with increasingly complex networks and ability to create and retain value (OECD, 2017g). A strong institutional framework is critical to support PDPs. Organisational capabilities are necessary to foster effective management of policy efforts and favour policy co-ordination across sectors and with the private sector. They are also needed to guarantee long-term support of strategic priorities and protect the policy process from capture by private interests (IDB, 2014). The state can take up a stronger "entrepreneurial" role to shoulder certain risks with high social returns that the private sector is unwilling to assume. It can also help diffuse new knowledge throughout the economy (Mazzucato, 2013).

Education and skills policies must adapt to prepare citizens for a new labour market and to favour employability. The main tasks performed by workers will significantly change as demand shifts towards skills related to cognitive ability, systems and complex-problem solving (OECD/CAF/ECLAC, 2016). This challenges educational and vocational training systems to be up to date, while anticipating new requirements and offering lifelong education and training. Education and skills policies will need to focus more on what is increasingly in demand and develop mechanisms to anticipate required skills. With the need to detect skills requirements of enterprises in real time, vocational training must move towards a framework of closer co-operation with the private sector. And education and skills policies must be rethought adopting a "whole-of-government-approach", so that they guarantee policy collaboration and coherence across ministries and policy makers from different areas (OECD, 2016).

Technological progress will also have an impact on the organisation of work and the nature of working arrangements in the LAC region, so *labour institutions and regulations* should also evolve (ILO, 2016). Labour market institutions should be designed so that they encourage employers to seize the opportunities offered by technological change and to prevent a disproportionate impact on workers of low pay or precarious conditions. This includes rethinking social security systems, strengthening activation frameworks, and promoting new forms of social dialogue (OECD, 2017h; OECD, 2017i). Non-standard employment includes temporary and part-time work, multi-party employment relationships, disguised employment relationships and dependent self-employment. This diversification challenges the concept of "decent work", given that many labour

laws and social security policies depend largely on standard employment relationships. Labour market institutions need to adapt, including measures to address employment misclassification, ensure equal treatment for workers and implement minimum hours and other safeguards. Institutions must also be able to assign obligations and liabilities in multi-party arrangements, restrict the use of non-standard employment, and promote collective responses and agreements. Women's labour market integration can improve with the proliferation of non-standard employment, as this seems to facilitate a balance between work and family tasks (OECD/CAF/ECLAC, 2016). However, particular attention must be paid to avoid the perpetuation of vulnerable working conditions. Social protection systems should be strengthened, ensuring non-discrimination and equal treatment among different contractual arrangements. Such systems should also adapt schemes to extend coverage to previously excluded categories of workers and complement social insurance with non-contributory mechanisms to provide a social protection floor.

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Chapter 1

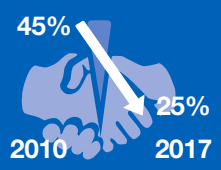
The social contract in Latin America and the Caribbean: Situation and policy challenges

This chapter illustrates the weakening of the social contract in the region, and aims to better understand its intricacies and the policy challenges and areas that are crucial for its strengthening. First, it presents evidence that suggests the growing disconnection between citizens and public institutions in Latin America and the Caribbean (LAC), which in turn is a sign of a weaker contract. This section argues that two factors could explain this growing disconnection: the rising aspirations of a middle class that has significantly expanded in the last decade, and the difficulties of public institutions to respond to new socio-economic challenges and guarantee greater well-being. The strength of the social contract is also assessed by exploring tax morale – i.e. the willingness to pay taxes – in the region. Second, it looks at how well-being has diminished recently in LAC, and suggests the need to rethink institutions to provide better opportunities and public goods and services and respond to citizens' evolving demands, thus improving their well-being.

The *social contract* in Latin America and the Caribbean: situation and policy challenges

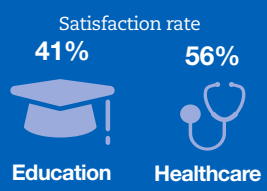
Latin America and the Caribbean witness a growing disconnection between citizens and the state

Lower trust in government



Trust in government has fallen from a level of **45%** in 2010 to around **25%** in 2017

Low satisfaction with public services

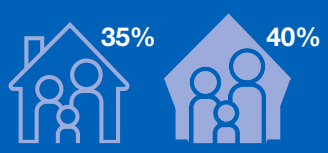


Over 2006-16, the share of people **satisfied with the quality of public services** also fell

Lower tax morale

More than half of Latin-Americans were willing to **evade paying taxes** in 2015

The unmet aspirations of a larger *middle* class are a key driver of the current social dissatisfaction



In 2015, around **35%** of LAC population could be **considered consolidated middle class** (21% in 2001), but around **40%** remains **vulnerable**

Dissatisfaction with public services brings **upper- and middle-class households** to move towards **better quality private services...**

... while **vulnerable middle class and poor households** remain using **low quality public services**, thus perpetuating social divides

In recent years, the Latin America and Caribbean (LAC) region has witnessed a growing disconnection between citizens and the state. This is illustrated mainly by a decline of trust in public institutions and an increase of citizen dissatisfaction with public services. The rising aspirations of a larger middle class, coupled with the difficulties of public institutions to respond to persistent and new socio-economic challenges emerging from both the domestic and the global context, explain to a large extent this disconnection.

These developments suggest a weakening of the social contract in LAC, with significant implications for people's perception of well-being. The social contract can be broadly understood as a tacit pact between the state and citizens. On the one hand, the state enables people to make the most of their lives (through guaranteeing fundamental rights and ensuring a certain standard of material conditions and quality of life through the provision of public goods and services). On the other, citizens fulfil certain duties and obligations (such as voting and paying taxes) that underpin the effective functioning of democratic societies.

Rebuilding the social contract is vital to foster higher well-being for all in LAC. To do so requires a rethinking of institutions to better respond to citizens' demands and to bridge the gap with them. In LAC, declining levels of trust and satisfaction with public services suggest that citizens no longer believe that public institutions can respond to their demands. As a result, they do not perceive sufficient benefits linked to the fulfilment of their duties as citizens, but rather see fewer incentives to engage in the obligations associated with the social contract. This, in turn, undermines the capacity of the state to provide quality public goods and services effectively. This leads to a negative impact on citizens' perception of well-being, which further fuels their disengagement from public institutions in a downward spiral.

This chapter illustrates the weakening of the social contract in the region, and aims to better understand its intricacies and the policy challenges and areas that are crucial for its strengthening. First, it presents evidence on the growing disconnection between citizens and public institutions in LAC. The strength of the social contract is also assessed by exploring tax morale – i.e. the willingness to pay taxes – in the region. Second, it analyses how a stronger social contract is critical to achieve greater well-being, and argues that a rethinking of institutions is needed in the LAC region in order to achieve this goal by better responding to citizens' demands and providing better public goods and services.

The social contract has weakened in LAC owing to the difficulties of institutions to respond to the rising and evolving aspirations of society

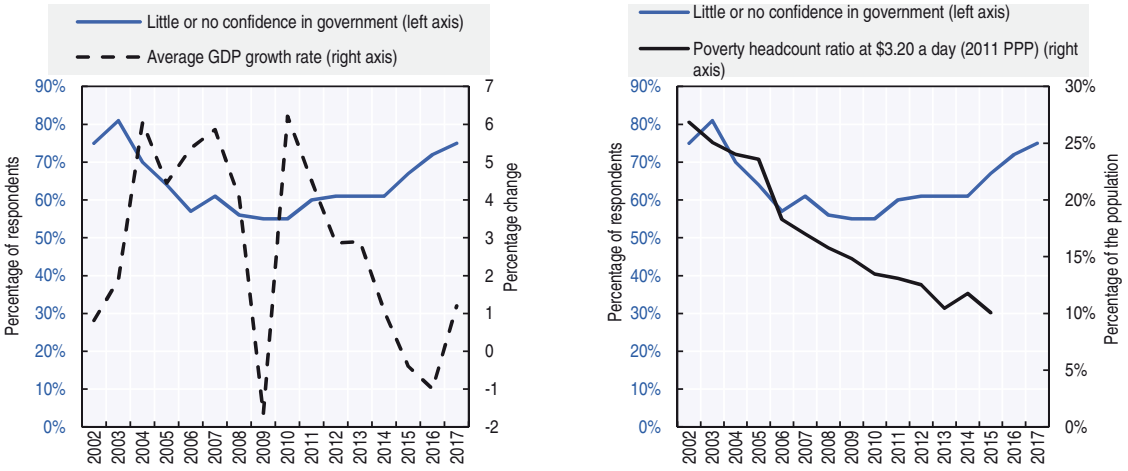
The widening gap between aspirations and perceptions suggests that the social contract has been weakening in LAC. The notion of the social contract is broad, although its strength can be measured through different indicators that help understand the vigour of the relationship between the state and society. Social contracts are generally characterised by a number of explicit and implicit agreements that determine what each socio-economic group gives to the state and what it receives back (Estefania and Martinez-Lillo, 2016). Citizens will only engage firmly in these agreements under three conditions. They must believe they are reliable (i.e. they trust state institutions), they must perceive these agreements are beneficial (i.e. they are satisfied with what they receive by engaging in them) and they must perceive the pact as fair (i.e. no one is favoured over others or benefits at their expense). Looking at the gap between social aspirations (what people would like to receive or what they demand from the state) and perceptions (what they feel they receive from engaging with the state) could reveal insights into the strength of the social contract. In LAC, both the indicators about perceptions and aspirations point to a weakening of the social contract in recent years.

Low trust and dissatisfaction illustrate the erosion of the social contract in LAC

Trust in institutions is low in LAC and has deteriorated in recent years. On average in the last decade, 62% of the Latin American population had little or no trust at all in governments. Lack of trust in governments has deepened since the global financial crisis, reaching levels of around 75% in 2017, up from a level of 54% in 2010 (Figure 1.1, Panel A). Trust has decreased even in a context of a large decline of poverty rates in the LAC region (Figure 1.1., Panel B).

Trust is usually understood as "holding a positive perception about the actions of an individual or an organisation" (OECD, 2017a). It is thus interpreted as having confidence that the actions of others will follow what is expected. In this respect, trust is a fundamental element for the success of public policies. Many such policies depend on co-operation and compliance of citizens, while many others assume the public will behave in a way that transforms these policies into successful action. There are different categories of trust: trust of citizens in governments; trust of governments in citizens; and trust among citizens. While the three are relevant for a solid social contract, the chapter focuses on trust of citizens in governments and in public institutions. Without trust, citizens do not perceive value in engaging in an agreement that may not be respected.

Figure 1.1. **Trust in governments vs. growth and poverty rates in Latin America**



Note: Unweighted averages for all variables for a sample of countries comprising: Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, the Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, Uruguay and Venezuela.

Source: OECD/CAF/ECLAC based on data from IMF (2016), *World Economic Outlook*; World Bank (2017a), *World Development Indicators;* and Latinobarometro (2017).

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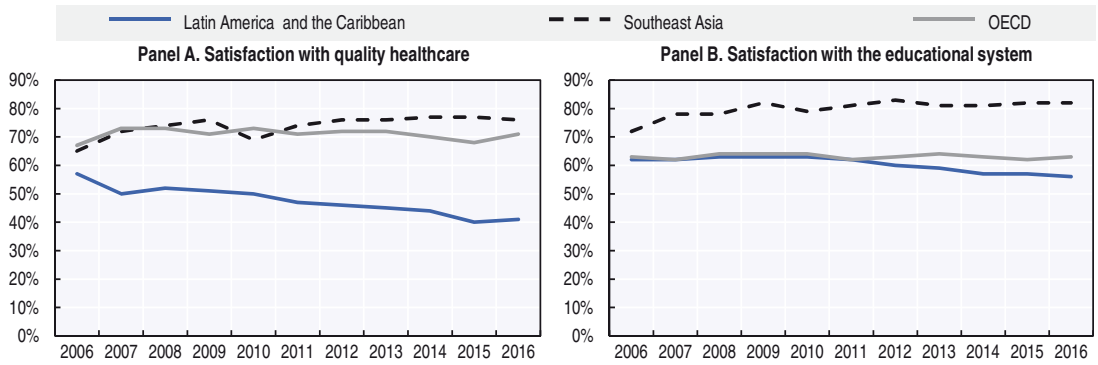
Other indicators also suggest that citizens in the LAC region are losing trust in institutions. Overall in 2016, only 23% of Latin Americans said they were confident in the honesty of elections (compared with 46% in the OECD). In addition, only 15% said they did not believe that corruption was widespread in government (compared with 28% in the OECD). Further, 34% had confidence in the national judicial system (compared with 49% in the OECD) (Gallup, 2017).

Overall satisfaction with public services has also diminished in the region. Over 2006-16, the share of people satisfied with the quality of healthcare fell from 57% to 41%. This remains well below satisfaction levels in OECD member countries (around 70%), which have remained stable (Figure 1.2, Panel A). Likewise, satisfaction with the quality of the education system fell from 63% to 56% over the same period (around 63% for OECD members in 2016) (Figure 1.2, Panel B).

Figure 1.2. **Satisfaction with main public services in Latin America, OECD and Southeast Asia (percentage of total population)**



Source: OECD/ECLAC/CAF based on Gallup 2017.

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Multiple factors drive citizen dissatisfaction in LAC. What seems to matter the most for citizens are economic problems (jobs and income), the quality of goods and services (especially to combat crime and violence, and provide health and education), and political issues (notably corruption), according to Latinobarometro (2017). An additional source of information to understand citizens' perceptions are internet searches, which in addition provide higher anonymity, sincerity and frequency than traditional surveys. These searches suggest that citizens' perceptions about economic problems, public insecurity, corruption or public services are directly linked to presidential approval rates in LAC – used as a proxy of citizens' overall satisfaction and potentially of their willingness to engage firmly in the social contract (Montoya, Nieto-Parra, Orozco and Vazquez, forthcoming) (Box 1.1).

Box 1.1. **Big data is a relevant source information to understand the main drivers of citizens' discontent**

Today, an increasing number of people from all over the world turn to the internet in search of information on politics, economics and jobs. Each minute, searches of people living in different countries generate large amounts of georeferenced data, reflecting concerns, opinions, preferences and needs. The absolute anonymity of these searches, and therefore the sincerity in their content, make the generated data more likely than traditional surveys to be objective (Stephens-Davidowitz, 2013). These reasons mostly explain why social scientists are increasingly using this massive amount of data with the aim of knowing more about people's behaviours. Likewise, this new source of information also has the potential to inform policy makers and governments on various aspects of citizens and public opinion (Reimsbach-Kounatze, 2015).

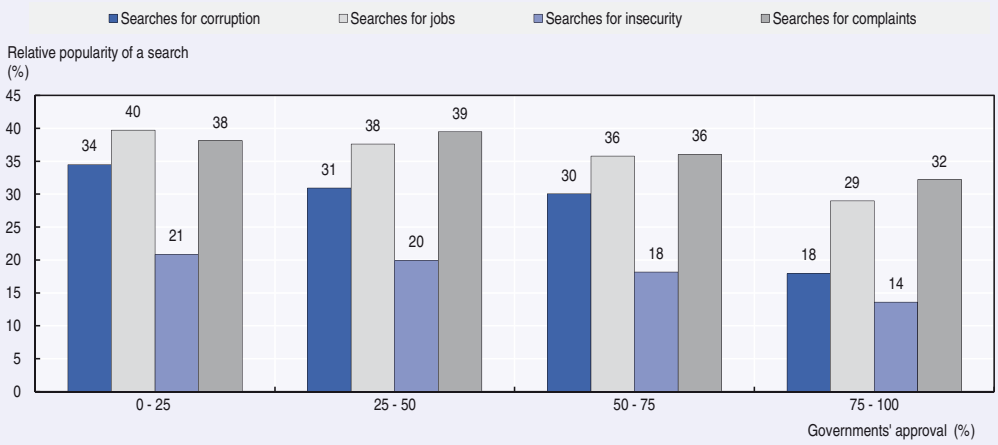
Recent empirical evidence shows that data obtained from internet search engines (in particular google data) is a useful source of information about citizens' main socio-economic concerns (Montoya, Nieto-Parra, Orozco and Vazquez, forthcoming). This analysis examines whether citizens' perceptions of the region's most important problems, measured using their searches on the internet, can explain executive approval rates, on the belief that the latter is a good proxy of the satisfaction of citizens with their government and thus their willingness to engage in the social contract. The analysis includes 18 LAC countries between January 2006 and December 2015, employs

Box 1.1. **Big data is a relevant source information to understand the main drivers of citizens' discontent** *(cont.)*

monthly panel data, and combines variables gathered from standard national statistics data and variables constructed from the results of internet searches done by citizens. The latter is included precisely with the goal of approaching citizens' perceptions and concerns (Montoya, Nieto-Parra, Orozco and Vazquez, forthcoming).

Stylised facts from Montoya et al. show a negative relationship between governments' approval and the volume of internet searches for corruption, jobs, insecurity, and consumer complaints in the region (Figure 1.3). This negative relationship suggests that the volume of searches for these issues, which mostly coincide with the main sources of concern of society according to Latinobarometro (Latinobarometro, 2017), is lower when executive approval rates are higher. In this respect, internet searches appear to be informative about citizens' sources of discontent with governments.

Figure 1.3. **Internet searches on economic, political, and social issues in Latin America, within different levels of executive approval**



Note: This graph displays the average popularity of internet searches within each quartile of government's approval data. It employs monthly observations between January 2006 and December 2015 of 18 LAC countries, including Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, the Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, Uruguay and Venezuela.

Source: OECD/ECLAC/CAF using data from Google trends and the Executive Approval Database (Carlin et al., 2016).

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The econometric analysis performed by Montoya et al. confirms that citizens' perceptions of corruption and insecurity – proxied using internet search query data – have a negative and statistically significant influence on the rates of approval of the incumbent government. Nevertheless and surprisingly, the unemployment variable, constructed with internet searches for terms related to the search of a job by citizens, does not seem to have an effect on governments' approval in the LAC region. The large presence of labour informality in LAC, which may well distort the dynamics of job searches – many don't need to look for a job as they already have one in the informal sector or only look for jobs through informal channels – may be one of the explanations behind this counterintuitive result. Other variables non-related to internet searches, such as the level of inflation, economic growth rates, and the international economic environment, are also strong determinants of executive approval rates.

Box 1.1. **Big data is a relevant source information to understand the main drivers of citizens' discontent** *(cont.)*

This analysis displays the potential that big data has to inform governments about citizens' concerns, opinions, preferences and needs with higher anonymity, sincerity and frequency than traditional surveys. Nonetheless, using information from internet search engines presents some limitations. First, the sample is unlikely to be representative, considering that internet access is constrained for certain segments of the population. This applies particularly to Latin America and the Caribbean (LAC), given the low levels of internet penetration in the region despite its progress over the last decade [54.5 internet users per 100 inhabitants in 2015 (World Bank, 2017a)]. This may limit the sample of people performing internet searches to mainly middle and high-income inhabitants from LAC. In order to test differences in the results depending on the evolution of internet access, Montoya et al. integrate different time-specifications according to the number of internet users per 100 inhabitants of each country. The second main caveat is the latent risk of capturing searches that are not of our interest. To limit biases generated by unrelated topics captured in the searches, Montoya et al. refine results from internet searches by excluding potential misleading words.

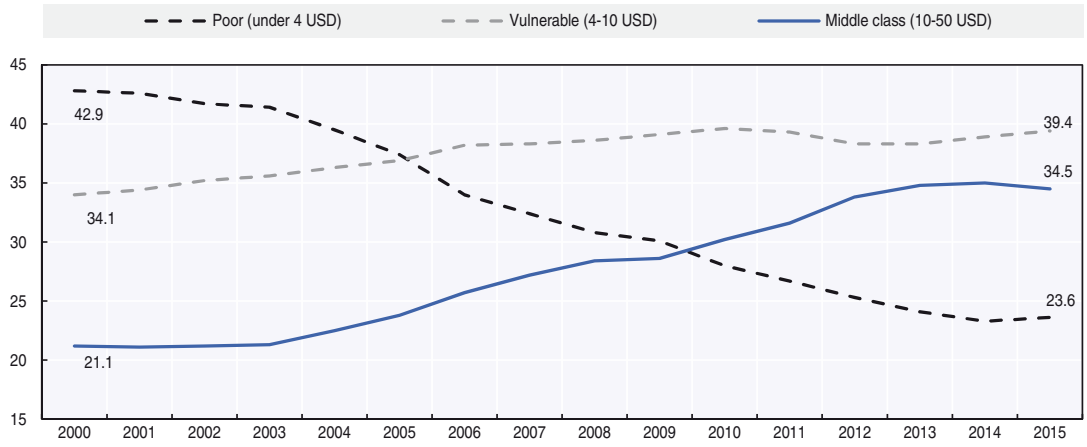
The rise of aspirations and the unmet demands of society are one of the main explanations to why discontent in LAC is growing even after unprecedented socio-economic progress. It is somewhat paradoxical that trust and citizen satisfaction have deteriorated even after an economic boom in LAC; poverty rates have declined sharply, inequalities have narrowed and overall living standards have significantly improved. Various explanations may lie behind this phenomenon. First, the recent economic slowdown could be creating a feeling across many segments of society that the previous socio-economic gains could be at risk. At least, people might believe it will be difficult to continue with a similar pace of progress. Second, increasing interconnectedness favoured by technological advances may have created new paradigms of social progress. It is easier to compare progress in LAC against societies of higher levels of development, thus inflating aspirations among younger generations. Third, a number of global trends such as rapid technological change, an ageing population, migration and climate change are perceived as challenges beyond the powers of the nation state, thus creating a sense of uncertainty and risk among citizens. Finally, the expansion of the middle class has been accompanied by higher aspirations and demands. This is particularly true in LAC, with one out of four citizens aged between 15 and 29 years old. It also has the first generation born and raised in democracy, and one that is highly urbanised, with almost 90% of its population living in cities: these factors also contribute to the evolving demands from society (OECD/CAF/ECLAC, 2016). The shifting aspirations of a larger middle class stand out as a major transformation in LAC's society and deserve special attention.

The rising and evolving aspirations of a larger middle class

The expansion of the middle class has been one of the major socio-economic transformations of recent times in LAC. In 2015, around 35% of the population could be considered consolidated middle class (earning USD 10-50 [2005 PPP] a day), up from 21% in 2000. Almost 40% of the population could be considered vulnerable middle class (living with USD 4-10 [2005 PPP] a day) (Figure 1.4). For the first time in history, the poor are the smallest socio-economic group in LAC, comprising near 24% of the population – individuals living on less than USD 4 (2005 PPP) a day (OECD/CAF/ECLAC, 2016).

Figure 1.4. **Latin American population by socio-economic groups**

Percentage of total population



Source: OECD/ECLAC/CAF based on LAC Equity Lab tabulations of SEDLAC (CEDLAS and the World Bank, 2016).

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Moreover, a majority of LAC's citizens perceive themselves as being part of the middle class. *Being middle class* is not the same as *feeling part of the middle class*. Subjective measures of social class suggest that the middle class in LAC is even larger than that shown by income measures. Further, it suggests the middle class is aspirational in the region (i.e. people have middle-class aspirations even when their levels of income are not necessarily those attributed to middle-class groups). Almost 40% of citizens perceive themselves as middle class according to some results (Figure 1.5). Other analysis puts the share at 53% (Penfold and Rodriguez, 2014). In terms of aspirations, expectations and social demands, then, as well as the role played by this socio-economic group in shaping and strengthening the social contract, the relevance of the middle class may be even larger than suggested by income measures.

Figure 1.5. **Latin American population by subjective socio-economic groups**

Percentage of total population according to the socio-economic group to which they believe they belong

Note: The question asked in the survey is: "Which social class would you describe yourself as belonging to? High, upper-middle, middle, lower-middle or low."

Source: OECD/ECLAC/CAF based on Latinobarometro, 2017, 2015, 2013, 2011.

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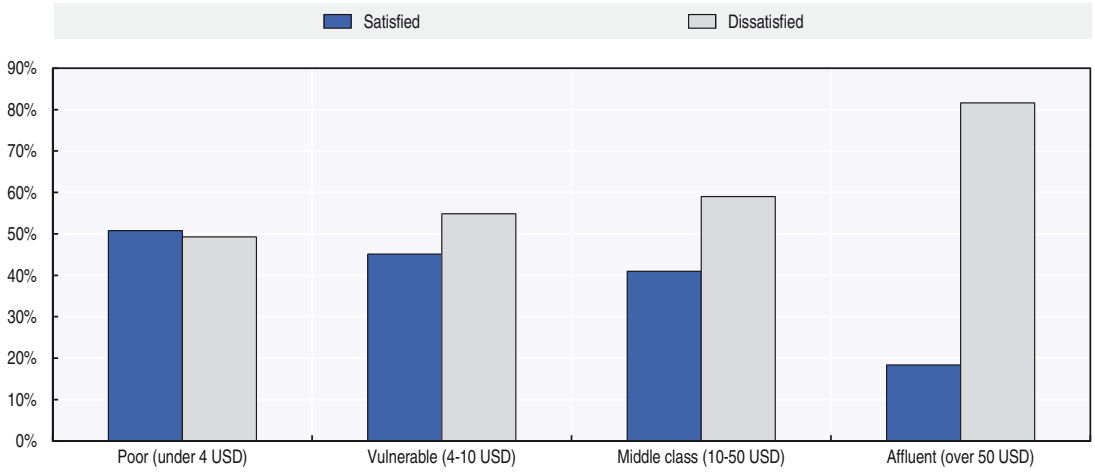
The enlargement of the middle class has brought with it a change in aspirations, expectations and demands, which significantly explains the current social dissatisfaction in LAC. Belonging to the middle class is usually associated with a certain set of

aspirations and demands. Middle-class citizens are strong supporters of democracy, but at the same time are critical of its functioning (OECD, 2010). In fact, when the middle class reaches at least 30% of the population, its members attain a collective power to demand better public goods and services more effectively (Birdsall, 2016). In this sense, an increase in the size of the middle class makes social policy on health and education more active, decreases official corruption levels and improves the quality of governance regarding democratic participation (Loayza, Rigolini, Llorente, 2012). In LAC, the large expansion of the consolidated middle class is presumed to have changed substantially the expectations of a large segment of society (Penfold and Rodriguez, 2014). Likewise, the members of the large vulnerable middle class live with the uncertainty that they could fall back into poverty in the advent of a negative shock. Indeed, in 2015 around 7 million people did fall back into poverty in the region (ECLAC, 2016). Altogether, increased expectations of the consolidated middle class and the sense of instability of the vulnerable middle class can largely explain the upsurge of social dissatisfaction witnessed in LAC in recent years.

Discontent with public health services is generalised across Latin American society, but seems to rise with income. As much as 55% of the vulnerable middle classes report dissatisfaction with these services, while almost 60% in the consolidated middle class do. Similarly, more than 80% in the high income group also report dissatisfaction with public health services (Figure 1.6). Dissatisfaction with public education, water and sanitation, and public security follow similar trends (LAPOP, 2016).

Figure 1.6. **Satisfaction with public medical and health services by income levels in Latin America, 2015**

Percentage of total population



Note: "Poor" refers to individuals whose daily per capita income is below 4 USD; "vulnerable" have a daily per capita income of USD 4-10; "middle class" have income between USD 10-50; "affluent" have an income above USD 50. 2005 USD PPP per day. PPP = purchasing power parity.

Source: OECD/ECLAC/CAF based on The Americas-Barometer by the Latin American Public Opinion Project (LAPOP), www.LapopSurveys.org .

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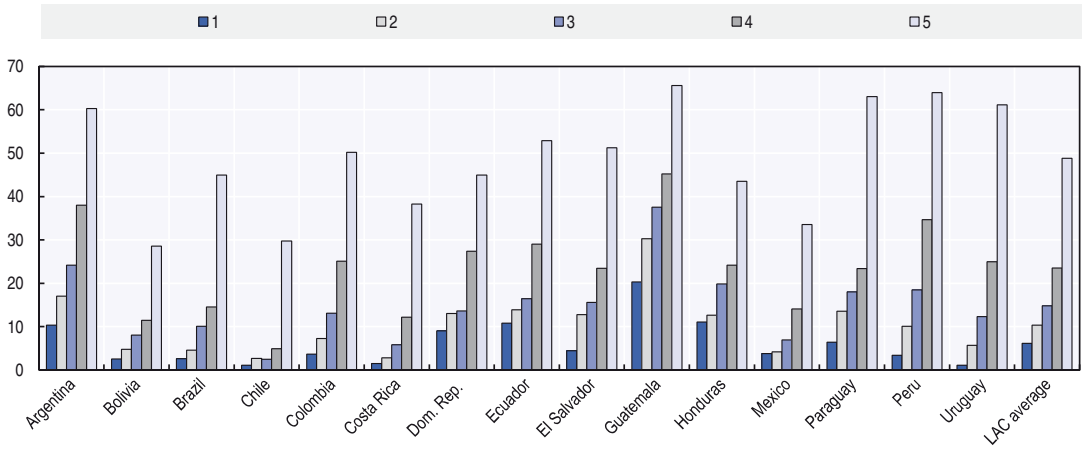
High levels of dissatisfaction with public goods may explain why a large share of Latin Americans with sufficient income chose private services over universal public services (such as education or health). For instance, the share of secondary students enrolled in private schools is strongly linked to household income, with a drastic increase for the fourth and fifth quintile (Figure 1.7).

Dissatisfaction with public services, and the subsequent opting out of those with sufficient resources, weaken the social contract. The welfare state remains highly fragmented, providing differentiated services to various population groups (Ribe, Robalino and Walker, 2010). On the one hand, individuals from upper- and middle-class households usually channel their dissatisfaction with public services by opting out; they move towards better quality private services they can afford. On the other hand, individuals from the *vulnerable middle class* and poor households are also dissatisfied with the quality of public services, but do not have the necessary income to opt out of them; they remain using low quality public services. This creates a fracture. Consolidated middle classes pay both for the cost of public services that they finance but do not use, and for the cost of private services that they eventually use. And vulnerable middle classes use public services, but are dissatisfied with them and are not able to afford higher quality options. In this context, these groups, which together represent around 75% of the population, are dissatisfied for different reasons, and they may find few incentives to engage firmly in a solid social contract.

Figure 1.7. **Enrolment in private schools by income quintiles in Latin America, 2014**

Share of secondary students in private schools



Source: OECD/CAF/ECLAC, based on CEDLAS and the World Bank (2016).

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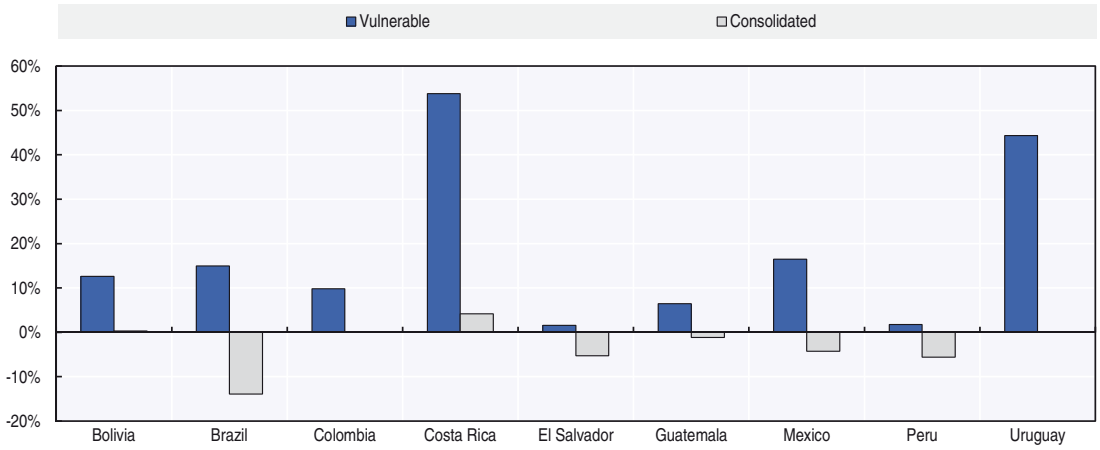
After accounting for the effect of taxes, transfers and public services, individuals from the consolidated middle class are net payers, while those from the vulnerable middle class are net receivers. As the consolidated middle class pay more in taxes than the monetary value of what they receive in transfers, (direct, indirect and in-kind transfers), they are net payers. Conversely, individuals from vulnerable households are net receivers, as the monetary value of the transfers and services they receive is larger than the taxes they pay (Figure 1.8). In fact, when the monetary value of education and health is not considered, the vulnerable in all LAC countries included in the Commitment to Equity Institute (Box 1.2) analysis, except for Ecuador, become net payers. This implies that the bulk of redistributive policies rests upon public services, which most often have poor quality (OECD, 2010; Daude, Lustig, Melguizo and Perea, 2017; Lustig, 2017a).

Although the middle class bears most of the cost of welfare policies, indirect taxes put more pressure on the poor and the vulnerable class. Indirect taxation, particularly value added taxes (VAT) and other excise taxes on inelastic products passed on to consumers via higher prices, affect middle-class and low-earning individuals the most. In the case of Brazil, Colombia, Costa Rica and Uruguay, the share of taxes as a percentage of market

income is higher for the vulnerable class than for the consolidated middle class. In the case of El Salvador, Guatemala and Peru, the share is relatively equal for both cohorts of the middle class.

Figure 1.8. **Net fiscal position of the middle class, circa 2010**

Change in final income with respect to market income, percentage



Notes: "Vulnerable" have a daily per capita income of USD 4-10; "middle class" have income between USD 10-50; 2005 USD PPP per day. PPP = purchasing power parity.

Source: OECD/ECLAC/CAF based on Daude, Lustig, Melguizo and Perea (2017), "Fiscal policy and the emerging middle class in Latin America, an analysis based on the Commitment to Equity".

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Box 1.2. **The Commitment to Equity**

The Commitment to Equity (CEQ) Institute at Tulane analyses the impact of taxation and social spending on inequality and poverty in individual countries, and provides a roadmap for governments, multilateral institutions and non-governmental organisations (NGOs) to build more equitable societies (Lustig, 2017b).

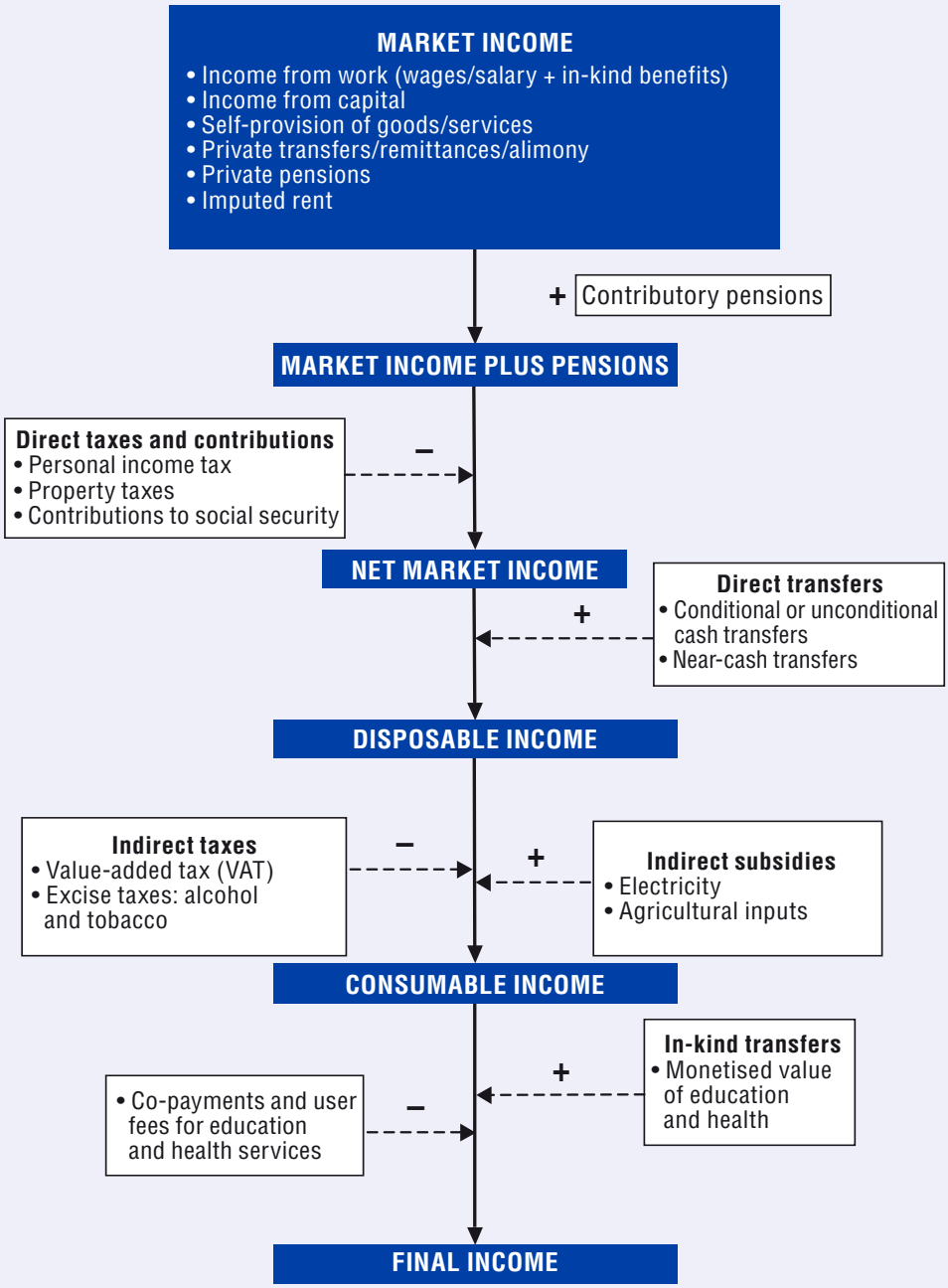
The CEQ produces tax and benefit incidence studies that aim to answer the following four questions:

1. How much income redistribution and poverty reduction are being accomplished through fiscal policy?
2. How equalising and pro-poor are specific taxes and government spending?
3. How effective are taxes and government spending in reducing inequality and poverty?
4. What is the impact of fiscal reforms that change the size and/or progressivity of a particular tax or benefit?

To address these questions and to measure the redistributive effect and poverty impact of taxes and benefits, CEQ produces a fiscal incidence analysis. This consists of allocating taxes (personal income tax and consumption taxes, in particular) and public spending (social spending and consumption subsidies, in particular) to households or individuals. This enables comparison of incomes before taxes and transfers with incomes after taxes and transfers (Lustig, 2017b). Figure 1.9 summarises the construction of these income concepts.

Box 1.2. **The Commitment to Equity** *(cont.)*

Figure 1.9. **Definitions of income concepts**

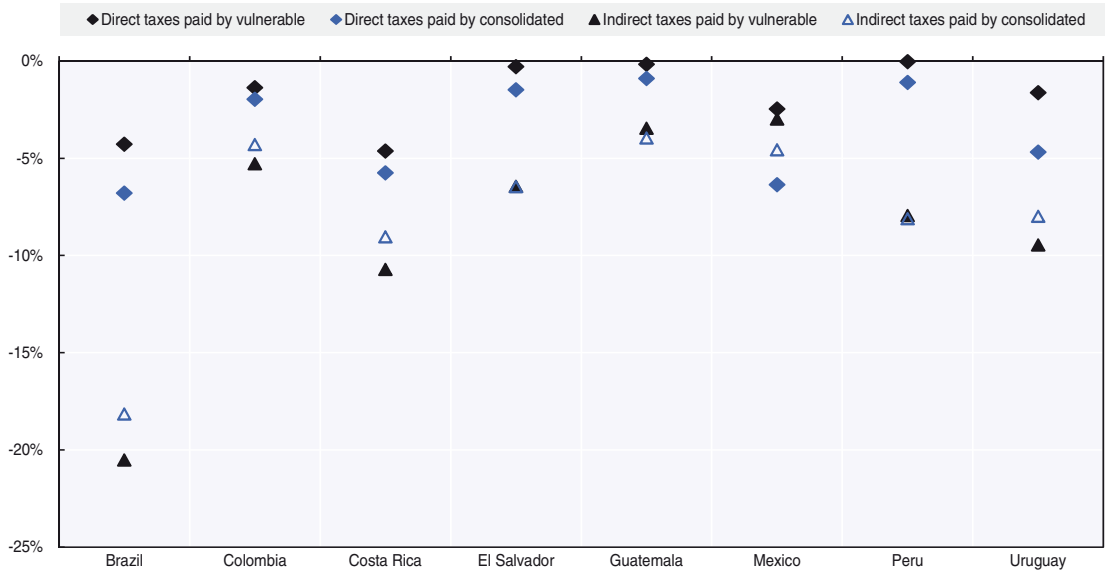


Source: Adapted from Lustig (2017b).

The consolidated middle class and the rich largely bear the weight of direct taxes, as personal income taxes are focused only on very high-earning individuals (Barreix, Benitez and Pecho, 2017). This is especially the case in Brazil, Costa Rica and Mexico,

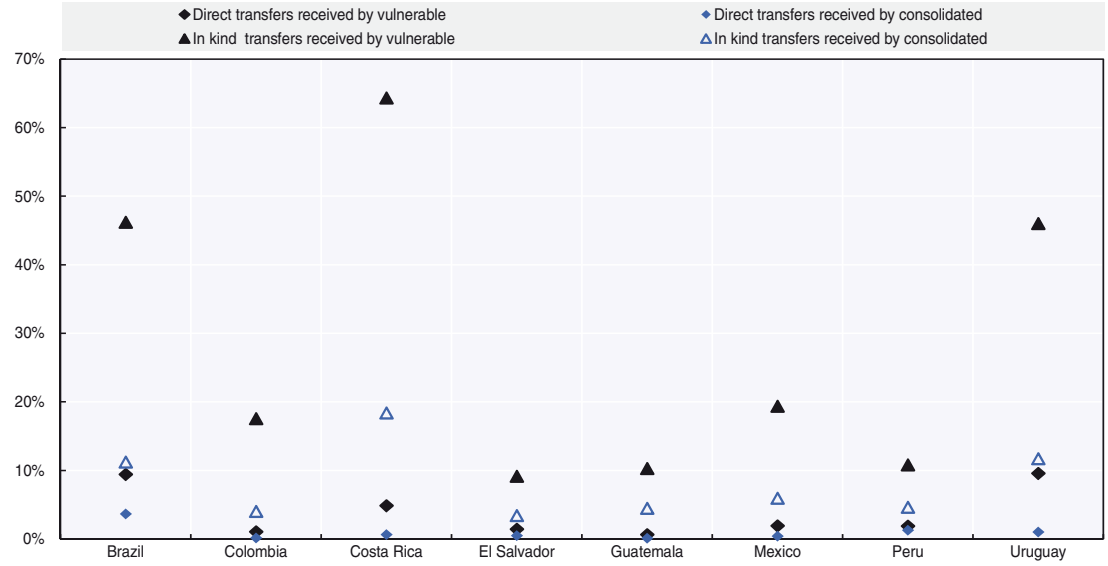
where direct taxes as a share of market income are higher for the consolidated middle class than for the vulnerable. Similarly, this is the case in El Salvador, Guatemala and Peru where the vulnerable do not pay direct taxes (Figure 1.10).

Figure 1.10. **Ratio of taxes paid to market income for the middle class (vulnerable and consolidated) by country in Latin America, circa 2010**



Source: OECD/ECLAC/CAF based on Daude, Lustig, Melguizo and Perea (2017).
StatLink http://dx.doi.org/10.1787/888933649829

Figure 1.11. **Ratio of transfers received to market income for the middle class (vulnerable and consolidated) by country in Latin America, circa 2009**



Source: OECD/ECLAC/CAF from Daude, Lustig, Melguizo and Perea (2017).
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The majority of transfers (direct and in-kind) benefit the vulnerable middle class on a larger scale compared with the consolidated middle class (Figure 1.11). Such transfers include education and health services as a percentage of their market income. This

probably occurs because the consolidated middle class can opt out of low-quality public services, especially in education and health, in favour of private services. Similarly, and because of the nature of their design, direct transfers (conditional and unconditional cash transfers, school feeding programmes, free food transfers, etc.) tend to be progressive in absolute terms (Daude, Lustig, Melguizo and Perea, 2017). This benefits the vulnerable middle class (as a percentage of their market income) rather than the consolidated middle class. In fact, in economies such as Colombia, Guatemala, El Salvador and Mexico, the impact of direct transfers on the consolidated middle class is rather small.

Assessing the strength of the social contract in LAC: A fiscal perspective using tax morale

One of the main components of the social contract is the fiscal pact. This can be defined as the agreement that citizens pay taxes to the state in exchange for certain public services and goods. The strength of the fiscal pact can be a good measure of the strength of the social contract in a broader sense.

The degree of involvement of LAC citizens in the fiscal pact is strongly determined by the perception about the net results of their participation in it (Avanzini, 2012). The engagement of Latin Americans in the fiscal pact depends on their trust in institutions, satisfaction with public services and the overall benefit they believe to have obtained by participating or fulfilling their obligations with the state. If Latin Americans are dissatisfied with their government and the services it provides, they are more likely to justify cheating on taxes and to potentially avoid paying them. They may also opt out of the use of public services, effectively undermining the social contract. Measuring tax morale, or willingness to pay taxes (Box 1.3) is thus a way to understand the degree of engagement of citizens in the fiscal pact. It ultimately indicates their trust and satisfaction with public institutions and services.

Box 1.3. **Measuring tax morale**

There exist different ways to measure tax morale based on household surveys. Both the World Value Survey (WVS) and the Latinobarometro ask whether "cheating or evading taxes can be justified", although the WVS adds, "If you have the chance". These results are not totally comparable with other regional surveys for other emerging regions. The Afrobarometro, for example, asks whether "not to pay taxes on income was wrong and punishable, or wrong but understandable, or not wrong at all". The Asiabarometer asks the question indirectly: "Would you like to see more or less government spending in each area?", with a reminder that more expenditure may require a tax increase. In both the Latinobarometro and the WVS, respondents are asked to rank from 1 to 10 their justification of tax morale (with 1 being never justifiable and 10 being always justifiable). For this chapter, "10" represents people who would never justify avoiding taxes, while "1" would be for those who would always justify cheating on taxes.

Results from Latinobarometro and WVS differ as the sample of countries and the period are not the same. For WVS, it consists of nationally representative surveys in almost 100 countries through waves of amplitude of five years (wave). In this chapter, results and analysis from the WVS are from wave 6, which consists of the years 2010-15. It features 58 countries, including Argentina, Brazil, Chile, Colombia, Ecuador, Mexico, Peru, Trinidad and Tobago, and Uruguay.

In the case of the Latinobarometro, it undertakes a yearly nationally representative survey (latest data available are 2015), which includes 18 Latin American countries: Argentina, the Plurinational State of Bolivia (hereafter "Bolivia"), Brazil, Chile, Colombia,

Box 1.3. **Measuring tax morale** *(cont.)*

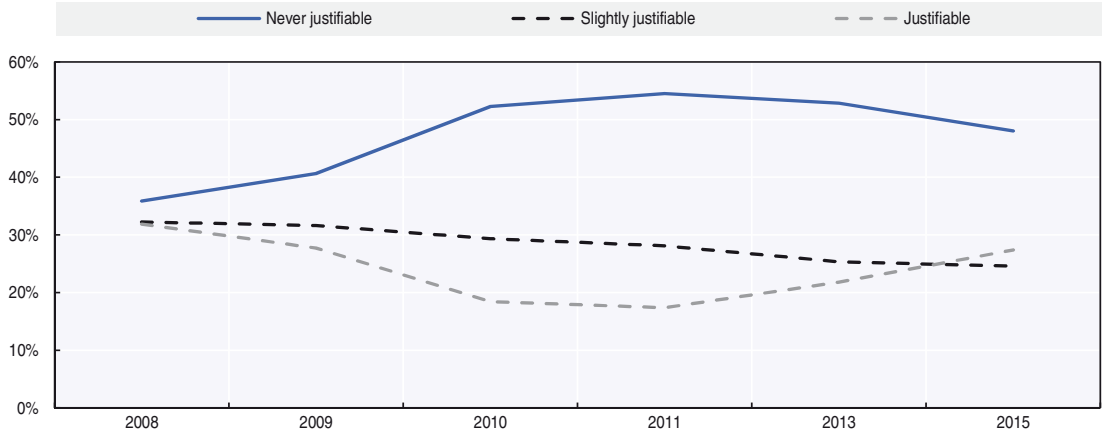
Costa Rica, the Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, Uruguay and the Bolivarian Republic of Venezuela (hereafter "Venezuela").

Independently of the source, there are some challenges in the measurement of tax morale. For instance, given the data are based on self-reports, in which subjects may tend to overstate their degree of compliance, the results or analysis might be biased (Andreoni, Erard, and Feinstein 1998). Similarly, using the question "cheating or evading taxes can be justified" ignores the fact that cheating is a "no-option," or at least much more limited in some developed countries, thanks to better enforcement mechanisms (Daude, Gutierrez and Melguizo, 2013). Nevertheless, and despite the possible weaknesses in the data, there does not appear to be a better substitute or database to Latinobarometro or WVS to measure tax morale.

The engagement of citizens in the fiscal pact, measured through tax morale, is relatively low in LAC and has been deteriorating since 2011. More than half of Latin Americans were willing to evade paying taxes if possible in 2015. Two groups can be observed among those willing to evade taxes: those who would strongly justify evading taxes and those who slightly justify evading them, representing 27% and 25% of Latin Americans in 2015, respectively (Figure 1.12). In the same year, those who believe that evading taxes cannot be justified by any means accounted for 48% of the population (Latinobarometro, 2015). Tax morale has deteriorated since 2011, when 54% of Latin Americans were unwilling to justify evading taxes (6 percentage points higher than in 2015). This deterioration comes after significant improvement of tax morale in the region, suggesting a reversal in the drivers of the willingness to pay taxes. In fact, there appears to be a correlation between this declining trend and those observed in indicators of trust in institutions and satisfaction with public services, among other self-reported measures on citizens' perception of states.

Figure 1.12. **Tax morale in Latin America**

Percentage of total population



Notes: Average for all available observations for Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, the Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, Uruguay and Venezuela. The specific question asked is: "Please tell me for each of the following statements whether you think it can always be justified to cheat on taxes, never be justified, or something in between". For practical purposes, we classify those as "never justifiable" to the share of respondents that answered 10 (the highest note); "slightly justifiable" is the fraction of respondents who answered between 9 and 6; and "justifiable" is the fraction of answers between 1 (the minimum possible) and 5.

Source: OECD/ECLAC/CAF based on Latinobarometro 2015.

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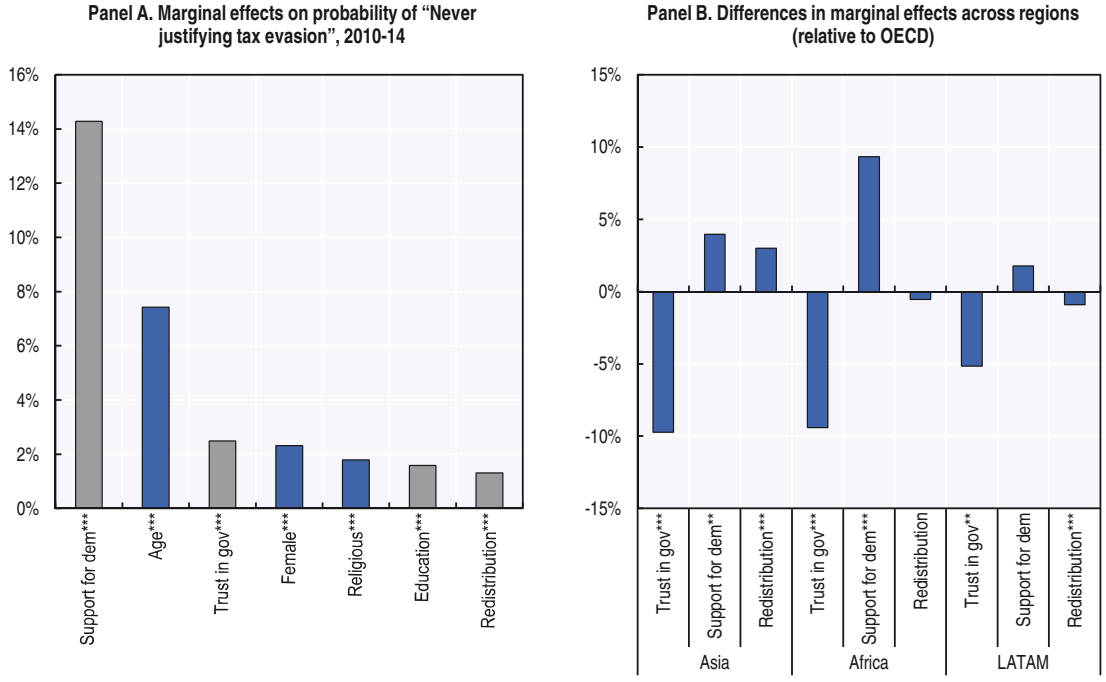
The degree of support for democracy, the redistributive capacity of the fiscal system, and the levels of trust in governments and of satisfaction with public services are critical determinants of tax morale. People who agree with being governed under a democracy are about 14 percentage points more likely to never justify cheating on taxes than those who do not agree (Figure 1.13, Panel A). Similarly, people with greater trust in government and who believe that redistribution is an essential characteristic of democracy are more likely to have higher tax morale (2% and 1% higher, respectively). Other determinants of tax morale are individual characteristics such as gender, age or religion, though to a lesser degree. However, these appear in different magnitudes and, with the exception of age, are rather small. Similarly, socio-economic characteristics such as the perceived economic situation, labour status or educational attainment all play a role in the willingness to pay (or avoid) taxes. For instance, a higher level of education would entail a higher willingness to comply with tax payments (2%) (Box 1.4). This highlights the need to invest in skills and the positive reinforcement mechanism that it can provide for economic development, decreasing inequalities and increasing tax morale (Torgler, 2005; Daude and Melguizo, 2010; Daude, Gutierrez and Melguizo, 2013; Melguizo, Olate and Orozco, forthcoming).

Figure 1.13. **Determinants of tax morale: Marginal effects on probability of "never justifying tax evasion", 2010-14**



Notes: Marginal effects, based on the coefficient in column 5, Table 1.1 described in Box 1.4. Robust standard errors *,**,*** denote significance at 10%, 5% and 1%, respectively. For female and religious, it reflects the change in the dummy variable (being female or religious equals 1); for support for democracy and trust in government, it reflects the difference between the maximum support and the minimum possible; age takes into account the difference between a 25-year-old and a 65-year-old person; educational attainment accounts for the difference between completed tertiary education versus completed primary education.

Source: OECD/ECLAC/CAF based on Melguizo, Olate and Orozco (forthcoming), "Revisiting the determinants of tax morale", forthcoming based on World Value Surveys (Wave 6, data for 2010-14).

StatLink http://dx.doi.org/10.1787/888933649867

At the same levels of trust in government and same vision of redistribution, citizens in LAC are less likely to report high tax morale than in the OECD. Analysing regional differences can show how additional changes in the institutional characteristics can affect the probability of reporting tax morale. For instance, improved trust in government would have a lower effect (still positive) on the probability to report high tax morale in LAC (5% lower) than in the OECD (Figure 1.13, Panel B). This characteristic is shared with economies from Africa and Asia, although in this case the probability is more accentuated (9% and 10% lower, respectively). Similarly, an increase of support for redistribution would improve tax morale in LAC by 1% less than in OECD economies. This result is similar to that of African economies, but contrary to Asian economies where the probability is actually higher. Conversely, those citizens from LAC with the same level of support for democracy have a higher probability (2%) than OECD citizens of having high tax morale, although it is not significant. These results suggest the importance of rebuilding trust, as the marginal gains in tax morale would be larger than in other emerging regions.

Box 1.4. **Revisiting the determinants of tax morale**

The drivers of tax morale can be better understood through a micro-econometric analysis, as shown by Melguizo, Olate and Orozco (forthcoming). Specifically, it uses a Probit model on an individual basis, following Daude, Gutierrez and Melguizo (2013). This analysis uses the World Values Survey database, with data for 2010-14 and 58 countries, where 9 are Latin American (Argentina, Brazil, Chile, Colombia, Ecuador, Mexico, Peru, Trinidad and Tobago, and Uruguay). For this analysis, the dependent variable is tax morale. This is a dummy that equals unity if the person rates 10 (cheating on taxes is never justifiable), and 0 from the answers ranging between 1 and 6 (with 1 being cheating on taxes is always justifiable).

Explanatory variables cover socio-economic dimensions and institutions. The socio-economic variables included are marital status, religion, gender, educational attainment, employment status, economic status and economic problems. The institutional variables include support for democracy – how individuals value having a democratic political system and the importance of redistribution as a characteristic of democracy.

The variables are defined as following: Marital status (married/living together; divorced/separated; widowed/single), religion (a binary variable taking the value of 1 if respondents consider themselves religious and zero otherwise), gender (a binary variable taking the value 1 if the respondent is a female and 0 otherwise), educational attainment (from no formal education to university level), employment status (divided in eight binary variables covering part- or full-time employment, self-employment, unemployment, students, housewives, retirees and other status).

The variables that deal more directly with general aspects of government in general are constructed such that a higher number indicates a stronger preference ("more is better"). These comprise "support for democracy": how individuals value having a democratic political system (from 1: very bad to 4: very good), "trust in government": the confidence of household in national government (from 1: none at all, to 4: a great deal) and "Preferences for redistribution": whether taxing the rich and subsidising the poor are an essential characteristic of democracies (from 1: not essential to 10: essential). The main results of these analyses are presented in Table 1.1 and Figure 1.13.

Box 1.4. **Revisiting the determinants of tax morale** *(cont.)*

Table 1.1. **Probit regressions explaining tax morale**

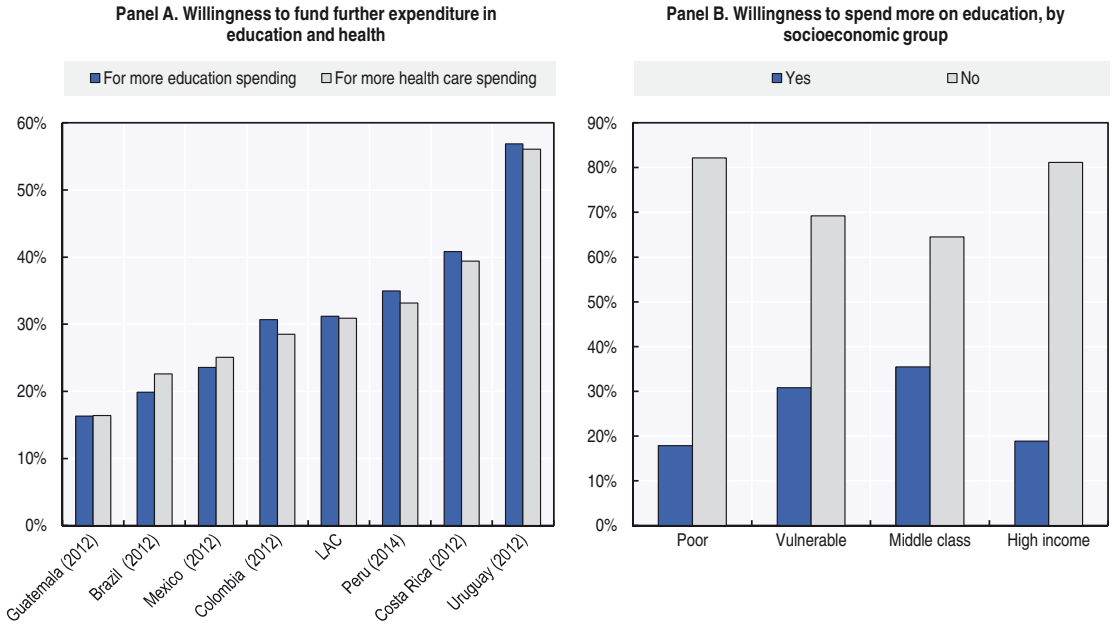
	(1)	(2)	(3)	(4)	(5)	(6)
Religious	0.02	0.02	0.018	0.019	0.018	0.019
	(0.004)***	(0.004)***	(0.004)***	(0.004)***	(0.004)***	(0.004)***
Female	0.027	0.024	0.025	0.026	0.023	0.023
	(0.003)***	(0.003)***	(0.003)***	(0.003)***	(0.004)***	(0.003)***
Age	0.002	0.002	0.002	0.002	0.002	0.002
	(0.000)***	(0.000)***	(0.000)***	(0.000)***	(0.000)***	(0.000)***
Educational attainment	0.003	0.003	0.002	0.004	0.003	0.002
	(0.001)***	(0.001)***	(0.001)***	(0.001)***	(0.001)***	(0.001)***
Part-time	-0.019	-0.019	-0.019	-0.021	-0.021	-0.019
	(0.006)***	(0.006)***	(0.006)***	(0.006)***	(0.006)***	(0.006)***
Self-employed	0	-0.001	-0.003	0	-0.003	-0.003
	(0.005)	(0.005)	(0.005)	(0.005)	(0.006)	(0.005)
Retired	0.011	0.012	0.012	0.01	0.011	0.012
	(0.006)*	(0.007)*	(0.007)*	(0.007)	(0.007)*	(0.007)*
Housewife	-0.005	-0.004	-0.004	-0.007	-0.006	-0.005
	(0.005)	(0.005)	(0.005)	(0.005)	(0.006)	(0.006)
Student	0.013	0.012	0.009	0.012	0.009	0.009
	(0.007)**	(0.007)*	(0.007)	(0.007)*	(0.007)	(0.007)
Trust in government		0.012			0.008	0.008
		(0.002)***			(0.002)***	(0.002)***
Support for democracy			0.05		0.048	0.048
			(0.002)***		(0.002)***	(0.002)***
Redistributive democracies				0.005	0.004	
				(0.001)***	(0.001)***	
Observations	58.478	56.691	55.323	56.432	52.954	54.078

Notes: Marginal effects. Robust standard errors in parenthesis. *,**,*** denote significance at 10%, 5% and 1% respectively. Regressions include country and marital status dummies not reported here. The dummy for full-time employment is omitted in the regressions.
Source: Melguizo, Olate and Orozco (forthcoming), "Revisiting the determinants of tax morale", OECD Development Centre.

Latin Americans have low willingness to increase their tax contributions even if it is for universal public services such as education or health, with heterogeneity amongst socio-economic groups. Low willingness to pay further taxes (even for universal public services) could indicate the low trust of Latin Americans in government institutions and the aspirations of citizens to use private services instead of public services. Only one-third of Latin Americans would be willing to pay more taxes for education and health, although with heterogeneity among countries. For instance, in Uruguay or Costa Rica, the willingness to pay taxes for education or health is higher than in economies such as Guatemala or Brazil (Figure 1.14, Panel A). Although generally low, the willingness to increase tax contributions for public services also varies through socio-economic groups. The vulnerable and consolidated middle class, for example, present the highest willingness to increase their contributions for public education (Figure 1.14, Panel B). The vulnerable group relies most on these public services, but is dissatisfied with their provision and quality. The consolidated middle class is similarly dissatisfied, but has the resources to opt out to the private sector.

Figure 1.14. **Willingness to pay higher taxes for public services (education and health) in Latin America, by country and socio-economic group, 2015**

Percentage of total population



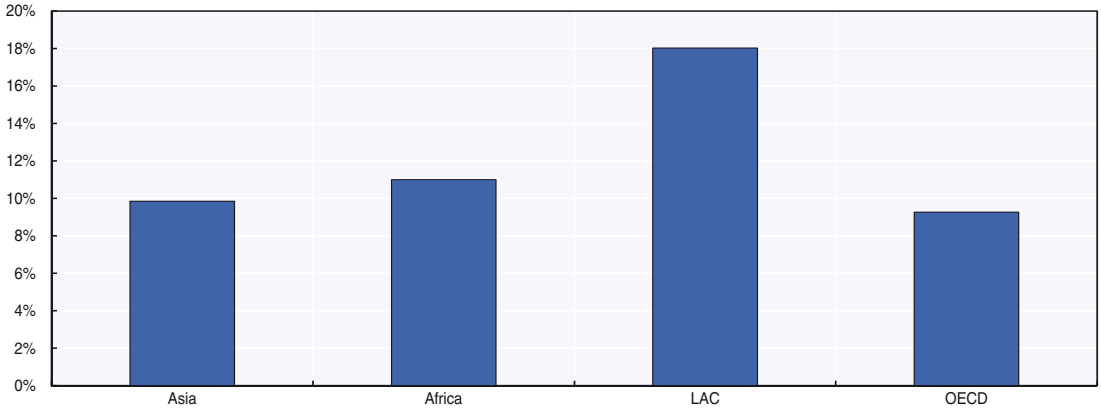
Notes: Poor refers to individuals whose daily per capita income is under 4 USD; "vulnerable" have a daily per capita income of USD 4-10; and "middle class" have an income of USD 10-50. The "affluent" have an income above USD 50. 2005 USD PPP per day. PPP = purchasing power parity. The question asked in the surveys is: "Would you be willing to pay more taxes than you currently pay, so that the government can spend more on primary and secondary education and on the public health service? Yes or no."

Source: OECD/ECLAC/CAF based on LAPOP (2015), The Americas-Barometer by the Latin American Public Opinion Project, www.LapopSurveys.org.

StatLink http://dx.doi.org/10.1787/888933649886

Figure 1.15. **Citizens agreeing that redistribution is not an essential characteristic of democracy, 2010-14**

Percentage of total population



Notes: The question asked in the survey is: "How essential do you think is the characteristic 'Governments tax the rich and subsidises the poor' in a democracy?" Respondents are asked to rank from 1 to 10, with 1 being "not an essential characteristic of democracy" and 10 "an essential characteristic of democracy". The figure shows the percentage of respondents who do not consider redistribution as an essential characteristic of democracy.

Source: OECD/ECLAC/CAF based on *World Values Survey* database (wave 6, 2010-14).

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The redistributive function of fiscal policy appears to be less clear for Latin Americans than for citizens in other regions, effectively undermining the fiscal pact and

decreasing tax morale. In LAC, almost 20% of the population believe that taxing the rich and subsidising the poor is not an essential characteristic of democracy (Figure 1.15). This result is much higher than in Africa (11%), Asia (10%) or OECD economies (9%). This may be a source of weakness of the fiscal pact in LAC. If a sizeable share of Latin Americans do not clearly perceive the main objective and destination of their taxes, then they may find more reasons to justify cheating on taxes when possible. This may jeopardise their overall engagement with the fiscal pact.

All in all, governance and institutions play a large role to increase tax morale. Latin Americans' low trust in government and democracy, their dissatisfaction with public services and the high levels of corruption leave citizens with little desire to engage with the state, pay taxes or generally participate in the social contract. Therefore, governments and institutions must attempt to regain the trust from citizens by becoming more transparent, providing more and better public services (with more efficient spending and more progressive taxation), guaranteeing participation schemes and implementing innovative policies.

A stronger social contract in LAC entails rethinking institutions to overcome persistent socio-economic challenges and promote greater well-being

One of the main reasons for the disconnection between citizens and the state is the inability of public institutions to satisfy the evolving and rising demands of society. Indeed, a number of socio-economic challenges persist in the region, while others are emerging. This section explores the recent evolution of some of the main, persistent socio-economic challenges in the region that hold back people's perception of well-being. It argues that to strengthen the social contract institutions need to be rethought to respond to the demands of society and promote greater well-being.

Recent erosion of the perception of well-being weakens the social contract in LAC

A strong social contract is critical to support greater well-being for all in LAC. At the same time, greater well-being supports a strong social contract. When citizens' perceive that public institutions are unable to respond to their demands, as seems to be the case in LAC, they find few incentives to fulfil their obligations in the social contract. This, in turn, undermines the state's capacity to effectively provide quality public goods and services, which has a negative impact on citizens' well-being. This creates a downward spiral that further fuels citizen disengagement from public institutions.

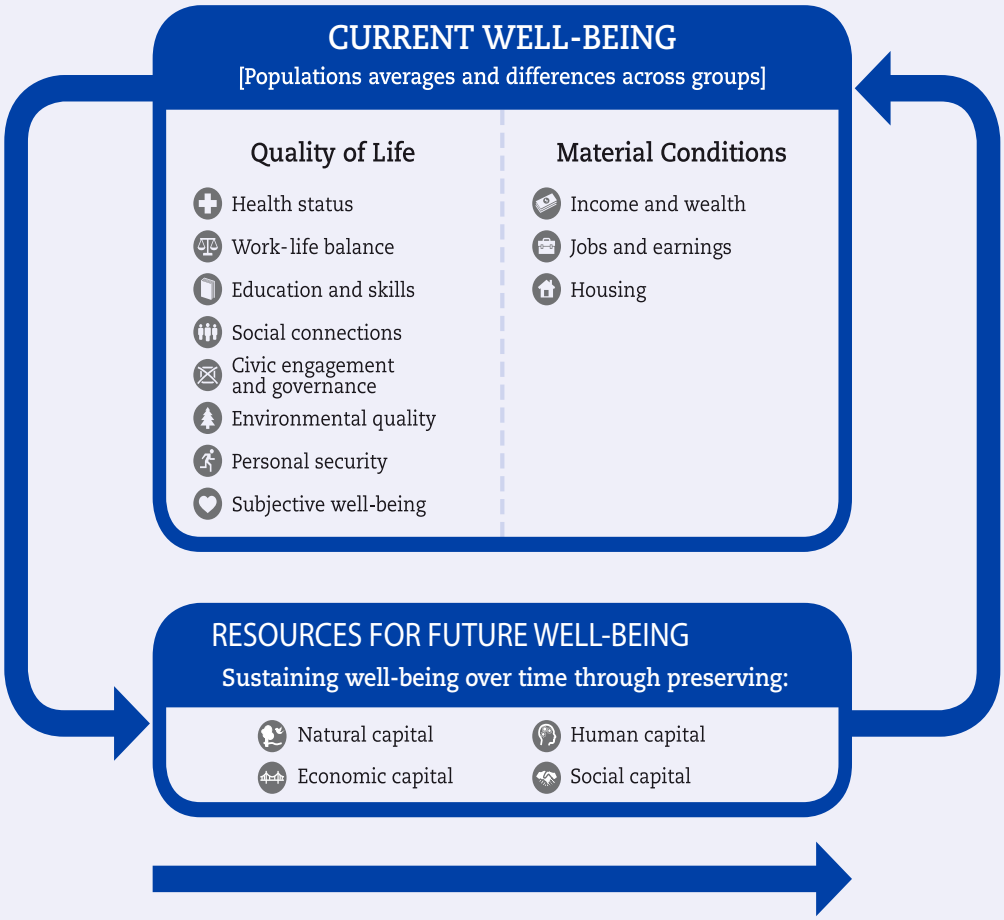
Indicators on people's perceptions of well-being show a deterioration in LAC in recent years (OECD/CAF/ECLAC, 2016). Following the structure of the OECD How's Life? Framework, well-being can be measured from a perspective of governance and civic engagement (OECD, 2017b; OECD, 2011; Boarini et al., 2014) (Box 1.5).

Box 1.5. **The OECD framework for measuring well-being**

The core mission of the OECD is to support countries in making "better policies for better lives". To understand people's life conditions, and to inform policies that aim to achieve inclusive and sustainable well-being, the OECD developed the *How's Life?* framework in 2011 (OECD, 2011) (Figure 1.16). The framework measures individual well-being outcomes in two broad pillars: material conditions (comprising income and wealth, jobs and earnings, and housing conditions) and quality of life (including health status, education and skills, work-life balance, social connections, civic engagement and governance, personal security, environmental quality and subjective well-being). In addition, the framework also encompasses resources for the sustainability of well-being over time in terms of natural, human, economic and social capital.

Box 1.5. **The OECD framework for measuring well-being** *(cont.)*

Figure 1.16. **The OECD How's Life? Framework for measuring well-being**



The measurement and analysis underpinned by this framework adopt four key principles: 1) a focus on people (individuals and households) rather than the economy; 2) a focus on outcomes rather than inputs, outputs and processes (e.g. educational attainment rather than expenditure); 3) a focus on inequalities and the distribution of well-being in the population alongside average achievements; 4) the use of both objective and subjective measures of well-being (since people's perceptions and personal experiences provide important information alongside more objective measures).

How's Life in Latin America?

The OECD *How's Life?* framework was conceived as a flexible tool rather than a straightjacket. While the 11 dimensions of current well-being are intended to be universally relevant, the indicators can be adjusted to reflect societal preferences that may vary across countries and groups. An adapted version of the framework intended for application in developing countries has already been developed (Boarini, Kolev and McGregor, 2014). The OECD and UN Economic Commission for Latin America and the Caribbean (ECLAC) are working with the statistical offices of 11 countries from Latin

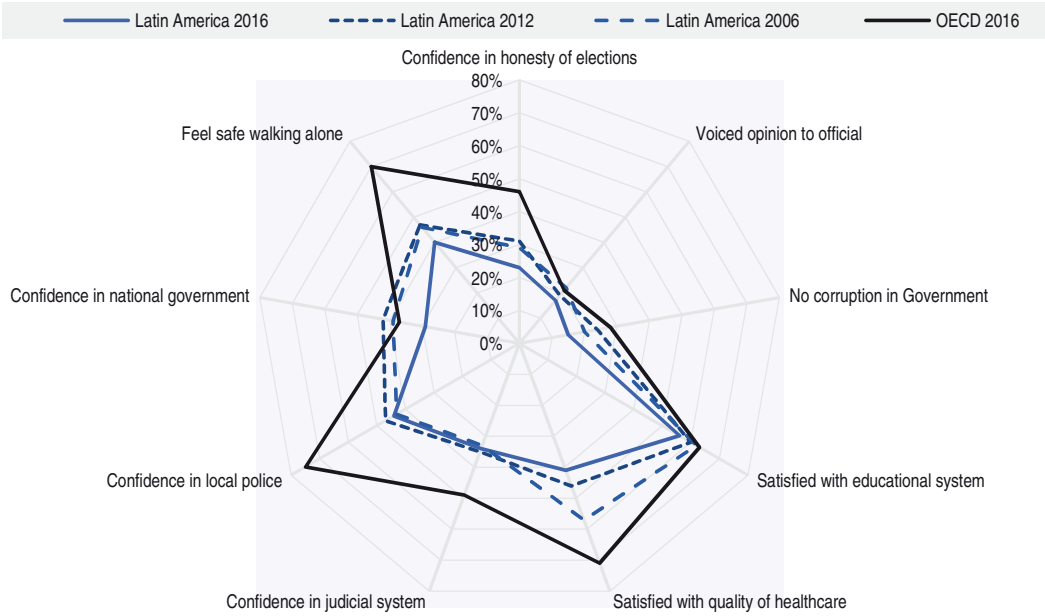
Box 1.5. **The OECD framework for measuring well-being** *(cont.)*

America and the Caribbean to identify concepts and indicators that are especially relevant for the region. A consultation carried out with participating agencies in 2016 highlighted a number of important issues for the region that are not emphasised in the original framework. These include food security, child labour, gender-based or intra-family violence, environmental rights, social protection, unpaid work and inclusiveness of institutions. Work is ongoing to identify the most appropriate comparable indicators to measure these aspects of well-being in the region.

Selected indicators related to governance show a deterioration of the perception of well-being in LAC (OECD, 2017b). These include people's satisfaction with democracy (confidence in the honesty of elections), political engagement (having voiced an opinion to an official), corruption in public services (perceptions of widespread corruption in government and business), satisfaction with services (such as education and healthcare), and trust in public institutions (confidence in the national government, the judicial system and local police). Across all these indicators, positive responses are low in LAC, especially when compared with the OECD average. In almost all cases, the share of people replying positively decreased over the decade 2006-2016, and notably since 2012 (Figure 1.17).

Figure 1.17. **Selected indicators of governance and well-being in Latin America and OECD**

Percentage of respondents replying positively to each question



Source: OECD/ECLAC/CAF based on Gallup World Poll 2017.

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Rethinking institutions for greater well-being: Towards a new state-citizens-market nexus

Rising aspirations and evolving demands, together with the uncertainties created by domestic structural weaknesses and a challenging global scenario, are weakening the social contract in LAC. What is at stake is people's current and future well-being. In this context, LAC can largely benefit from rethinking its institutions, which can be understood as policies, organisations, and laws and regulations (Box 1.6). This is necessary to embrace upcoming opportunities, shield against emerging risks, and build the pillars of sustained social and economic progress where citizens' demands are met.

Box 1.6. **Defining institutions: The LEO 2018's conceptual framework**

The *Latin American Economic Outlook 2018* (LEO 2018) aims at rethinking institutions and their role in supporting inclusive development through a better *state-citizens-market* nexus. The notion of institutions is broad, encompassing a wide-ranging set of issues. In fact, unanimity on this concept does not exist (Hodgson, 2006).

Institutions as the "rules of the game" in a society

The influential work by Douglas North laid the foundations of what has since been a fertile ground for economic literature and analysis: the role of institutions for economic development. He defines institutions as "humanly devised constraints that structure political, economic and social interactions" (North, 1991). These are devised as formal rules (constitutions, laws, property rights) and informal restraints (sanctions, taboos, customs, traditions, codes of conduct), which usually help perpetuate order and safety within a market or society.

North's contributions allow us to make categories that are relevant for the LEO 2018: formal institutions vs. informal institutions. The former are created by societies. The scope is broader to affect, influence and transform their nature through policy action than with informal institutions, which are conventions or codes of behaviour that evolve over time. The LEO will focus more on formal institutions, although informal institutions will be discussed when useful to complement the analysis or to illustrate the nuances of a particular institutional challenge.

Another contribution of North's approach is its understanding of institutions as "the rules of the game" in society. This approach has been developed by later authors. Hodgson, for example, sees institutions as "durable systems of established and embedded rules that structure social interactions" (Hodgson, 2006).

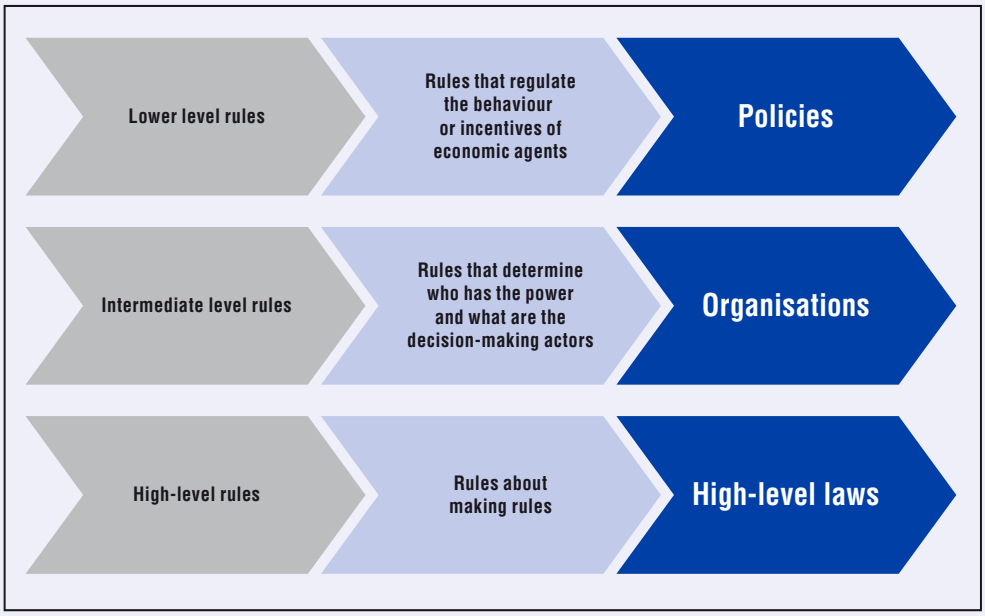
Different types of rules of the game: policies, organisations, and regulations and laws

The literature on institutions in LAC develops this rules-based approach. Acuña and Tommasi (1999) build on North's ideas and consider institutions "as sets of rules that structure interactions in particular ways" and establish a hierarchy of rules, as Tommasi (2004) further developed. This categorisation broadly suggests the existence of three levels of rules: 1) lower-level rules that regulate the behaviour of economic agents; 2) intermediate-level rules that determine who has the power and/or the distribution of competences; and 3) higher-level rules to govern how other rules are determined and define the actual working of the policy making system. This framework is also used in the *2017 World Development Report* (World Bank, 2017b), where lower-level rules are associated with specific policies; intermediate-level rules refer to organisational forms; and higher-level rules relate to "rules about changing rules" (e.g. constitutions).

Box 1.6. **Defining institutions: The LEO 2018's conceptual framework** *(cont.)*

LEO 2018 uses its own taxonomy of rules, adapting it from the work of North, the World Bank, and Acuña and Tommasi. The broad concept of institutions is broken down in three different categories: 1) *policies*, which refer to concrete plans and/or sets of actions directed towards achieving a specific social, economic or political outcome; 2) *organisations* understood as the bodies or structures within which some people act, or are designated to act, towards some purpose; and 3) *high-level laws*, which usually take a legal or normative form, and can be understood as formal rules that enable the adoption of organisational or policy changes (Figure 1.18). Throughout the LEO 2018, the notion of institutions will be broad, with a focus on the former two, policies and organisations. They will all be considered as critical pillars of the institutional framework, determining social, political and economic outcomes.

Figure 1.18. **Taxonomy of rules (institutions) for the LEO 2018**



Source: OECD/CAF/ECLAC, based on Acuña and Tommasi (1999) and World Bank (2017).

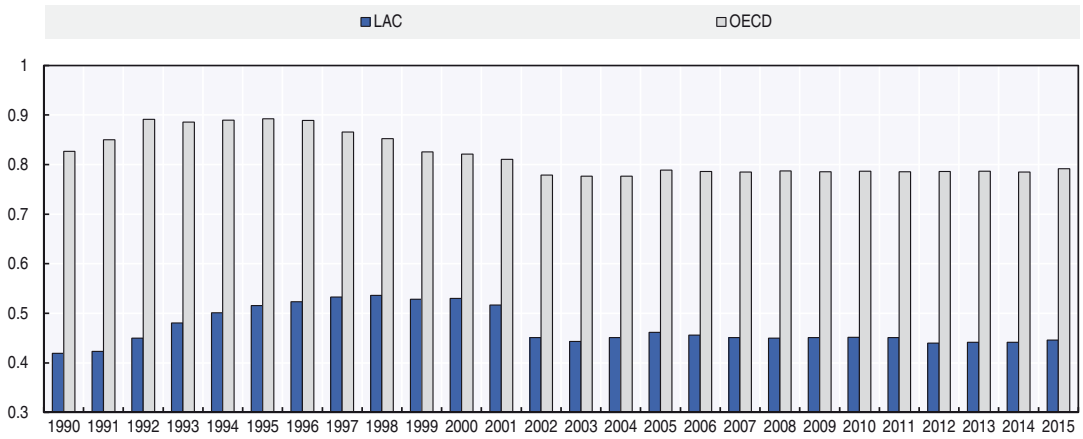
Institutions must be rethought in a way that build and reinforce a new *state-citizens-market nexus*, creating and exploring interactions among its three core parts, promoting synergies, and placing citizens' demands and well-being at the centre. To support a *state-citizens-market nexus* that puts society's demands at the centre, reforms should focus on institutions linked to the main sources of discontent of *citizens:* the *market* and the *state*. Citizens expect an economy – *the market* – to provide increasing income and job opportunities. Similarly, they expect public institutions – *the state* – to provide good services and deliver their functions in an efficient, reliable and innovative manner. While these issues are the focus of Chapters 2, 3 and 4, the remainder of this chapter focuses on analysing the main challenges related to the state capacities in the region, as well as the situation regarding economic opportunities and provision of main public services.

State capacities remain limited in the LAC region

State capacities in most Latin American economies face some limits. LAC countries are at an earlier stage of institutional development with fewer available resources and weaker governmental capacity. Consequently, they perform fewer tasks and provide fewer services than OECD member countries, as reflected by an aggregate Quality of Government (QoG) indicator (OECD/IDB, 2014).

Moreover, compared with LAC, many OECD countries have accumulated greater stocks of institutional capacities, more developed legal and oversight levers, a better trained bureaucracy and higher flows of financial resources. Accordingly, the average in the QoG index, which ranges from 0 to 1, is in LAC countries systematically below that of OECD countries by 0.35 points for 1990-2015 (Figure 1.19).

Figure 1.19. **Quality of government in Latin America and the OECD**



Note: The quality of government indicator is a composite average that captures measures of corruption, law and order, and bureaucracy quality. Higher values indicate higher quality of governments, and it ranges from 0 to 1. Unweighted averages for OECD, Latin American and Caribbean economies.

Source: OECD/ECLAC/CAF based on Dahlberg et al. (2017), *The Quality of Government Institute Dataset*, version January 2017.

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Nonetheless, both regions share a similar trend in time. For both regions, the QoG indicator declines at the beginning of the 2000s decade and remains steady throughout the rest of the period. The rise of the middle class may have important effects given that more affluent societies favour the creation and consolidation of democracies and influence the quality of governance (Ferreira et al., 2013). This will exert pressure on LAC countries to enhance governance capacities and effectiveness in the public sector.

In a context of decreasing levels of trust and rising social aspirations, the state and its institutions in the LAC region need to evolve accordingly to meet growing demands and expectations. The role of the state within market economies has historically evolved with social preferences and demands from society. The ongoing theoretical discussions regarding the optimal level of state intervention is far from settled. Indeed, the state has played different roles during the last century. However, the existence of market failures has been the guiding principle that has justified interventions during the last 60 years (Tanzi, 2011). Notwithstanding their allotted roles, states have not always successfully addressed market failures. In many cases, these issues were too complex given their weak institutional capacities.

Institutions need to be strengthened to improve the state's capacity to respond to citizens' demands. State capacities or government quality are associated with the institutions' ability to function effectively and efficiently, deliver outputs and remain insulated from political micromanagement (Fukuyama, 2013; Manning and Holt, 2014). State capacity is usually linked to issues such as the professionalisation of the state

bureaucracy, as well as to the ability to protect property rights, credibly commit to private investors and raise revenues from society (Rauch and Evans, 2000; Soifer and Vom Hau, 2008; Cárdenas and Tuzemen, 2011; Savoia and Sen, 2012; CAF, 2016).

The predominant view is that high-quality governments and institutions will perform quality functions and deliver better services that will lead to improved outcomes. At the same time, they will use resources more efficiently, which will be conducive to inclusive economic growth. There is a lot to gain from having more efficient and effective states and governments: if all governments improved their productivity to be on a par with the rates of the top-performing nations in their peer group, the world could potentially save as much as USD 3.5 trillion a year by 2021. This is equivalent to reducing global government budgets by 9% without compromising outcomes (McKinsey, 2017).

Institutional abilities and outcomes are difficult to gauge as many underlying factors can influence their results. Numerous scholars and international organisations have attempted to quantify the states' capacity with respect to outputs or services delivered. For instance, the QoG dataset studies how high quality institutions can be achieved and the effects of QoG in different policy areas (Dahlberg, et al. 2017). Similarly, the Bertelsmann Stiftung's Transformation Index (BTI) "analyses and evaluates the quality of democracy, a market economy and political management" (BTI, 2016). For its part, the World Bank's Worldwide Governance Indicators measure government effectiveness, regulatory quality, political stability, control of corruption and violence (World Bank, 2017a). Despite the limitations and caveats, these datasets remain the most comprehensive compilation of quantitative and qualitative measures of the state and the different institutions that encompass it.

LAC's average citizen perceives its government as ineffective. The ability of governments to operate effectively relies highly on the management of policies and practices. Assessing citizens' perceptions of the overall functioning of institutions is crucial to understand the extent of their satisfaction with delivery of public services. This, in turn, allows the establishment of a baseline to measure progress. The average LAC citizen perceives that government effectiveness in the region lags behind that of OECD economies (Figure 1.20). Heterogeneities on how different socio-economic groups "experience the state" also emerge within countries (see Box 1.7).

Figure 1.20. **Government effectiveness perception index in Latin American countries and the OECD, 2015**

Note: The figure plots the Government effectiveness perception index for available countries and available years. Government effectiveness captures perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies. Higher values indicate higher quality of governments from -2.5 up to 2.5.

Source: OECD/ECLAC/CAF based on World Bank (2016b), *Worldwide Governance Indicators*.

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Within the region, perceptions of government effectiveness are quite heterogeneous. Countries like Chile and Barbados have the highest perception of effective governments throughout LAC countries, yet the level remains below the OECD average. Moreover, countries with positive perceptions of government effectiveness have experienced a deterioration in these perceptions over the last decade. In the best cases, they have remained relatively constant, a salient feature also reflected by the QoG trend.

State capacities vary across the different functions and levels of government (Fukuyama, 2013). All of the different functions that governments perform require continuous review and upgrading. In particular, however, the legal, fiscal and bureaucratic functions of the state can boost the effectiveness of policy implementation. Additionally, since the division of responsibilities between levels of government strongly influences public sector efficiency, the capacity to achieve efficient multi-level governance at all of these levels becomes crucial.

Box 1.7. **Exit, voice and compliance: How people "experience the state" in Latin America**

In 1742, political philosopher David Hume wrote that "nothing appears more surprising to those who consider human affairs with a philosophical eye, than the easiness with which the many are governed by the few". Indeed, throughout history, effective states rely on the citizen's willingness to pay taxes, to co-operate and not free-ride on others, to save and invest and, in summary, to be part of the social contract. The "state" is, in the end, the manifestation of a collective decision to live together. But why would people voluntarily comply and co-operate? This is a central question to understand the enormous heterogeneity we see in terms of state effectiveness across the world (World Bank, 2017b). Institutions, like rules that involve agreements among actors, are not effective if they do not induce compliance. Many countries are known for having the best "laws on paper", but a very uneven implementation of such a legal structure.

One central aspect, sometimes neglected, is the idea of how citizens "experience the state". This experience is shaped through their interactions with public officials over provision of public goods and services, as well as with different levels of authority. The percentage of people who report abuse by the police is an example of an experience with the state that shapes citizens' willingness to comply with rules and may also induce exit. In the same way, positive experiences, such as receiving social programmes or public services, shape the way in which people engage politically and their willingness to be part of the social contract (Estevez, Diaz-Cayeros and Magaloni, 2016).

Concrete experiences such as registering a child for school, seeking help from the police, attending a public hospital, requesting official documentation or applying for social assistance benefits may greatly influence how people perceive the state. Differential barriers to such services can render such experiences exclusionary and ineffective. Barriers such as lack of information, cost of access, administrative complexity, and discrimination or social/physiological barriers weaken an important source of "process legitimacy". People in marginalised neighbourhoods, for example, may experience the police as a source of violence and coercion rather than protection. Indigenous families may refuse needed healthcare because they have been previously stigmatised in a public hospital where doctors and nurses do not speak their language. As a final example, citizens who must travel long or costly distances to register for services to which they are entitled may perceive the state less favourably than those with accessible services in their community.

Box 1.7. **Exit, voice and compliance: How people "experience the state" in Latin America** *(cont.)*

Trust and legitimacy are foundational pillars for achieving co-operation among members of a society and ensuring the sustainability of the social contract (World Bank, 2017b). Citizens may choose to "exit" rather than co-operate by choosing informal or privately provided services. They may even withdraw from services all together, weakening incentives to contribute through tax compliance. Exit behaviour can lead to fragmented social contracts (Ferreira et al., 2012). Conversely, positive experiences in the provision of goods and services can shift perceptions of the state and its role in people's lives. Cortés et al. (2006), for example, reported how a rural family in Mexico changed its view of the state after their children benefited from the *Oportunidades* Conditional Cash Transfer programme.

In designing and assessing the provision of public services and the implementation of public programmes, it is fundamental to have a broader perspective. This should aim for effectiveness, but also provide people with an experience that triggers a sense of belonging to a social contract. This, in turn, will strengthen incentives to comply as an essential dimension of citizenship.

Source: Lopez-Calva and Bolch, based on *World Development Report 2017: Governance and the Law,* World Bank.

Better economic opportunities and stable prospects

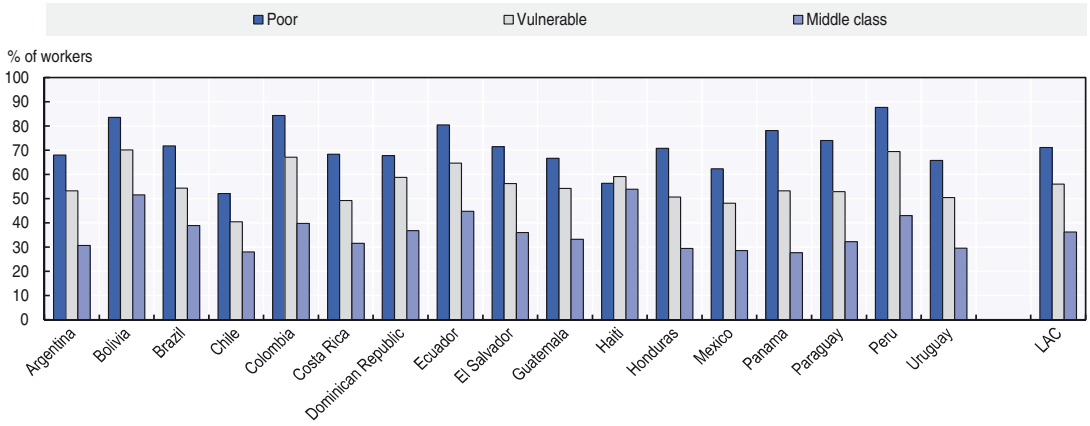
The LAC region is undermined by the large presence of labour informality, which is both a cause and a consequence of a weak social contract. Providing better economic opportunities, mainly through more and better jobs, is a critical aspect of a strong social contract. Citizens must feel they have a stable socio-economic status and good prospects for future progress. More and better jobs are critical to satisfy this aspiration, but high levels of labour informality remain a critical constraint.

The high levels of informality in LAC have negative consequences in terms of low social protection and widening inequalities, which in turn erode the social contract. Most businesses, especially small and medium-sized enterprises, are informal. Two out of five workers in the region hold non-registered jobs (CEDLAS and the World Bank, 2016). Informality is a key obstacle to making earnings more equal and societies more inclusive, and is more pervasive among poor and vulnerable (Figure 1.21). Additionally, informal work, by definition, leaves workers without the right to a pension, health insurance and the general entitlements of the formal sectors.

Informality is also a consequence of a weak social contract. In a context of low trust and dissatisfaction with public services, business and workers find incentives to remain informal. Such incentives could include low tax morale, dissatisfaction with public services, low trust in governments, high formality costs and benefits not anchored to contributions. These incentives are especially true for the consolidated middle class, which has the means to pay for private services. Social security contributions and other non-wage costs (e.g. regulations) can be too costly relative to informal workers' income and productivity. These factors, in combination with weak enforcement, can doom poor and vulnerable workers to informality (OECD/CIAT/IDB, 2016). As such, they are left out of the scope of the states' responsibilities. This widens inequalities, creating higher distrust of the state. This, in turn, further disconnects citizens with governments and powers the vicious circle of tax evasion and poor or no access to quality public services.

Figure 1.21. **Labour informality in Latin America by socio-economic group**

Percentage of workers that hold non-registered jobs, 2014



Notes: Legal definition of informality: informality is defined as workers without the right to a pension, health insurance, social protection, work contracts and the general entitlements of the formal sectors.

Source: OECD/CAF/ECLAC based on OECD World Bank tabulations of SEDLAC (CEDLAS and the World Bank, 2016).

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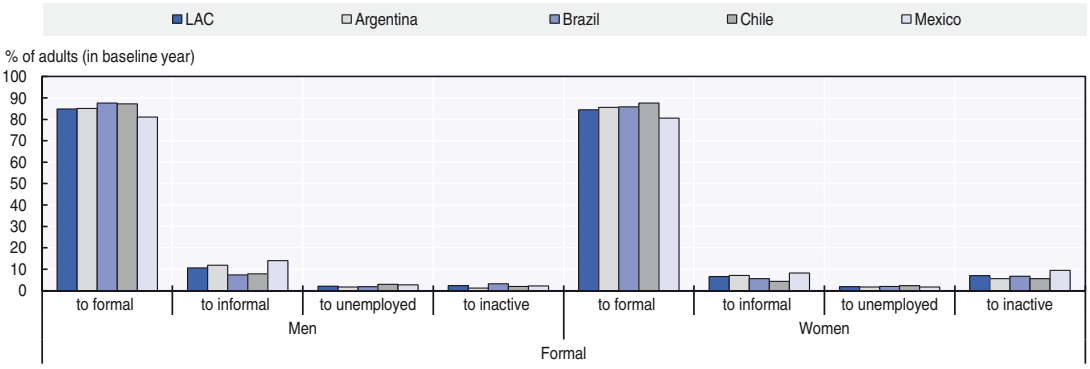
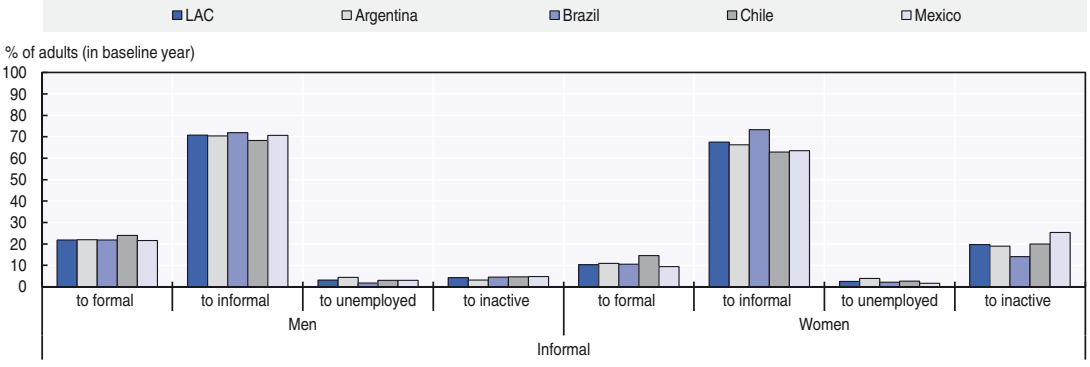
Figure 1.22. **Latin American labour market transitions**

Panel A. Yearly transition rates from formality, men and women
Adults (aged 30-55), 2005-15



Panel B. Yearly transition rates from informality, men and women
Adults (aged 30-55), 2005-15



Note: Results show yearly transition rates out of formal and informal jobs for the pooled period 2005-15. Transitions rates are calculated as the ratio between flow of people moving that transitioned from Condition 1 to Condition 2 between time 0 and time 1, over the total stock of people in the population in Condition 1 in time 0 (i.e. informal employment to formal employment). The transitions are year to year (from year t to year t+1). This analysis is limited to urban populations due to data limitations. Data for Argentina are representative of urban centres of more than 100 000 inhabitants.

Source: OECD/CAF/ECLAC based on OECD and World Bank tabulations of LABLAC (CEDLAS and the World Bank).

StatLink http://dx.doi.org/10.1787/888933649981

Most labour markets in LAC are far from being segmented and exhibit sizeable transitions between formality and informality (Bosch, Melguizo and Pagés, 2013). Flows out of informal jobs are more common than those out of formal jobs. Still, a considerable share of informal workers make the transition into formal jobs every year. In Argentina, Brazil, Chile and Mexico an average of 33% of female workers and 29% of male workers currently in the informal sector will not remain there for more than a year (Figure 1.22). Almost 10% of informal female workers will move into formal jobs, and 22% of their male counterparts will do so. Flows out of the formal sector and into the informal sector are also sizeable, stressing the need to place better incentives in the former. On average, 16% of women workers currently in the formal sector and 15% of their male counterparts will leave within a year. More than 9% of all formal workers will be informal a year later (71% of males who exit formal wage work and 43% of the women), compared with 2% who will be unemployed. Frequent flows of workers both ways between the formal and informal sector suggest that policies to promote formal, good quality jobs should focus on strengthening the incentives to become formal.

This pattern of entering and leaving the formal sector suggests that informal jobs are more unstable owing to higher risk of job loss. Informal jobs appear to be associated with a higher probability of making the transition into inactivity, particularly among women: 60% of those women make the transition out of informality compared with 15% for men. Certainly, this can also result from personal choice. Women who are planning to leave the labour force soon for family reasons, for example, may be more likely to look for more flexible work, and thus self-select into informal work (OECD/CAF/ECLAC, 2016).

Yet informal jobs seem to be a trap for some groups, particularly youth, women and low-skilled workers, and have long-term adverse effects on equity. While an informal job might be a "springboard" for some, it can have scarring effects for workers' employment prospects and future wages. Bosch and Maloney (2010) and Cunningham and Bustos (2011) found that informal salaried work in Argentina may act as a preliminary step towards the formal sector. In fact, it might be a regular step towards formal work, especially for younger workers, which provides training time that does not necessarily harm an individual's career path. However, Cruces, Ham and Viollaz (2012) found strong and significant scarring effects: people exposed to higher levels of unemployment and informality in their youth fare systematically worse in labour markets as adults (OECD/CAF/ECLAC, 2016).

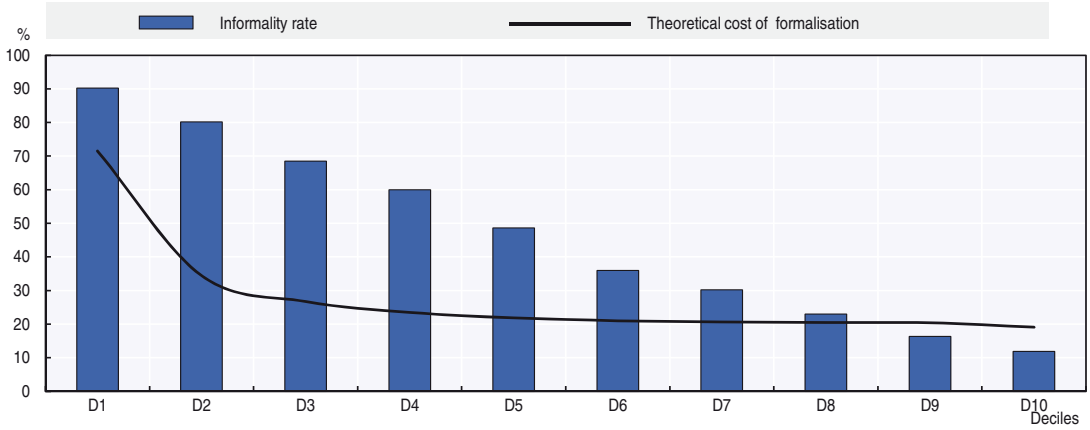
Labour market institutions can help provide better quality, formal jobs and strengthen the social contract. First, and from the demand side, more incentives are needed in the formal sector to benefit from the relatively easy transitions from informality to formality. Introducing progressivity into social security contributions can incentivise both workers and businesses to register workers. Lowering these same contributions temporarily for low-paid workers whose jobs are brought into the formal sector can also work as incentives for the transition from the informal sector. It is also important to simplify companies' and workers' registration in the formal sector. Enforcement of stricter and more frequent workplace controls are also key since most informal workers are employed by informal firms. Second, institutional responses such as investments in skills to support workers' productivity and matching with formal jobs can help create formal jobs from the supply side. Additionally, the creation of good quality jobs demands strong and innovative productive development policies. This is particularly the case in the context of the fourth industrial revolution, where new opportunities and sectors are emerging and where the nature of jobs is expected to change profoundly.

Social security contributions tend to be regressive in the LAC region. In some countries, regulatory frameworks render these too high for low-paid workers to join the formal sector. Social security contributions are low in most LAC countries. In Argentina, Brazil, Uruguay, Colombia and Costa Rica, conversely, social security contributions are similar to

those of OECD member countries (OECD/IDB/CIAT, 2016). Nonetheless, contributions to social security programmes are too costly relative to informal workers' income, especially for those at the lower end of the income distribution (Figure 1.23). Breaking these vicious circles can be challenging. In Colombia, for example, when employers reduced payroll contributions by 13.5 percentage points in 2013, they created about 213 000 formal jobs (Bernal, Eslava and Meléndez, 2015; Medina and Morales, 2016). Their actions also reduced informality by between 1.2 and 2.2 percentage points (Fernández and Villar, 2016).

Figure 1.23. **Informality and formalisation costs by income deciles in Latin America and the Caribbean, 2013**

Percentage of a worker's income



Note: LAC is the simple average of Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, the Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Jamaica, Mexico, Nicaragua, Panama, Paraguay, Peru, Trinidad and Tobago, Uruguay and Venezuela.

Source: OECD/CIAT/IDB (2016), *Taxing Wages in Latin America and the Caribbean*, http://dx.doi.org/10.1787/9789264262607-en.

StatLink http://dx.doi.org/10.1787/888933650000

In many LAC countries, registration of businesses and workers in the formal sector can be burdensome and costly, while workplace controls are weak and infrequent. In Peru, for example, informality is partially explained as a by-product of excessive regulations and barriers to entry into the formal sector. This is especially true for SMEs that are affected by the overlap of several tax regimes targeted at a similar base (OECD, 2016a). At the same time, in Panama, higher informality rates among wage earners do not correlate with higher formalisation costs (OECD/CIAT/IDB, 2016); poor controls and enforcement are much more relevant here. Usually informal workers have low skills and poor upgrade opportunities. This makes it hard to escape the low productivity trap and find jobs that are a good fit for their capabilities. Getting a formal job is difficult for people with low skills. Almost three-quarters of the informal workers in LAC have not completed secondary education, compared with one-third of those holding formal jobs (OECD and World Bank tabulations of SEDLAC, 2016). Additionally, informal firms generally provide workers with fewer opportunities to accumulate human capital and are less productive (La Porta and Schleifer, 2014). All of this might thus pose an additional burden to the most vulnerable earnings and to career advancement (OECD/CAF/ECLAC, 2016). Low productivity sometimes translates into workers not being sufficiently productive to offset the costs of formalisation (IDB, 2015).

Creating formal, good quality jobs entails policy action on the supply side too. This occurs mainly by providing more and better skills for workers, and through productive development policies to support sectors with potential for the creation of formal jobs. Upgrading the skills of informal workers requires expanding training programmes. Alternative skills certifications that describe capacities developed during informal jobs could increase prospects for formality. In several OECD member countries, training,

employment, counselling services and incentives to develop small business have helped improve the employability of job seekers in a cost-effective manner (OECD, 2015). Providing better active labour market policies (ALMPs) can also raise productivity and the likelihood of getting a formal job. As education expands for new generations, ALMPs should focus on all individuals who face skills challenges on the labour market, not only on youth and high-school dropouts from poor households as most programmes in Latin America do.

Moving towards stronger and innovative productive development policies will also be crucial to create good jobs and socio-economic opportunities, particularly in the context of the fourth industrial revolution, which brings new challenges.

Equality of opportunity must be improved through better public services for increased well-being: Education, health, transport and basic services

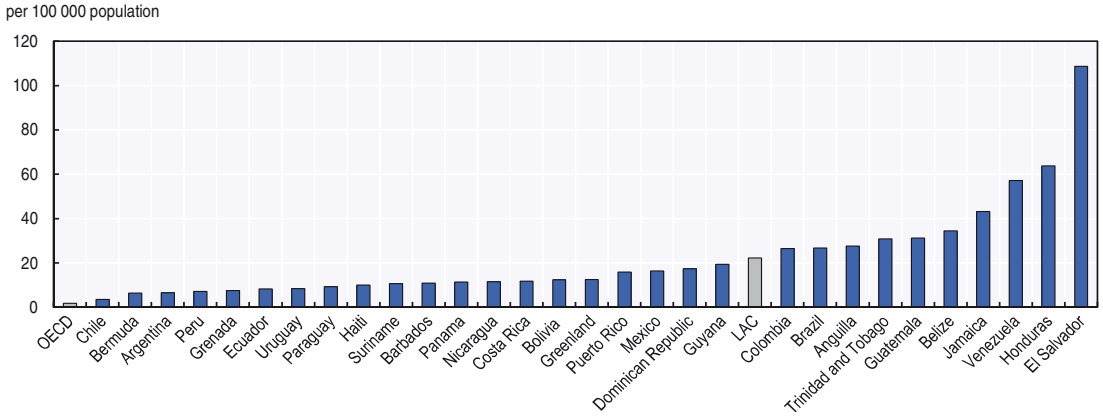
Strong social contracts need to be fair so that citizens perceive they have access to good quality goods and services, and equal opportunities for all members of society. Given that rising aspirations of the middle class for better quality services have not yet been fulfilled, persistent inequalities in LAC may be one reason why citizens seem increasingly dissatisfied. Citizen security, education and health, and transport and other basic services are key dimensions of citizens' demands for better services and equality of opportunities.

Crime and violence erode the social contract and hinder well-being

Individuals' security, an essential determinant of well-being, has become a major concern for citizens in the region. LAC is one of the most violent regions in the world: while it is home to 9% of the global population, it has 33% of world homicides. This represents a homicide rate above 22 per 100 000 (Figure 1.24) (Jaitman et al., 2015). The growth of crime and violence during the past decades has entailed high economic and social costs to the region since it constrains investment decisions of firms and disproportionally affects the poor. At the same time, it has compromised governance and the legitimacy of the state by undermining the confidence of citizens in authorities and institutions, and among themselves (CAF, 2014).

Figure 1.24. **Crime and violence in Latin America and the Caribbean, 2015**

Homicide rate per 100 000 people



Note: "Intentional Homicide" means unlawful death purposely inflicted on a person by another person. Data on intentional homicide should also include serious assault leading to death and death as a result of a terrorist attack. It should exclude attempted homicide, manslaughter, death due to legal intervention, justifiable homicide in self-defence and death due to armed conflict. Data are for assault at the national level, number of police-recorded offences. Data for Chile are for 2014, Ecuador and Guatemala are for 2013, and Bolivia, Haiti and Nicaragua are for 2012. LAC average includes: Anguilla, Argentina, Barbados, Belize, Bermuda, Bolivia, Brazil, Chile, Colombia, Costa Rica, the Dominican Republic, Ecuador, El Salvador, Greenland, Grenada, Guatemala, Guyana, Haiti, Honduras, Jamaica, Mexico, Nicaragua, Panama, Paraguay, Peru, Puerto Rico, Suriname, Trinidad and Tobago, Uruguay and Venezuela.

Source: UNODC (database), https://data.unodc.org/ (2017), *Statistics on Drugs, Crime and Criminal Justice at the International Level* https://data.unodc.org/

StatLink http://dx.doi.org/10.1787/888933650019

Most security initiatives in the region fail because of low levels of governance. In particular, human resources are poor, budgets are small and incentives are not properly aligned with intended results. In fact, workers in the criminal justice system often have a lower educational level than the rest of the public sector. Resources allocated vary widely between countries – from 2% to 10% of the total public budget. Finally, the incentive structure that rises from the form of compensation, promotion and control of the rules governing certain functions may limit or enhance the capacity of the public sector to implement security policies (CAF, 2014).

Inequalities in education remain a crucial challenge in the region

Education in Latin America is subject to strong access and quality disparities among students of different household income, territories, ethnicity and gender. The socio-economic background, ethnicity and gender of students, as well as the geographical location of schools, have a marked influence on access to education, performance and completion.

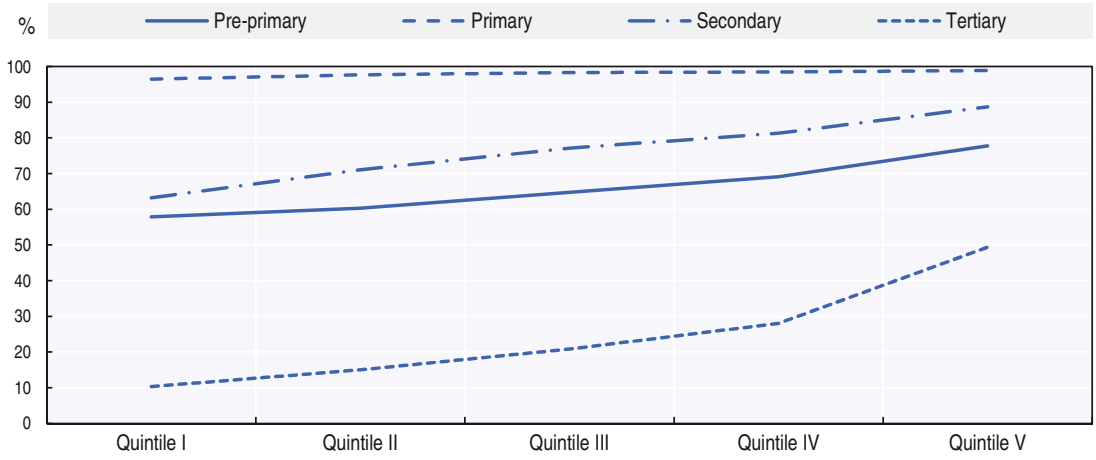
Inequities in education start early and increase along students' educational path. More than three-quarters (78%) of three- to five-year-old children from households in the highest quintile of income distribution attend pre-primary school. However, only 58% of those from the lowest quintile do so. This is particularly relevant as secondary-school performance improves by the equivalent of almost a full school year among those who had pre-primary education (OECD/CAF/ECLAC, 2014).

Access to secondary and tertiary education is also strongly linked to socio-economic background and geographical location. Among the lowest income quintile, 63% attend secondary school compared with 89% of the highest quintile; only 10% of the lowest group graduate and continue into tertiary education compared with 49% of the highest group (CEDLAS and the World Bank, 2016). Likewise, only 62% of young Latin Americans are enrolled in secondary education in rural areas compared with 80% in urban areas (CEDLAS and the World Bank, 2016).

Half of the students from the richest households opt out of public education. At primary level, in which the region is close to universal coverage, only 49% of students from the highest quintile of income distribution attend a public institution. The figures are similar for secondary education. Thus, when they have the means, Latin Americans are likely to choose private education. This is especially the case in countries such as Argentina (70% of the students in the upper quintile of the income distribution attend private institutions), Colombia (64%), Paraguay (65%), Peru (63%) and Uruguay (75%) (CEDLAS and the World Bank, 2016).

Despite some improvement in recent years, education quality and learning outcomes in the region are poor. Performance in successive rounds of the global education survey known as PISA shows a moderate improvement over time in students' learning outcomes. Still, results from Latin American countries participating in PISA (Argentina, Brazil, Chile, Colombia, Costa Rica, the Dominican Republic, Mexico, Peru and Uruguay) are telling. Fifteen-year-olds from these countries performed 92 points lower than OECD students in mathematics, 69 points lower in reading and 78 points lower in science (Figure 1.26) (OECD, 2016b). This is equivalent to approximately two years of schooling, two-and-a-half years of schooling and three years of schooling, respectively.

Figure 1.25. **Education enrolment by levels of education and income quintiles in Latin America and the Caribbean**



Note: LAC average includes Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, the Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru and Uruguay .

Source: Own calculations based on CEDLAS and the World Bank (2016).

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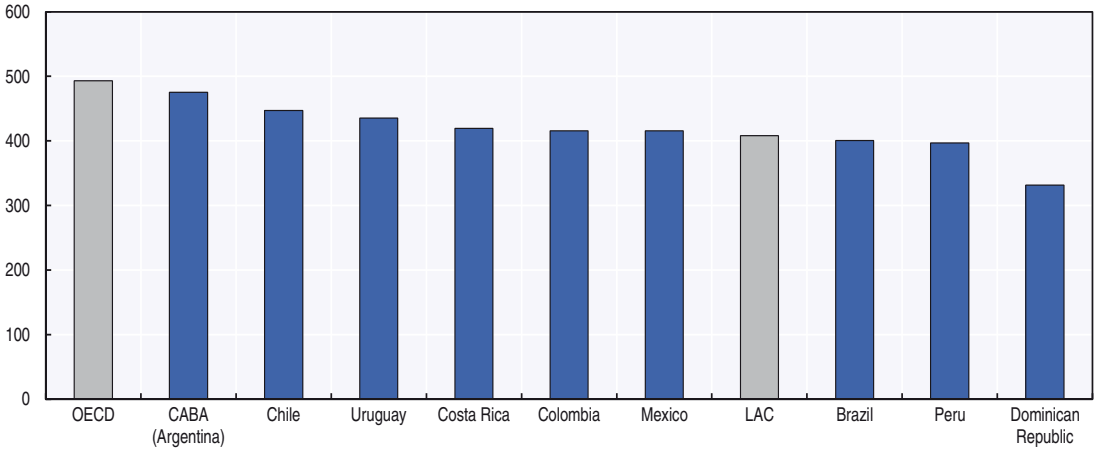
Figure 1.26. **Latin American learning outcomes in PISA, 2015**

PISA 2015 score in points



Note: Argentina results only reflect results for the City of Buenos Aires. LAC simple average includes the economies from the region that participated in the 2015 PISA test.

Source: OECD/CAF/ECLAC based OECD, *PISA 2016* (database).

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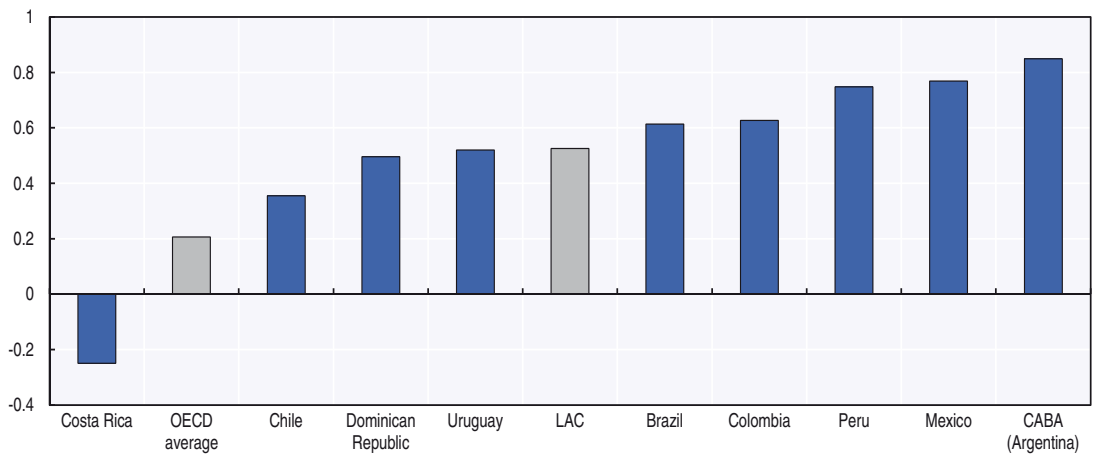
The socio-economic status of students and schools has a powerful influence on learning outcomes of students in Latin America. Indeed, this status can explain 17% of the performance variation in Latin America compared with 13% for OECD economies in PISA 2015 (OECD, 2016b). The strength of the socio-economic gradient refers to how well socio-economic status predicts performance and indicates the extent to which education policies should target socio-economically disadvantaged students. Advantaged students generally perform better than disadvantaged students. On average, a one-unit increase in the PISA index of economic, social and cultural status of the student is associated with an increase of 28 score points in the science assessment in Latin America. This represents about one year of schooling. Moreover, students with low socio-economic

status are at greater risk of not attaining the baseline level of skills in science, the focus of the PISA 2015 test. Latin American students from disadvantaged socio-economic backgrounds are almost four times more likely than more advantaged students not to attain the baseline level of proficiency in science (OECD, 2016b). Similar results are obtained when looking at mathematics and reading performance.

Similar to the large differences in performance among different groups, the distribution of educational resources appears to be linked to the socio-economic background of students and schools. High-performing countries, such as Finland, Germany and Korea, tend to allocate resources more equitably across socio-economically advantaged and disadvantaged schools. This is not the case in Latin American countries where principals of disadvantaged schools are more likely to report more shortage or inadequacy of educational resources than counterparts in advantaged schools (OECD, 2016c). In fact, the correlation between a school's mean socio-economic background and the index of educational resources (including the books, instructional material and laboratories) in LAC (0.53 in 2015) is considerably higher than in OECD economies (0.21 in 2015) (Figure 1.27). Moreover, principals of rural schools report more shortages or inadequacy than do those in towns (OECD, 2016c). In the long run, improving the distribution of educational resources is an important challenge to improve both performance and equity in Latin America's educational systems. In the short run, educational resources need to target students from poorer socio-economic backgrounds to reduce inequalities.

Figure 1.27. **Education resource allocation and socio-economic status in Latin America and the OECD, 2015**



Note: LAC average includes Brazil, Chile, Colombia, Costa Rica, the Dominican Republic, Mexico, Peru and Uruguay. Argentina only reflects results for the City of Buenos Aires. Schools' educational resources refers to aspects such as physical infrastructure, e.g. school buildings, heating and cooling systems and instructional space; and educational material, such as textbooks, laboratory equipment, instructional materials and computers. This figure uses a shortage of educational resources index based on school principals' perception of the extent to which shortage of educational resources hindered the school's capacity to provide instruction.

Source: OECD/CAF/ECLAC based on OECD (2016b); *PISA Products* (database), www.oecd.org/pisa/pisaproducts/, www.oecd.org/pisa/pisaproducts/

StatLink http://dx.doi.org/10.1787/888933650076

Infrastructure and services are still a source of inequity

Citizens in the region need reliable and accessible transport to reduce transport costs and ultimately improve quality of life. Improving transport connectivity goes beyond questions of infrastructure. It also recognises the need for policies and strategies

that increase efficiency and reduce transport costs, including time, financial cost, and negative environmental and social impacts.

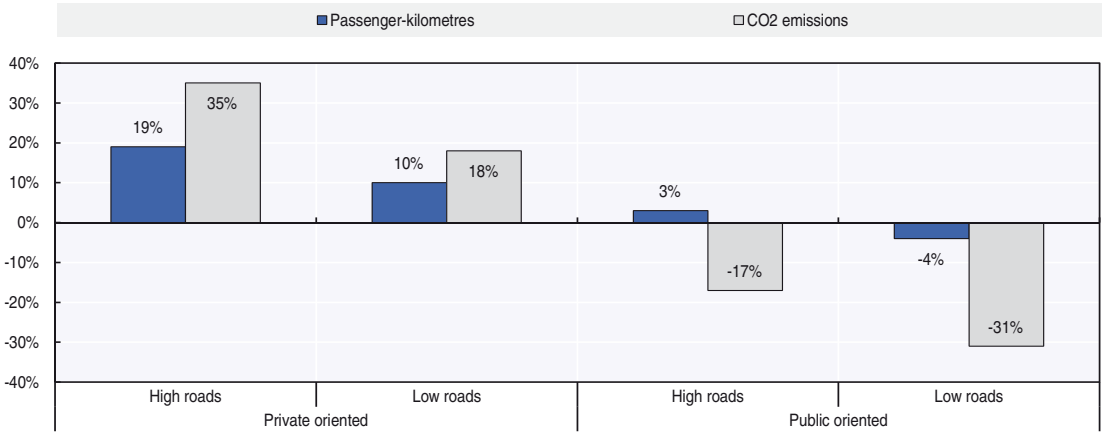
The development of a strategy for improving connectivity is particularly relevant in the region, where transport costs are high, compared with OECD member countries. Further, transport is considered one of the main bottlenecks to development. Better logistics in transport and adopting a multi-modal approach that shifts focus from roads (e.g. developing railways, ports and waterways) are central to this strategy. Also key are improving the design and implementation of transport policies at national and sub-national levels.

Citizens, particularly in urban areas, require better public services to reduce congestion and, to a lesser extent, environmental costs. The urban population perceives increased congestion as a major problem. The accelerated growth of the vehicle fleet is a major challenge, especially in a context of limited traffic management capacity. Whether urban transport policies favour public transport or private vehicles and the development of roads over the next decades will determine vehicle fleet growth in Latin America. This, in turn, will affect both congestion and CO_2 emissions (Figure 1.28).

Urban transport policies favouring public transport, co-modality and other modes of transportation beyond roads (e.g. cycling, intra-city trains, metro) would bring significant benefits to the region. They could both enhance CO_2 mitigation potential and improve mobility (compared with a business-as-usual scenario or one in which urbanisation increasingly supports private vehicle use). This highlights the importance to support, at a national level, sustainable urban transport policies as a common objective for the country.

Figure 1.28. **Mobility and CO_2 emissions in Latin American cities, compared with baseline scenario (2010-50)**

Alternative road and public/private scenarios



Note: Baseline: Per capita road infrastructure expands at a rate that corresponds to the evolution of urban density under the *baseline sprawl* scenario. It follows the negative relation between urban density and road intensity observed in historical data. *High roads*: Urban roads expand at higher rates than urban population, following the highest trend observed in the country or region. *Low roads:* Urban road infrastructure per capita grows following the *low sprawl* evolution of urban density, following the lowest trend observed in the country or region.

Source: ITF (2015), *ITF Transport Outlook 2015*, OECD Publishing, Paris, http://dx.doi.org/10.1787/9789282107782-en.

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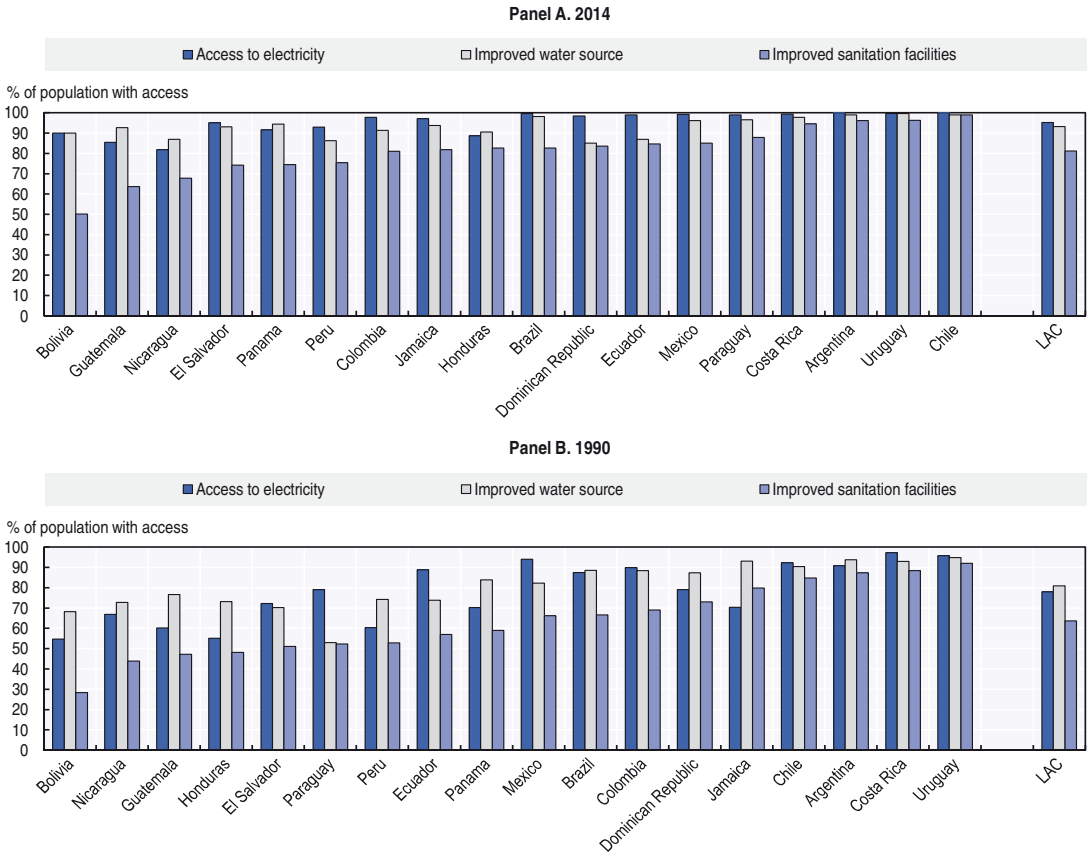
In terms of water and electricity, and to a lesser extent sanitation, the region has advanced in the past decades, achieving high levels of coverage at national level (Figure 1.29). Electricity access has improved the most, covering 99% of those living in urban areas. Still, 12% of those living in rural areas remain uncovered. Similarly, although 93% of the Latin American population at national level has access to safe water,

the share drops to about 84% of the rural population. This leaves more than 20 million people uncovered (World Bank, 2017a). In terms of sanitation, about 81 million people (36% of the rural total) have access to improved services. The remaining 46 million people use unimproved systems. This contrasts with urban coverage levels, where 97% of the urban population has access to safe water and 88% to improved sanitation.

Inequalities persist beyond rural and urban borders and expand to sub-national regions. Access to water, sanitation and electricity infrastructure is unequal across territories, especially in Bolivia, Ecuador, Guatemala, Honduras and Peru (Figure 1.30). Most disparities can be observed in sanitation services, partially because it lags behind in terms of coverage. On average, there is a 40 percentage point difference within sub-national regions between the largest and lowest coverage of sanitation infrastructure. In Argentina, El Salvador, Guatemala, Honduras and Paraguay, the gap is as large as 50 percentage points.

Figure 1.29. **Water, sanitation and electricity access in Latin America and the Caribbean**



Note: LAC average includes Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, the Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Jamaica, Mexico, Nicaragua, Panama, Paraguay, Peru and Uruguay.

Source: World Bank (2017a), *World Development Indicators*.

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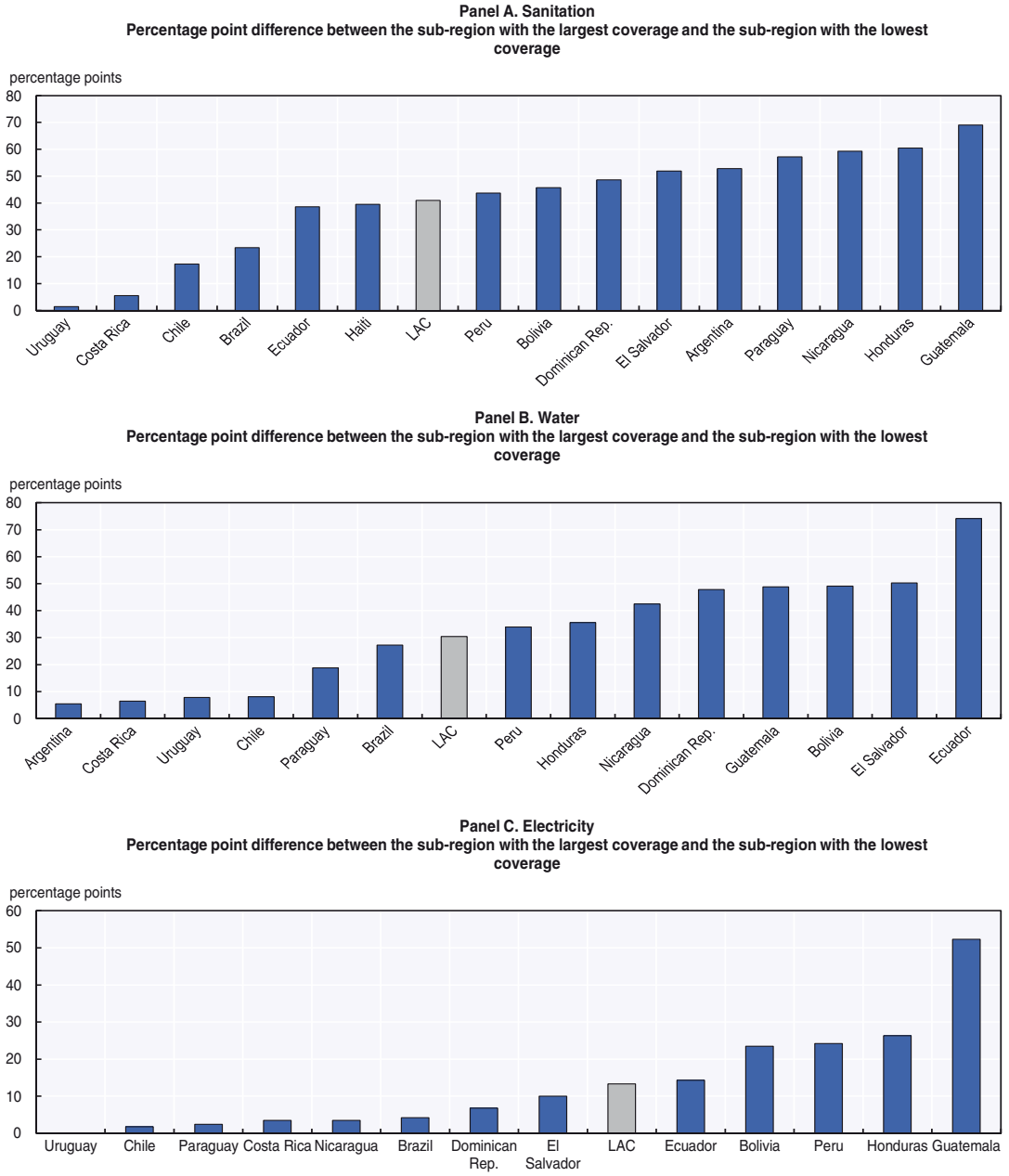
Access to good quality health remains largely unequal

Most countries in the region still fall short on achieving universal health coverage despite having taken different paths towards this goal. In the past decade, the region has especially advanced in terms of population coverage and access to basic health services (i.e. immunisation, family planning, antenatal care, skilled attendance at birth, improved water and sanitation) (Figure 1.31, Panel A). However, population coverage

remains insufficient, public spending on health is low and out-of-pocket payments are high. As a result, Latin Americans, especially those in the poorest sectors, find it difficult to receive needed health services without facing financial hardship (World Bank, 2015).

Figure 1.30. **Access to water, sanitation and electricity by countries and territories in Latin America and the Caribbean, 2014**



Note: Territories covered in each country vary due to data availability. Data for Argentina and Uruguay are only representative of urban areas. LAC average includes countries in each figure.

Source: Own calculations based on CEDLAS and the World Bank (Equity Lab tabulations) (2016).

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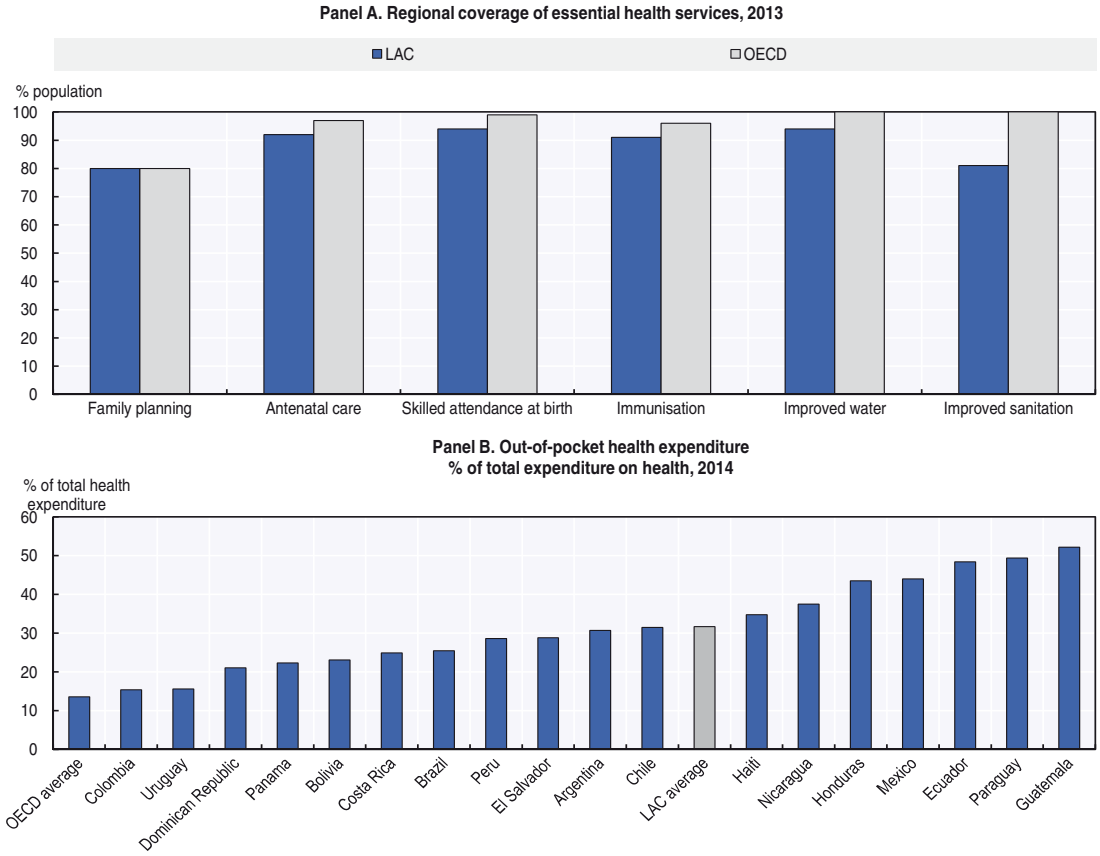
Individuals are responsible for a relatively large share of total health expenditures in LAC. Across the region, individuals paid 31.7% of health expenditures out of their own pockets in 2015 (Figure 1.31, Panel B). This was significantly above the 20% recommended

by the World Health Report and above the 13.6% prevalent in OECD member countries (World Bank/WHO, 2017). Lower out-of-pocket expenditure is associated with low risks of catastrophic or impoverishing health spending. Similarly, higher public spending on health is associated with higher financial protection (WHO, 2017a; 2016). Thus this indicator reflects the extent to which public health systems offer protection to citizens. High out-of-pocket payments are of great concern as they may force low-income households to cut back in relevant areas such as food and education, or fall into deeper poverty levels when faced with large exogenous health shocks (WHO, 2017a).

Access to health service in LAC has been linked to the different insurance schemes offered in the region. On the one hand, beneficiaries of contributory schemes can access both private and public providers. Beneficiaries of subsidised regimes have only access to public health providers. There are large disparities in terms of quality across public and private providers. These create differences in access across types of regimes that have significant implications for equity (World Bank, 2015). In this context, the structure of the different insurance schemes predominant in the region perpetuates inequities within countries.

Inequalities in access to health services among and within LAC countries persist; ensuring equity in both access and quality of services remains a key challenge. In the five LAC countries for which recent data were available, the average difference in immunisation rates between the highest and lowest income quintiles is approximately 13.9 percentage points (Figure 1.32, Panel A). At the same time, the average difference in the mortality rate in children under five between the two quintiles is 50 deaths per 1 000 live births (WHO, 2017b) (Figure 1.32, Panel B).

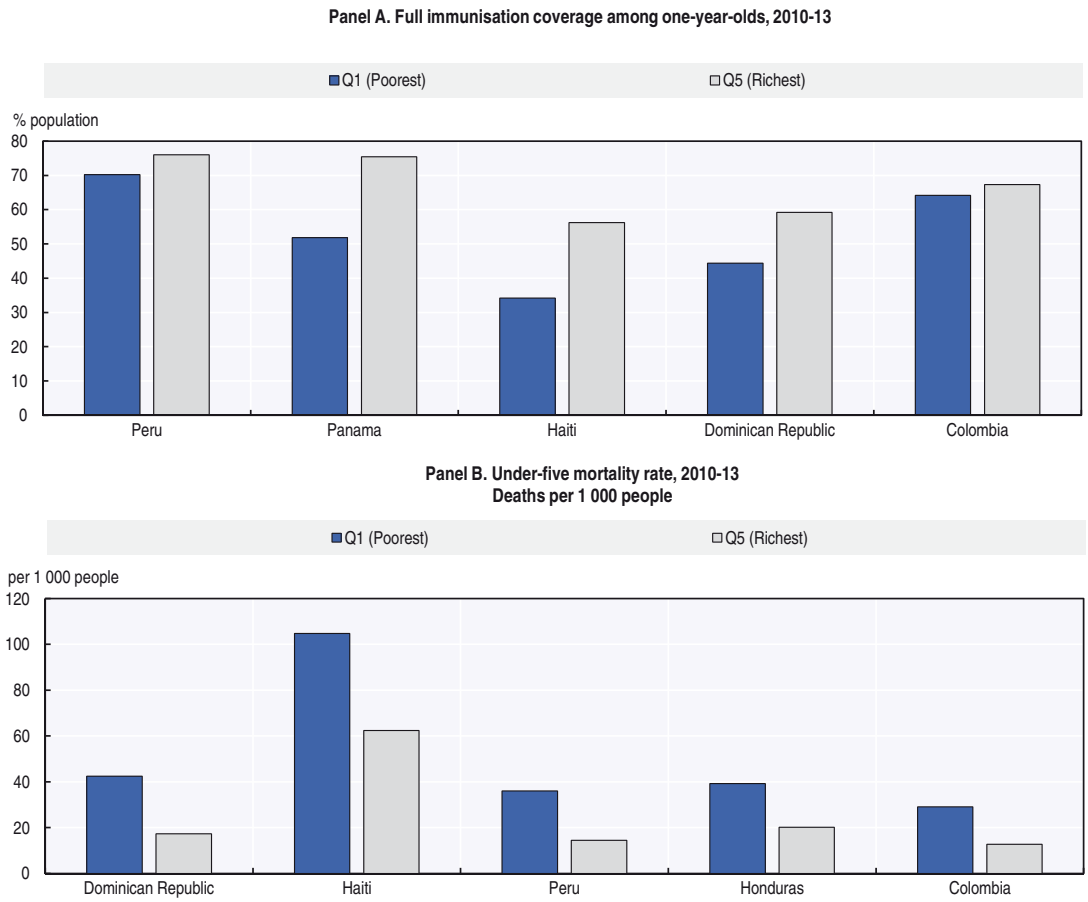
Figure 1.31. **Health coverage in Latin America and the OECD, 2013**



Source: World Bank Databank, 2017.

StatLink http://dx.doi.org/10.1787/888933650152

Figure 1.32. **Inequity in access and quality of health services within LAC countries by socioeconomic group, 2010-13**



Source: OECD/CAF/ECLAC based on WHO (2017).
StatLink http://dx.doi.org/10.1787/888933650171

Additionally, large differences persist in the quality of services provided across the region's systems and subsystems. One common way to assess the quality of these services is to analyse the extent to which health services translate into improved health outcomes. Trends in amenable mortality serve as an indicator for a combination of access and quality of health services. It is estimated that almost 14% of all deaths in the region are attributed to communicable diseases; this number is twice as large as the OECD average (World Bank/WHO, 2017).

Conclusions

The social contract in LAC has weakened in recent years, as illustrated by the decline of trust in public institutions and the increasing dissatisfaction with public services. There is a growing disconnect between citizens and institutions that results from both the rising aspirations of a larger middle class (which reached a level of 34.5% in 2015) and the limitations faced by public institutions to respond to current and emerging challenges, particularly in a rapidly changing global context.

These developments suggest that citizens increasingly believe that public institutions are not ready to respond to their demands and rising aspirations. As a result, citizens do

not perceive sufficient benefits linked to the fulfilment of their duties as such, but rather see fewer incentives to engage in the obligations associated with the social contract. In fact, the willingness of citizens to pay taxes (tax morale) has declined in recent years in LAC, thus undermining the capacity of the state to provide quality public goods and services effectively. This leads to a negative impact on citizens' perception of well-being, which further fuels their disengagement from public institutions in a downward spiral.

There is a need to rethink institutions in LAC to bridge the gap between society and institutions and support greater well-being for all. Institutions must be rethought in a way that build and reinforce a new *state-citizens-market nexus*, placing citizens' demands at the centre. For this, reforms should focus on institutions linked to the main sources of discontent of *citizens:* the *market* and the *state*. Citizens expect an economy – *the market* – to provide increasing income and job opportunities. Large rates of informality in the region need to be overcome to support better quality jobs. Similarly, citizens demand public institutions – *the state* – that provide good services and deliver their functions in an efficient, reliable and innovative manner. Rethinking institutions to support state capacities as well as to improve public services will also be critical in a region where the quality of government and education, health, transport and other basic services are still far from OECD standards.

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Chapter 2

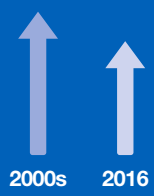
Macroeconomic prospects for Latin America and the Caribbean

Latin America and the Caribbean (LAC) is undergoing a subdued recovery after a two-year recession. In the short term, growth paths vary from one country to another, reflecting differences in exposure to external shocks and soundness of domestic policy. In the medium term, potential growth is lower than expected and most of the region seems to be tangled in the middle-income trap, with low productivity growth at the heart of the problem. This chapter assesses LAC's growth prospects and explores the role that trade could play to increase productivity and ensure higher potential growth. In addition, it analyses the need for the region to continue to pursue openness and globalisation, with a special focus on regional integration.

Macroeconomic prospects for Latin America and the Caribbean

Better but not good enough

Slow growth



Potential annual growth rate is **lower than expected**, unlike the average rate that characterised **the mid-2000s**

Low labour productivity

Low labour productivity in Latin America explains the **70% gap of GDP per capita** between LAC and the upper half of OECD economies

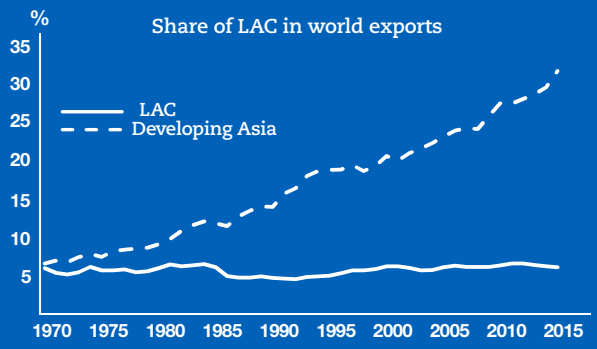
Middle-income trap

As Latin American countries reached middle-income levels, **growth exhibited a long-lasting slowdown,** known as **the middle-income trap (MIT)**

Trade can help boost productivity and increase potential output

The share of LAC in world exports **has stagnated since 1970,** unlike the performance of developing Asia

Tapping on the **unexploited potential of regional integration** is an effective policy response to the challenging global environment



The deterioration of the macroeconomic outlook in Latin America and the Caribbean (LAC) in recent years has already had an impact on living standards, as well on the prospects for socio-economic progress. It is thus emerging as one of the main drivers of citizens' discontent.

The slowdown that began in 2011 led to a two-year recession in 2015 and 2016, from which the region is currently emerging. Activity is expected to expand modestly in 2017 and continue to gain momentum in 2018. However, despite the decline of potential output, the output gap will remain in negative territory, highlighting the weakness of the recovery. The region will benefit from the mild improvement of global activity and the stabilisation of commodity prices, but policy uncertainty may dent investment. Furthermore, political uncertainty and the delay of large infrastructure projects will also contribute to tilt the balance of risks upwards.

It is still about "Americas Latinas" rather than "America Latina" in terms of cyclical positions and policy options. In general, activity in net commodity exporters in South America bottomed in 2016; in most countries, output gaps are closing. In particular, growth momentum will benefit from Argentina and Brazil coming out of recession. Agents are downgrading expectations for growth in Mexico and Central America, but growth will still outpace South American economies. The scope for demand policies to stimulate growth remains limited. The space for monetary policy is opening up for South America, but higher prices in Mexico and Central America may call for some tightening. Fiscal space remains constrained since most countries need further adjustments to stabilise debt.

In the medium term, the region's low productivity will hamper momentum for growth. Although cyclical factors are causing part of the slowdown, the main reason remains structural shortfalls: low productivity is at the heart of the problem. Furthermore, LAC has been unable to reap productivity gains from trade as it has not achieved diversification (both by partner and product), to increase participation in global value chains (GVC) or add more value to its exports and or integrate, both intraregionally and globally, owing in part to the complexities of the region's trade architecture (trade agreements, non-tariff measures, etc.).

All in all, this macroeconomic outlook suggests the need to undergo a series of institutional responses. The region needs to build the pillars of a growth model that can guarantee sustained socio-economic progress and thus improve well-being. This will in turn have an impact on citizens' prospects for advancement and strengthen the social contract in LAC. The institutional response must include actions to face short-term risks. However, it needs mainly to adopt institutional reforms to overcome the middle-income trap, underpin productivity growth and further exploit the potential benefits of deeper regional and global economic integration. This will necessitate a greater focus on policies to enhance the productivity-inclusiveness nexus.

To further analyse these issues, this chapter first examines the global context. It focuses on the economic outlook for key partners of the region, as well as the perspectives for global financial and commodity markets. An analysis of the short-term economic perspective for LAC will then highlight the heterogeneity among countries ("Americas Latinas") and the lack of policy space for demand policies (fiscal and monetary). Consequently, the chapter dwells on the medium and long-term perspective for the economies of the region, analysing the causes of low potential growth and the main policy areas to increase productivity and overcome the middle-income trap. Finally, and as in previous editions of the *Latin American Economic Outlook*,[1] the chapter focuses on a key policy area for the region. This year's edition analyses the potential gains from deeper and more effective regional and global trade integration as a channel to increase productivity as an engine for growth.

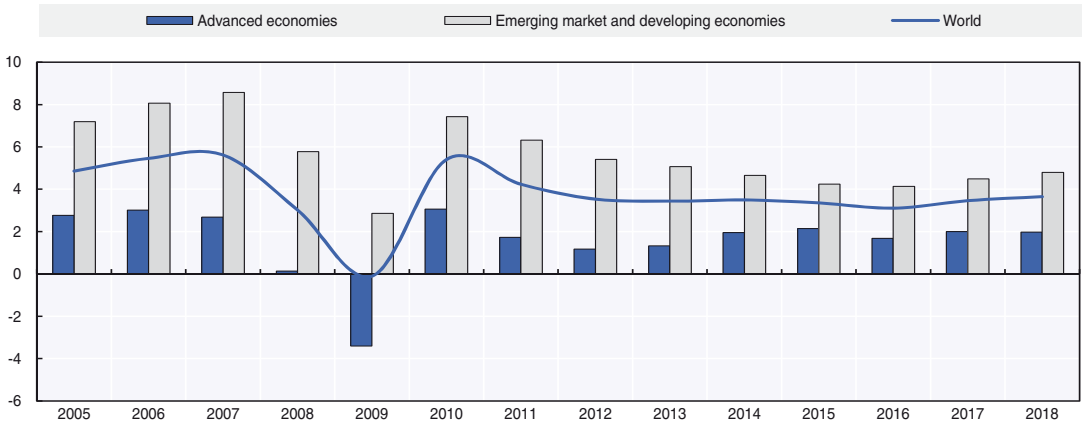
A subdued recovery in Latin America and the Caribbean with a brighter global context

A more positive global context

Global growth is expected to improve in 2017 and 2018 as the global economy recovers, supported by policy stimulus, solid progress in employment, a moderate upturn in investment and a pick-up in trade growth (IMF, 2017a; OECD, 2017a) (Figure 2.1). Activity in advanced economies will gain more traction, particularly in the United States (US), but also in the European Union and Japan. However, low productivity growth restrains a more robust recovery in the medium term. Emerging economies will pick up the pace as activity in the People's Republic of China (hereafter "China") stabilises and large commodity-dependent economies leave recessions behind (Russian Federation and Brazil) or accelerate (India).

Figure 2.1. **Economic growth outlook by groups of economies**

Annual growth percentage



Source: OECD/ECLAC/CAF based on IMF (2017a), *World Economic Outlook Database*, April 2017.

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Economic growth in the US is expected to accelerate in 2017 and 2018, despite policy uncertainty. Industrial production continues to strengthen, while the labour market tightens and wage growth accelerates. Expectations remain optimistic and investment should increase, especially in the mining sector. Inflation is nearing its target and the Federal Reserve will likely continue its progressive tightening cycle; the reduction of its balance sheet will soon be appropriate (OECD, 2017b). As the economy is close to its potential, further fiscal stimulus may prompt a faster monetary tightening cycle. This could induce volatility in financial markets.

Activity in European countries improved in 2016. It is expected to slightly pick up pace over the next two years, supported by a stronger global backdrop. Consumer confidence is on the rise and business indicators suggest further acceleration in economic growth in 2017. Unemployment rates are falling, but remain high in several countries and growth remains below potential. Investment prospects may be hit by political noise due to elections and the Brexit negotiations. Inflation will remain below target so the European Central Bank is expected to hold monetary stimulus in place at least until 2019.

Growth in Japan is expected to pick up in 2017, before slightly slowing in 2018. Growth in 2017 will be supported by stronger export growth, an expansionary fiscal stance and a recovery in consumption after the stagnation that followed the tax increase in 2014. The labour market is tight, which could improve wages. Industrial production is also improving as domestic demand recovers and external demand gathers momentum. Deflationary pressures have eased, but the Bank of Japan is likely to sustain monetary stimulus, particularly if efforts for fiscal consolidation advance. Growth is projected to slow down in 2018 as the fiscal stimulus fades and the downward trend in public investment resumes (OECD, 2017b).

China is expected to continue towards a soft landing. Activity picked up pace in 2016 thanks to monetary and fiscal stimuli. However, the reversal in credit growth to avoid financial instability will eventually soften the impulse of demand. Production indicators suggest that activity is no longer accelerating. The risks to growth are more medium term owing to lack of progress on the rebalancing process with loose credit, creating more industrial overcapacity and debt overhang. A continued inefficient allocation of resources would hamper potential growth. This, in turn, would elevate the risk of a disorderly financial unravelling in the medium term.

World trade will recover slightly in 2017, but remains less robust than in the pre-crisis decade. In 2016, world trade growth was particularly low at 2.4%, but is expected to pick up for 2017 and 2018 above 4% per year. This is below the historical average of 7% growth (IMF, 2017a; OECD, 2017a). Weak trade growth can be explained by changes in aggregate demand, structural developments such as a low growth in GVCs, a possible rise in non-tariff protectionism and the declining impact of financial deepening (IMF, 2017b; IRC, 2016). The pervasive low trade-growth rates and international trade elasticities to output growth indicate a "new normal" where the high growth rates of the pre-crisis were an exception (Martinez-Martin, 2016).

Financial markets are under strong uncertainty

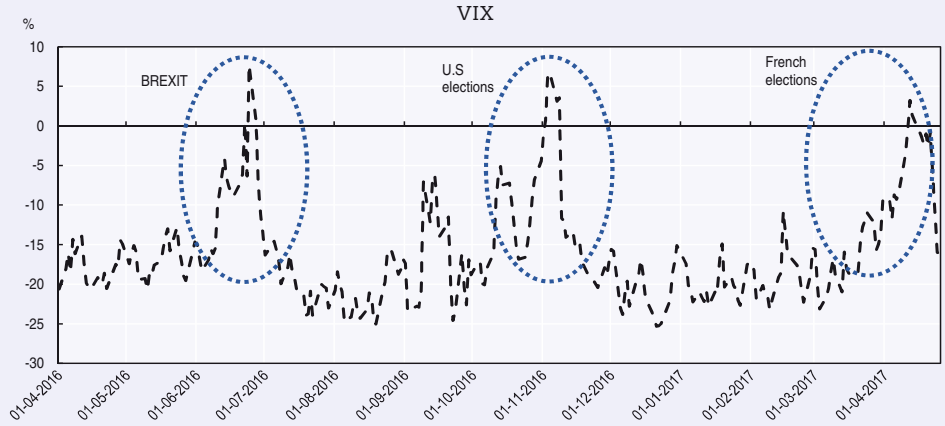
US policies regarding fiscal stimulus and trade are perhaps the largest sources of global uncertainty in the short term.

Financial volatility may surge around elections in Europe and Brexit negotiations (Box 2.1). Geopolitical risks – such as rising tensions in the Middle East – may also dampen investor sentiment towards emerging markets. China poses medium-term risks; potential growth may falter if Chinese authorities favour short-term output over the correction of imbalances (over capacity and increasing leverage).

Box 2.1. **The effect of financial volatility in Latin America**

Following the result of the US elections, stock markets in developed economies climbed on the prospects of a large fiscal stimulus in the US. However, investors have curbed their enthusiasm as the chances of significant changes in the tax code or infrastructure investment have decreased. Spikes in volatility around the political events also took place around the Brexit referendum and French elections (Figure 2.2).

Figure 2.2. **Volatility bouts: The new normal?**



Note: VIX refers to the Chicago Board Options Exchange Market Volatility Index.

Source: OECD/ECLAC/CAF based on the Institute of International Finance (IIF).

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Box 2.1. **The effect of financial volatility in Latin America** *(cont.)*

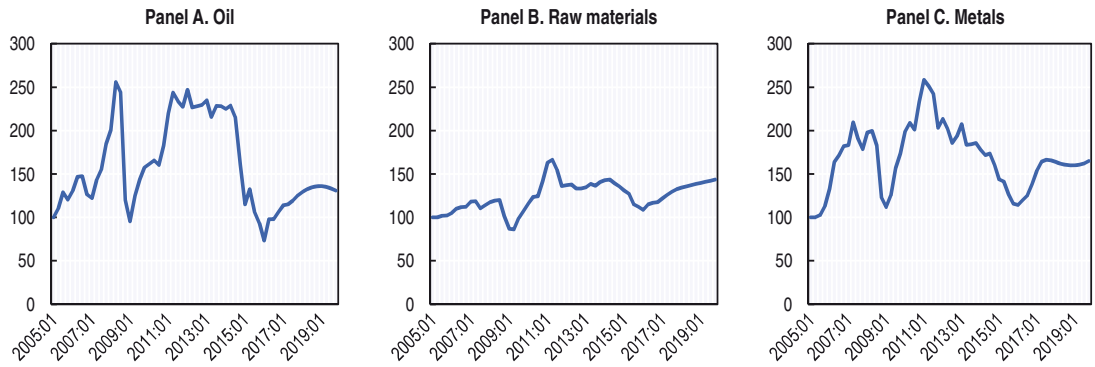
The effects of the events, however, have been short-lived. Markets recovered the losses after Brexit – perhaps the British pound being the only longer-lasting casualty. Even the Mexican peso, which plummeted more than 20% in a matter of hours following the US elections, returned almost fully back to pre-election levels. Likewise, these events have not derailed the ongoing recovery in developed and emerging markets. In fact, in spite of these spikes, volatility is at record lows. According to Gibbs et al. (2017), four factors may explain the apparent disconnect between political uncertainty and financial volatility. First, investors may be unable to adequately price unprecedented outcomes of political events. Therefore, a future correction may take place. Second, the mild recovery of the global economy entails that fundamentals are more supportive of financial assets. Given that the extent of the expected fiscal stimulus has diminished, any initial enthusiasm after the US elections has somewhat waned. Third, there is abundant liquidity in global markets. Central banks in advanced economies expanded their balance sheets and lowered interest rates to negative levels to stabilise global markets. So lower volatility should actually be expected. Fourth, a savings glut persists. Some countries with large current account surpluses are still investing in financial assets, while firms in developed markets have reduced capital expenditure in favour of savings.

In a context of low volatility and improving fundamentals, capital flows to emerging markets have been benign, quickly resuming after these political events. In Latin American economies with open capital markets, currency flexibility has also been a crucial shock-absorbing mechanism. Therefore, the shocks did not undermine momentum. Support for financial asset prices, however, should weaken as central banks increase interest rates and unwind quantitative easing (QE), and as external imbalances diminish. More volatility might be expected, particularly considering that valuations in developed markets may be high and thus prone to corrections.

Commodity markets will slightly recover

The baseline scenario for commodity markets is of a slight recovery in prices as global demand gathers pace (OECD, 2017a). Commodity prices recovered mildly in 2016 after the sharp decline of previous years (Figure 2.3). A moderate increase of oil prices is expected over the next two years, but with large uncertainty and below previous levels. On the one hand, the rapid response of non-conventional crude production in the US to price changes caps a price surge. On the other, the recovery of global demand should support prices. The important compliance of the Organization of the Petroleum Exporting Countries (OPEC) with the production agreement – over 90% in the first three months – should also support a price recovery. However, there is uncertainty regarding the compliance of the agreement, owing to political tensions between some member countries in the Middle East. The structural slowdown and rebalancing in China may weigh on prices for industrial metals. However, if a boost in infrastructure investment in the US materialises, prices may climb. In the case of agricultural commodities, prices are likely to remain stable. However, rebalancing efforts in China may push prices up, as consumption increases.

Figure 2.3. **Commodity prices outlook (2005=100)**



Source: OECD/ECLAC/CAF projections based on a GVAR.
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Latin America is undergoing a subdued recovery, with risks ahead

LAC is undergoing a subdued recovery after a protracted decline in economic activity. Following a two-year contraction, activity bottomed in 2016. It is expected to expand in 2017 and continue to recover towards 2018.

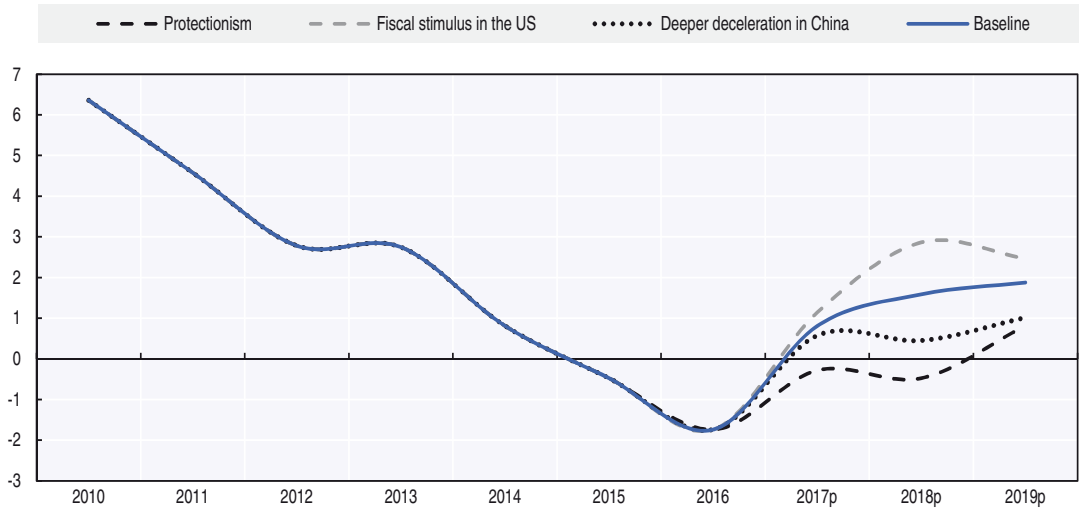
The region faces uncertainty stemming from external factors that could derail growth. Policy uncertainty in the US is perhaps the most relevant external source of risk that LAC faces in the short term. The US plays a key role in the global and regional economy because of its size and multiple linkages. First, it is the single largest importer in the world, accounting for one-fifth of global purchases. Exposure to developments in the US is also uneven across countries in the region. Mexico, Colombia, Ecuador and Central American countries have the largest trade exposures to the US among LAC countries. Second, the US is also the largest source and recipient of foreign direct investment (FDI) flows. This leaves Mexico, Costa Rica, Chile and Brazil as the most vulnerable to changes in the volume of these flows. The US also accounts for the largest share of emerging markets' portfolio assets. Changes in monetary policy could become important sources of changes in the direction of capital inflows. This is particularly true in countries that partially rely on these flows to fund current account deficits, such as Colombia, Panama and some Central American countries. It could also have implications for fiscal sustainability in some highly indebted countries in the Caribbean with a large fraction of foreign currency debt. Third, the US is still a key producer and consumer of commodities, in spite of the gains China and India have made in these markets. In consequence, business cycles in advanced economies and emerging markets tend to be synchronised with the US. At the same time, growth, financial and policy shocks in the country have sizable spillovers on the global economy and thus in Latin America (Kose et al., 2017). More recently, cycles in Mexico and Central American countries exhibit a larger co-movement with the US cycle than South American countries, which have become more exposed to China (Izquierdo and Talvi, 2011). Similarly, a larger than expected deceleration in China would represent an important setback for recovery in LAC. Resource misallocation and debt overhang entail medium-term risks for productivity and growth in China, which should not be neglected. However, the risks of a hard landing in China in the short term have somewhat dissipated as policy stimulus helped stabilise activity.

To illustrate the possible impact of policy changes in the US and a deeper than expected deceleration in China, three alternative scenarios are modelled under a Global VAR model. In the first scenario, a surge in US growth due to a large fiscal stimulus

continues for two years. It entails personal and corporate tax cuts, as well as spending in public infrastructure investment. Growth gradually comes down as monetary policy in the US tightens faster than expected to curb inflationary pressures. This is an upside for global growth and the region benefits from trade and commodity links. While all countries gain from stronger activity in the US, Mexico is the largest beneficiary. In the second scenario, the fiscal stimulus in the US is muted by a more protectionist stance, targeting Mexico and China. The global implications of this scenario are negative, particularly since activity takes a toll on China, but also on Europe. The region would be strongly impacted over the next two years through the impact of protectionism in Mexico. Further, the pervasive slump caused by protectionism in China would particularly hit industrial metal exporters in South America (Brazil, Peru and Chile). The third and final scenario is a stronger than expected deceleration in China. This exercise highlights the region's sensitivity to activity in China through trade and commodity prices. This is particularly the case for net commodity exporters in South America, since the exposure of Central American and Caribbean economies to China is more limited (Figure 2.4).[2]

Figure 2.4. **GDP growth in Latin American economies under alternative scenarios: Fiscal stimulus in the United States, an increase in protectionism and a deeper than expected deceleration in China**

Annual percentage



Notes: Weighted average for Argentina, Brazil, Chile, Colombia, Mexico, Peru, Uruguay and Venezuela. The fiscal stimulus scenario is operationalised by a surge in GDP growth in the US compared to our baseline scenario. Oxford Economics US GDP growth projections for a similar scenario, entailing a USD 1 trillion cut in personal and corporate taxes and USD 250 billion in public infrastructure investment. Growth picks up to 2.2% in 2017 (from a baseline of 1.8%) and to 3.3% in 2018 (from a baseline of 2%). It diminishes progressively to 2% by 2021. We adjust the resulting growth acceleration to our baseline scenario. For the protectionist scenario, we assume targeted measures by the US against Mexico and China. These measures are operationalised by a one-off 20% currency depreciation in Mexico and in China against the US dollar by Q3 2017. Exchange rate levels change with respect to the baseline for the simulation period, but the rate of variation stabilises. For the scenario of deeper deceleration in China we assume that growth diminishes from 6% to 4.5% between 2017 and 2021.

Source: OECD/CAF/ECLAC simulations based on a Global Bayesian VAR model.

StatLink http://dx.doi.org/10.1787/888933650247

There are also important domestic risks to the downside. In particular, delays in the execution of infrastructure projects (mostly in Peru, Panama, Argentina, Colombia and Costa Rica) will undermine investment and dent growth (Box 2.2). Expectations may also be affected by volatility due to upcoming elections, political noise and corruption scandals.

Box 2.2. **The Odebrecht case and its regional impact**

Odebrecht, the largest engineering and construction company in Latin America, has been involved in corruption scandals with public authorities in more than ten Latin American countries.

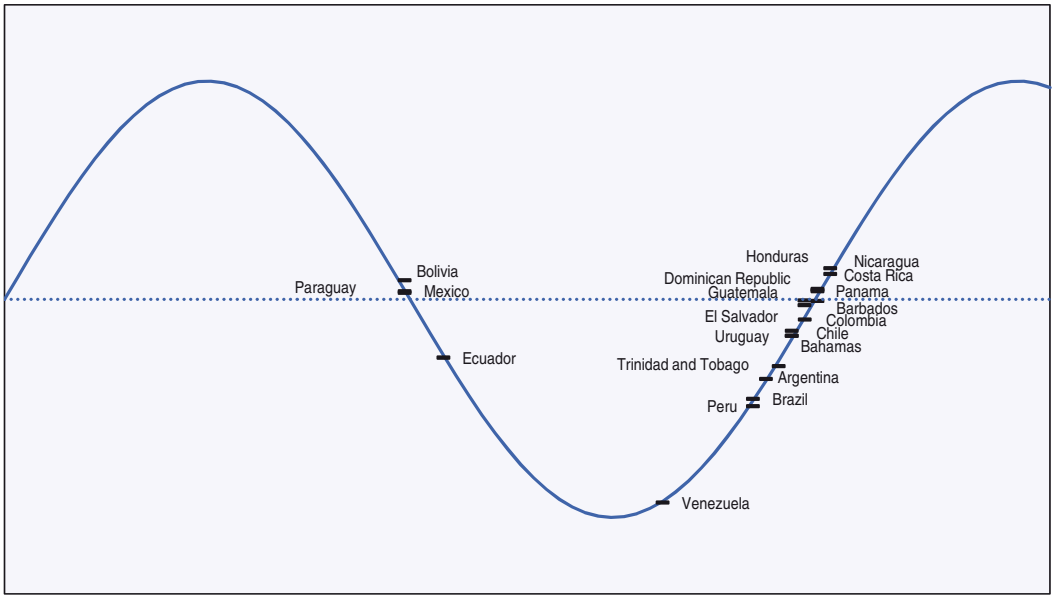
These corruption scandals, apart from the impact on Odebrecht itself, have caused the delay of infrastructure investment in LAC. To some extent, substitutes for the company are not abundant in the market in the short term. The company will only be able to bid for public tenders in Brazil (and probably worldwide) after cancelling the fines for over USD 2 billion, undergoing management restructuring and adherence to strict anti-corruption mechanisms. This could take some time, hampering the prospects of timely completion of projects.

Many infrastructure projects of the Brazilian conglomerate are now paralysed, at the request of justices, to review the conditions in which they were tendered. Companies associated with Odebrecht face costs to their reputations, generating a capital crunch, especially in Brazil, that threatens the short-term dynamics of investment in infrastructure. Outside Brazil, the more serious repercussions so far are in Peru, Colombia and Panama. According to Moody's, the potential cancellation of the Chan II hydroelectric project in Panama may cost 0.5 percentage point of growth this year. In Colombia, delays in the Ruta del Sol road corridor and in the Rio Magdalena navigation projects may keep growth under 3% over the next two years. In Peru, the paralysis of the Gaseducto del Sur energy project, among others, downgraded growth by almost 1 percentage point this year.

This unfortunate episode compromises business integration, highlighting the pervasive corruption and institutional weakness in the region. Latin American institutions face the great challenge of a timely and competent resolution of this scandal through justice. Lessons learned from the anti-corruption operation in Brazil, the so-called Lava Jato Operation, should help configure stronger institutions that allow a more transparent and efficient management of infrastructure projects and foster regional co-operation.

The region shows an important heterogeneity that needs to be factored in and can be illustrated in the cyclical position of countries placed within a stylised economic cycle (Figure 2.5). This reflects the differences across countries in exposure to the external backdrop, as well as the soundness of the domestic policy framework. Commodity exporters in South America are on a recovery phase, benefiting from recent gains in commodity prices and the decline of inflation. Brazil and Argentina will emerge from recession, but no large rebound is expected, particularly in Brazil. Growth in Andean countries will advance over the next two years as the adjustment to the commodity shock progresses. Activity may be dented by weaker than expected investment as large infrastructure plans lag behind, with greater risks in Peru, Panama, Colombia (delays in some project financing agreements for 4G projects) and Argentina. Only the Bolivarian Republic of Venezuela (hereafter "Venezuela") is expected to remain in recession. Mexico and Central America, on the other hand, will struggle more amid policy uncertainty in the US, but still outperform South American economies. Activity in Mexico, particularly investment and consumption, will be mostly affected by uncertainty due to rising inflation and increasing interest rates. Although the protectionist rhetoric against Mexico has softened, uncertainty is still denting a stronger performance. The Caribbean will experience a passive recovery after the 2016 contraction. In spite of the recovery of net commodity exporters in South America, most countries maintain negative output gaps, highlighting the frailty of recovery. This is even taking into account lower potential output growth (OECD/CAF/ECLAC, 2016).

Figure 2.5. **An illustration of the cyclical position of selected Latin American and Caribbean economies**



Note: The output gap is calculated for 2016 and its projected evolution. The output gap is calculated as a deviation from trend using Hodrick-Prescott (HP) filter (lambda=6.25).

Source: OECD/CAF/ECLAC based on IMF (2017a), *World Economic Outlook Database*, April 2017, OECD (2017b), *OECD Economic Outlook*, Vol. 2017/1, OECD Publishing, Paris for Argentina, Brazil, Chile, Colombia, Costa Rica and Mexico and OECD (2017c), OECD *Multidimensional Economic Survey on Argentina*, OECD Publishing, Paris for Argentina.

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External adjustment continues

Current account deficits keep narrowing and remain mainly financed by FDI. In 2016, current account correction was largely via import compression and to some extent substitution by domestic producers rather than to increasing exports. Lacklustre export dynamics reflect a weaker currency depreciation in real effective terms than the one depicted by depreciation against the US dollar (Powell, 2017). For 2017, exports are expected to aid the forecasted current account correction as they are showing signs of recovery (Figure 2.7). The use of flexible exchange rates has become widespread in the region. It has been useful as a first line of defence against adverse external shocks. Real depreciation has led to a small boost in exports (Box 2.3) and a strong reduction in imports, with demand shifting towards local goods (IMF, 2017c). Exchange rates may continue to cede ground as the dollar strengthens, but the recovery in commodity prices should contain further losses in South America, while the Mexican peso will continue under pressure. Current account deficits remain largely financed by FDI, although for the last three years FDI inflows have continuously decreased.

Box 2.3. **The trade impact of exchange rate depreciations**

In Latin America, real currency depreciations continue to exert a positive effect on exports. Trade increasingly takes place in the context of value chains, and the share of foreign content in exports rises. With this in mind, research has suggested the positive impact of real exchange rate depreciations on export performance has declined or ceased (Ahmed, Appendino and Ruta, 2015; Leigh et al., 2015). This is not the case in Latin America. Estimates for the period between 2003 and 2015 show the real exchange

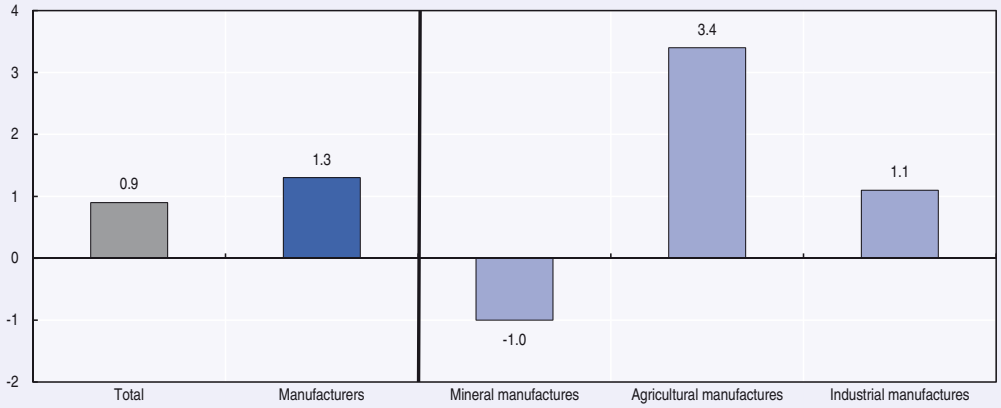
Box 2.3. **The trade impact of exchange rate depreciations** *(cont.)*

rate elasticity of exports remains economically and statistically significant, although it has indeed diminished in recent years (Giordano, 2016). Similarly, Latin America is less responsive to real depreciations than advanced economies or emerging Asia (IMF, 2017c). Furthermore, it is not only the level of the real exchange rate that has an impact on export performance; its volatility was also found to exert a negative effect on some exports.

The responsiveness to real depreciations and its magnitude varies across product category and trade partner. Manufactures are particularly responsive to real depreciations (Figure 2.6). During the period under analysis, a real depreciation of 1% generated an average increase of 1.3% in exports of manufactures compared with 0.9% in total exports. The effect is nonetheless heterogeneous across sub-categories: exports of agricultural and industrial manufactures increased 3.4% and 1.1%, respectively, while exports of mineral manufactures were negatively affected (1.0%)[3] (Giordano, 2016).

Figure 2.6. **Elasticity of Latin American exports to the real exchange rate by product category**

Estimated coefficients, 2003-15



Notes: The reported coefficients are statistically significant at the 1% level.

Source: IDB Integration and Trade Sector, with data from INTrade/DataINTAL, IMF and national sources.

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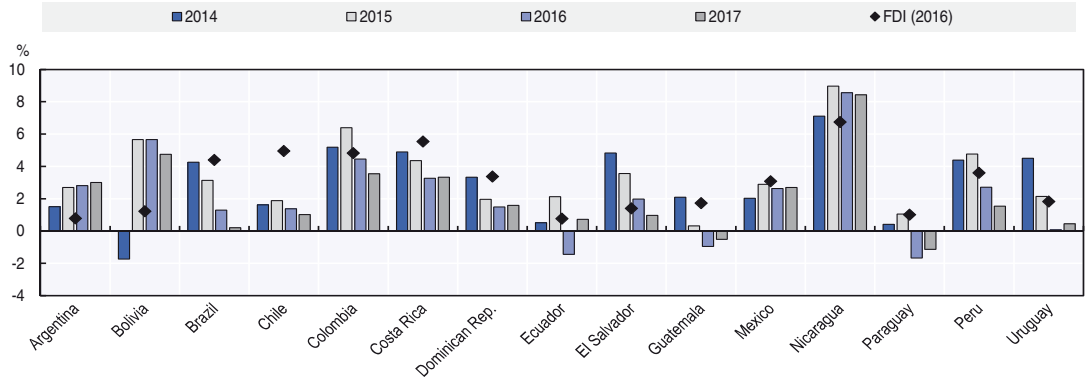
The elasticity of exports to real depreciations could also enhance intra-regional trade. In the observed years, a real depreciation of 1% translated into an average increase of 0.5% for total intra-regional exports compared to a statistically insignificant impact on extra-regional ones. Similarly, a real depreciation of 1% caused an average increase of 0.9% in exports of intra-regional manufactures compared with an impact of 0.6% in those directed to extra-regional partners. All of these effects have nonetheless been diminishing over the years. Between 2003-08 and 2009-15, for example, elasticity of exports fell from 3% to 1% for manufacturing exports. The same trend was observed in intra-regional trade: a real depreciation of 1% led total exports to increase by 3% (2003-08). Conversely, between 2009 and 2015 the effect of depreciation on total exports fell to 0.4%.

Despite the decline over time, the effect of real depreciations on Latin American exports continues to be mostly positive and significant, especially in intra-regional trade. Real exchange rate volatility was found to also negatively impact competitiveness, particularly by tampering with the exports of manufactures (Giordano, 2016).[4] These findings are particularly relevant because over the last two years, as a consequence of a regional terms-of-trade shock, exchange rates have experienced significant realignments. This has major implications for intra- and extra-regional trade flows.

Figure 2.7. **Current account deficits and foreign direct investment in Latin America**

Percentage of GDP



Source: OECD/CAF/ECLAC based on IMF (2017a), *World Economic Outlook database*, OECD (2017a), *OECD Economic Outlook*, Volume 2017/1, OECD Publishing, Paris for Brazil, Chile, Colombia, Costa Rica and Mexico, OECD (2017c), *OECD Multidimensional Economic Survey on Argentina*, OECD Publishing, Paris and ECLAC (2017a), *Foreign Direct Investment in Latin America and the Caribbean 2017*, Economic Commission for Latin America and the Caribbean, Santiago.

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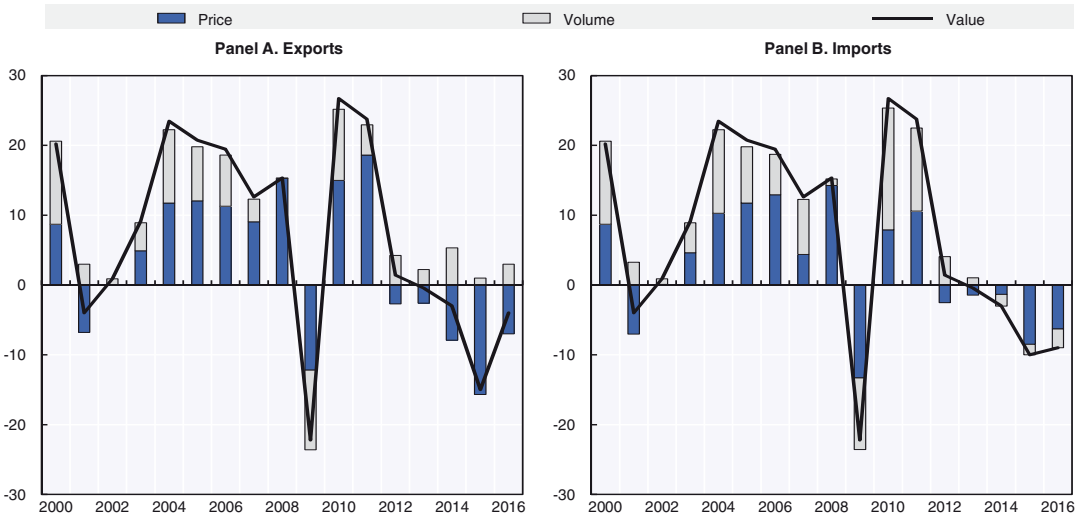
The region has experienced four consecutive years of declining export and import values. The value of the region's merchandise exports fell by 4% in 2016. A breakdown of this contraction reveals a 7% drop in prices and a 3% increase in volume (Figure 2.8). However, the contraction in 2016 was much smaller than the one in 2015 (-15%). Exports dynamics were uneven across the region. While the value of Mexico's exports contracted by 1.8% in 2016, the rest of the countries experienced an average decline of 5.6%. This decline reflected lower commodity demand from Asia, a further decline in prices and the dramatic decline of intra-regional trade in South America. Imports value decreased by 9% in 2016, a similar drop to that registered in 2015 (-10%). Unlike exports, however, imports are not yet showing signs of recovery. Furthermore, while Mexican imports contracted by 1.9% in 2016, the rest of the region's imports fell much more (-14.5%). This drastic decline reflects mostly the second year of recession in South America, with Brazilian imports falling almost by 20% in value in 2016.

Figure 2.8. **Annual variation in goods trade by volume, price and value in Latin America and the Caribbean**

Percentages



Source: OECD/ECLAC/CAF on the basis of official information from LAC countries.

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For 2017, the region's trade is already showing signs of recovery. In the first quarter, exports and imports expanded by 15% and 10%, respectively. These high rates are partially explained by the low base of comparison. In the case of exports, this improvement is mainly explained by the slight recovery in commodity prices. The recovery mainly benefited South American economies, although Mexico and Central America also improved (Giordano, Ramos and Michalczewsky, 2017).

FDI inflows towards Latin America have been decreasing for the last three years, and 2017 will likely continue the pattern. In 2016, FDI inflows decreased by about 7%, reaching USD 168 billion (ECLAC, 2017a). For 2017, FDI flows towards Latin America are forecast to decrease for the fourth year running. Investment in extractive industries will be restrained as prices remain low. Meanwhile, uncertainties about US economic policies could also hold back investments in LAC. Renegotiation of the North American Free Trade Agreement (NAFTA) or potential tax reforms in the US could have important consequences on investments in the region. Despite this trend, LAC countries have a relatively higher ratio of FDI income relative to their gross domestic product (GDP) compared with the rest of the world. The FDI flows received in the region accounted for 3.6% of GDP in 2016 (ECLAC, 2017a), while the global average was 2.3% (UNCTAD, 2017).

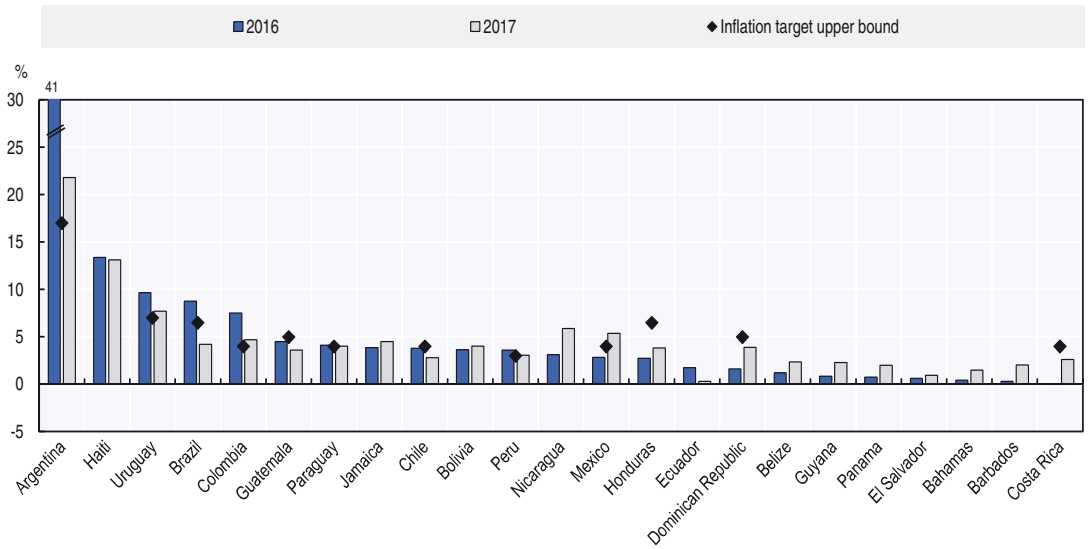
FDI inflows at the country level are highly heterogeneous in Latin America thanks to global- and country-specific factors. South America is facing an important decrease in investment (-8.1%). Only three countries – Brazil, Colombia and Paraguay – registered a growth in FDI inflows. In Brazil, FDI increased by 5.7% to reach USD 78.9 billon. In Colombia, the privatisation of the energy company Isagén for USD 2 billion largely explains the 15.9% increase in FDI. In contrast, countries such as Argentina, the Plurinational State of Bolivia (hereafter "Bolivia"), Chile, Ecuador, Peru and Uruguay faced an important decrease in FDI inflows. In Chile, for example, FDI fell for the second consecutive year; with a drop of 40.3%, to USD 12 225 million, it reached the lowest value of the last ten years. This performance can mainly be explained by a fall in loans between companies, which are one of the most volatile components of FDI. In Mexico, despite a 7.9% decrease compared with the 2015 level, FDI inflows remained at a record high, reaching USD 32 113 million in 2016. After Brazil, Mexico is the second most important market for foreign capital in the region. Mexico also has a unique feature within the region: between 1999 and 2016, 49% of FDI was concentrated in manufacturing. In 2016, this figure reached 61%. The automotive industry is Mexico's most attractive sector, attracting 19% of FDI in 2016. Central America registered a growth in FDI (3.7%). The increase in investments in the two main recipients of the sub-region, Panama and Costa Rica, compensated for the drop in FDI in all other Central American countries. The Caribbean sub-region also saw an increase in total FDI (4.1%), largely explained by the continuous positive trend of the Dominican Republic. The Dominican Republic, which concentrated 55% of all investment in the sub-region, has shown an increasing trend over the last decade. This was confirmed in 2016 with a 9.2% increase in inflows, reaching USD 2 407 million (ECLAC, 2017a).

The predominant sources of foreign investment in Latin America are concentrated in the US and the European Union (France, Germany, Spain, United Kingdom, Luxembourg). However, China played an increasingly important role as a provider of capital to the region in services sectors such as telecommunications, finance and clean energy (Avendano, Melguizo and Miner, 2017). The heterogeneity of capital flows among countries, which includes FDI, portfolio flows and other investment flows, is mainly explained by the global business cycle and by country-specific factors such as better governance, more efficient public institutions, stronger regulatory and legal frameworks, and higher political stability and accountability (IMF, 2017c).

Space for monetary policy might be opening up

Scope for monetary stimulus is opening up thanks to lower inflation rates, although with differences across countries. On the one hand, lower inflation rates in South American economies are widening the space for monetary policy. This is mainly explained by a weaker demand and as the effects of currency depreciation and supply shocks are left behind. This is most notable in Brazil, where inflation breached the mid-range target of the central bank during the first quarter of 2017. Inflation expectations are receding in Argentina, after the adoption of inflation targeting. Annual headline rates remain high and will probably end this year above target, after the surge in 2016 following adjustments in the exchange rate and utilities. Inflation in Colombia also declined; it remained contained in the rest of the Andean countries (Figure 2.9). On the other hand, inflation will uptick in Mexico, driven by currency depreciation and gasoline price adjustments, but also in Central America and Caribbean countries. However, inflation will remain low, considering that many of these countries tend to have less flexible exchange rate regimes. This allows them to avoid the inflationary push of currency depreciation, but at the cost of adapting to external shocks through demand adjustment rather than exchange rate fluctuations.

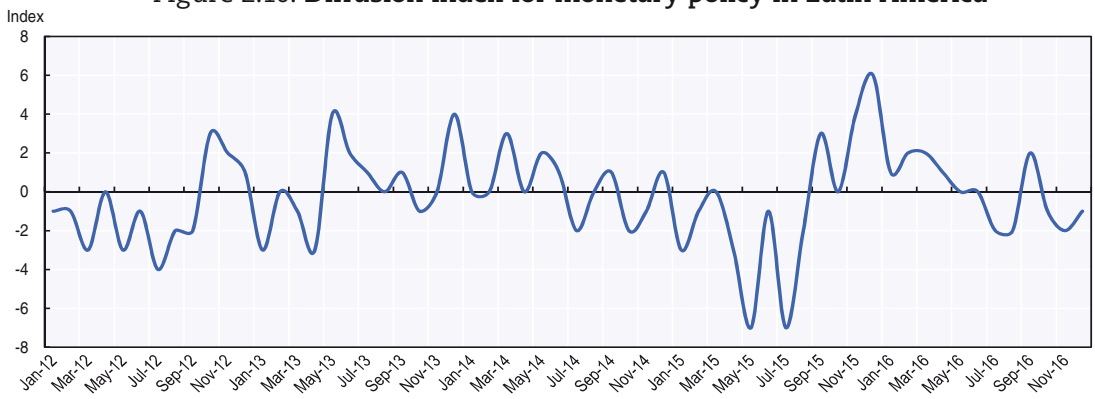
Figure 2.9. **Inflation rates in selected Latin America and Caribbean economies**



Source: OECD/CAF/ECLAC based on IMF (2017a), *World Economic Outlook database*, and OECD (2017a), *OECD Economic Outlook*, Vol. 2017/1, OECD Publishing, Paris for Brazil, Chile, Colombia, Costa Rica and Mexico. OECD (2017c), *OECD Multidimensional Economic Survey on Argentina*, OECD Publishing, Paris for Argentina.
StatLink http://dx.doi.org/10.1787/888933650342

By mid-2016, the number of central banks loosening monetary policy in the region started to outstrip the ones tightening (Figure 2.10). A more neutral stance for monetary policy will likely be more supportive in the coming quarters, considering that most countries are still running negative output gaps. Mexico is an exception as peso depreciation and gasoline price adjustments in 2017 pushed prices up, forcing the central bank to increase rates. Central banks must tread carefully, considering possible bouts of global financial volatility or a faster-than-expected monetary normalisation in the US, which would trigger currency depreciation in the region.

Figure 2.10. **Diffusion index for monetary policy in Latin America**



Notes: The diffusion index measures the number of countries that increase interest rates net of those that lower them for each period. Countries included: Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Paraguay, Peru, the Dominican Republic, Uruguay and Venezuela.
Source: OECD/CAF/ECLAC based on central bank data.
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Space for fiscal policy is still limited

Fiscal space remains limited as debt keeps increasing, while structural primary balances remain below the level necessary to stabilise debt. Average deficit slightly deteriorated in 2016 and debt levels continued to increase. However, fiscal performance was uneven across countries. While primary balances improved in countries like Mexico, Colombia and Barbados, they deteriorated in Brazil, Uruguay, and Trinidad and Tobago. Highly indebted countries with elevated tax pressures must undertake further measures to stabilise debt by reallocating expenditure from current to capital as indicated in previous editions of the *Latin American Economic Outlook* (OECD/CAF/ECLAC, 2016). They must also focus on efficiency of spending to guarantee and improve public goods (see Chapter 4). Spending caps and social security reform were announced in Brazil to curb high deficits and restore credibility. Argentina will gradually adjust spending, benefiting from renewed access to international capital markets and low debt levels in the hands of private markets. However, advances in fiscal consolidation from 2018 onwards will be critical to restore credibility and stabilise debt. Barbados and Trinidad and Tobago will continue fiscal consolidation. The situation in Barbados is more delicate since debt levels surpass 100% of GDP and the primary deficit reduction stalled (Figure 2.11).

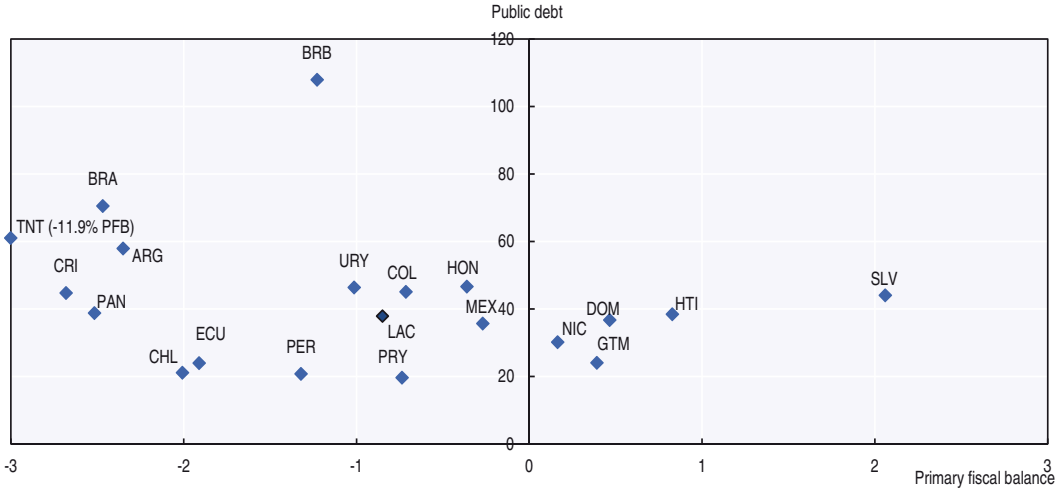
Countries with moderate debt levels and lower taxes to GDP ratios may benefit from tax reform. This could help them avoid cuts to spending, particularly investment with higher multiplier effects. In some cases, depending on the need of fiscal consolidation, economies must both reform taxes and decrease public spending to stabilise public debt. At the same time, they must improve efficiency of public expenditure to guarantee investment and necessary social programmes. So far, adjustments have cut capital expenditure rather than current expenditure (OECD/CAF/ECLAC, 2016).

With respect to fiscal reforms there is some progress in the region (Powell, 2017). There were advances in Mexico, Ecuador, Chile and Colombia. However, fiscal reform is politically challenging as the experience in Colombia shows (Box 2.4). In the case of Ecuador, financing needs have been around 8% of GDP over the past three years. Therefore, further fiscal effort is needed to stabilise debt in the country. Uruguay also has high debt levels, but fiscal balances are moderate. Peru and Chile have more space for countercyclical action than other countries. Chile recently increased social spending to support growth, notably on health and education. Public debt increased rapidly, though higher non-copper revenues from the 2014 tax reform and Chile's structural fiscal rule

allow for gradual fiscal consolidation (OECD, 2017b). In the case of Peru, the government is also using the available fiscal space to stimulate the economy, although it expects to reduce the deficit by 2021 to comply with the fiscal rule.

Figure 2.11. **Gross public debt and primary fiscal balance in selected Latin American and Caribbean countries, 2016**

Central government, percentage of GDP



Note: Estimates for 2016. LAC is a simple average for the 17 economies used. For Mexico, primary balance refers to non-financial public sector, for Peru to general government. For Ecuador, this is net debt (with the private sector), while in Argentina it is gross debt. For Trinidad and Tobago, and Barbados, both figures are general government.

Source: OECD/CAF/ECLAC based on OECD/ECLAC/CIAT/IDB (2017), *Revenue Statistics in Latin America and the Caribbean 2017*, ECLAC (2017b), *Fiscal Panorama of Latin America and the Caribbean 2017: Mobilizing resources to finance sustainable development* and IMF (2017a), *World Economic Outlook Database*, April 2017.

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Box 2.4. **Tax reform in Colombia: What was achieved and what remains to be done**

Passing a comprehensive reform to increase revenue and improve the efficiency and equity of the tax system is not an easy task. Wide-ranging tax reforms inevitably encounter substantial opposition on a number of fronts. It is particularly hard to ensure a comfortable majority in Congress to ensure their approval.

Subject to political support and informal lobbying, the government of Colombia has limited the scope of the tax reform proposals before submitting them to Congress. Between 2010 and 2016, four tax reforms of limited scope were enacted.

The tax reform approved in December 2016 entails an adjustment from distortionary taxes to less distortionary taxes, which are expected to have a positive impact in terms of formalisation and economic growth. The reform should yield enough revenue until the end of the current administration (0.7% and 0.5% of GDP in 2017 and 2018), but falls short of what is needed to fulfill the fiscal needs and to ensure the fiscal adjustment in the long run. The gap between the required revenue and the tax reform revenue increases from 0.9% to 2.2% of GDP over 2018-20 (Table 2.1).

The gains obtained by the hike in value added tax (VAT) rates would be gradually offset by the reduction in direct taxation. The general VAT rate was raised from 16% to 19% (probably the most politically costly element of this reform). Along with other minor

Box 2.4. **Tax reform in Colombia: What was achieved and what remains to be done** *(cont.)*

adjustments in consumption taxes, this would yield 1.0% GDP annually. Conversely, adjustments in direct taxes would have a negative impact, which starts at -0.2% in 2017 and adds up to -1.0% of GDP in 2020.

The original tax proposal aimed to reduce the excessive reliance on tax payments from corporations, while increasing taxes on individuals. However, in its passage through Congress the proposal to increase the income tax base for individuals was rejected, while a watered-down reduction on corporate income tax was approved. The maximum corporate income tax rate went from 40% to 33% over 2017-19. Colombia also made other adjustments to corporate taxes that had a negative impact on tax collection. These included a new deduction of the VAT paid on capital goods and elimination of the equity tax from 2018 onwards. The reduction in revenue due to these changes increases from 0.2% to 1.2% of GDP annually from 2017 to 2020.

Adjustments on personal income taxes did not have a significant impact on revenue. The main changes were the elimination of the previous exemption of dividends from personal income tax and increases on the tax rates applied to non-labour income. The additional revenue raised by these changes would amount to 0.2% of GDP annually.

The 2016 tax reform included some positive aspects to increase the efficiency and effectiveness of the taxation system, but further adjustments are still needed. The most welcome changes include integrating the CREE (a special corporate tax) and the CREE surtax within the corporate income tax; bringing the statutory corporate tax rate closer to the OECD average; ending the business wealth tax as planned; introducing a dividend tax at the shareholder level; reforming the tax treatment of non-profit organisations; and substantially improving tax administration and penalties for tax evasion. However, some key recommendations by the OECD were not retained. These included expanding the personal income tax base, ensuring the progressivity of the taxation system and eliminating the financial transaction tax (OECD, 2017d, 2013a).

There seems to be little space for further cuts in spending. The medium-term fiscal framework already reduces central government investment levels to 1.7% of GDP from 2018 onwards; during the past five years, it was kept to around 2.8% of GDP. Therefore, a new tax proposal could be expected in the near future, with a new administration.

Table 2.1. **2017 tax reform: Additional revenue (percentage of GDP)**

	2017	2018	2019	2020
Tax reform: additional revenue	0.7	0.5	0.2	0.1
VAT and other consumption taxes	0.9	0.9	1.0	1.0
Direct taxes	-0.2	-0.5	-0.8	-1.0
Individuals	-0.1	0.2	0.2	0.2
Corporations	-0.2	-0.7	-1.0	-1.2
Central gov deficit w/tax reform	3.6	3.6	3.8	3.8
Fiscal rule CG target	3.6	2.7	2.2	1.6

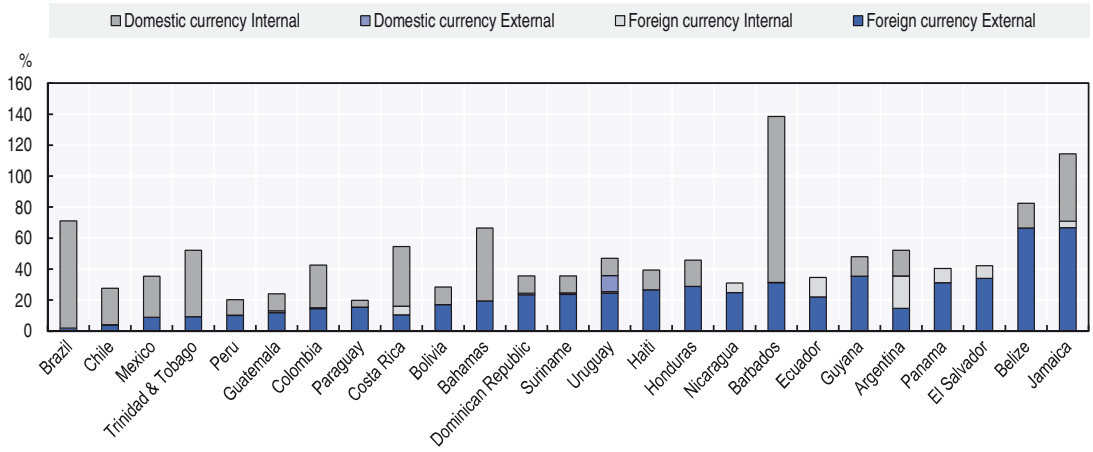
Source: OECD/CAF/ECLAC based on Fedesarrollo.

Fiscal rules may also be helpful to enhance credibility and attain stabilisation. Fiscal rules are associated with a more stabilising role for fiscal policy (Alberola et al., 2016). Structural fiscal rules allow more space for countercyclical action as the observed deficit may temporarily adjust while attaining the structural target. The debt, however, may take longer to stabilise. Rules based on the observed deficit are easier to implement and may help stabilise debt faster. However, they reduce space for countercyclical actions.

High volatility in exchange rate markets could further limit fiscal space. This is especially the case in economies with a large percentage of public debt in foreign currency such as Argentina (68%) or the Dominican Republic (69%). On the contrary, economies such as Brazil (3%), Chile (14%) or Mexico (25%) have small percentages of public debt in foreign currency and are less exposed (Figure 2.12). Small economies are not large enough to fund public debt internally and must recur to foreign markets. For their part, large economies can fund a larger share of debt internally.

Figure 2.12. **Public debt by currency and legislation, circa 2016**

Percentage of GDP, central government



Source: OECD/CAF/ECLAC based on IDB, *Standardized Public Debt Database*.

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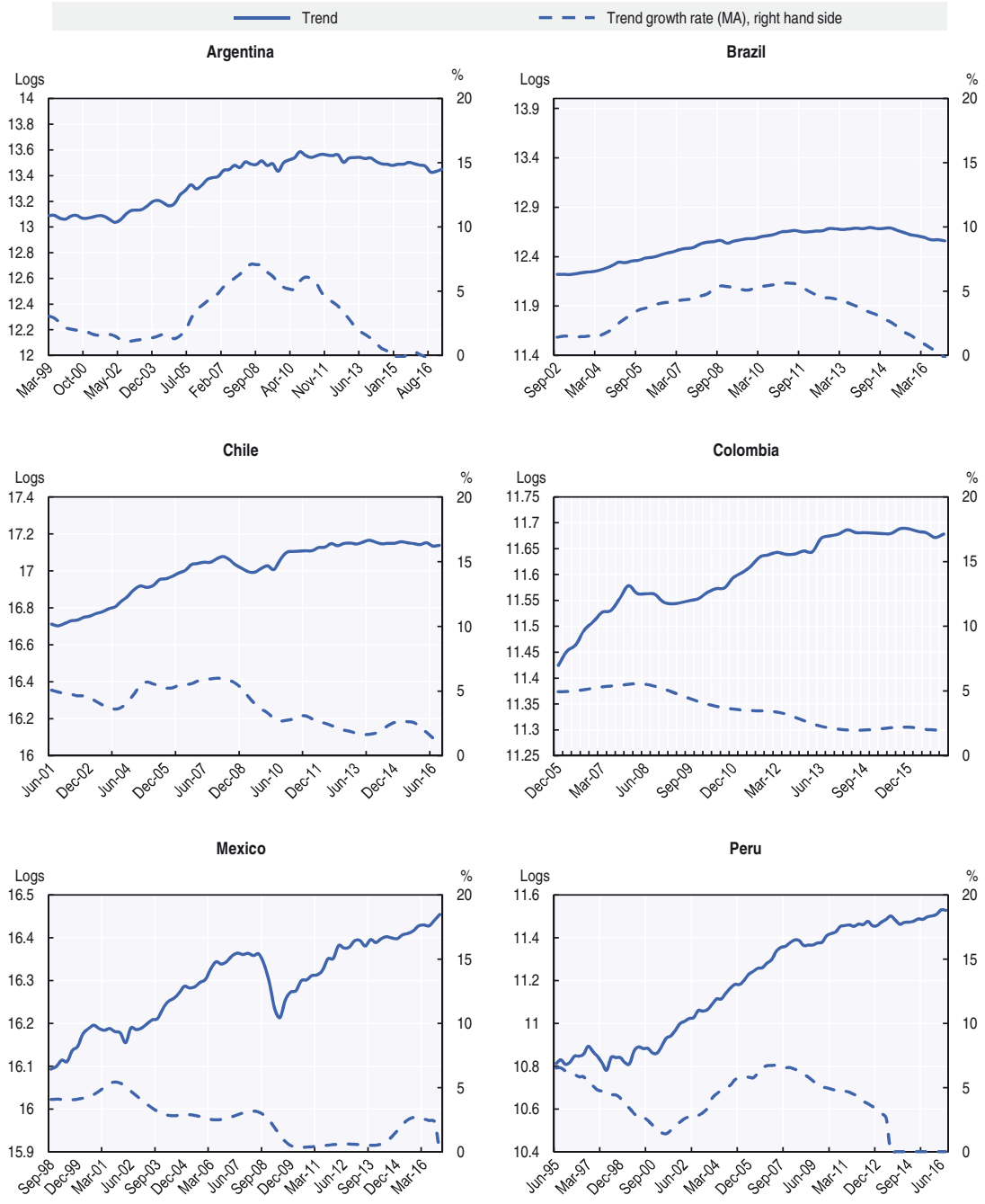
Institutions and openness matter

Growth potential is lower than expected in Latin America and the Caribbean

In spite of the region's cyclical heterogeneity in the short term, trend output has slowed down since 2011 across the region. Medium-term growth projections suggest that potential output in Latin America is less robust than previously thought. Evidence indicates that potential growth is lower than expected, close to 3%. This stands in sharp contrast to the 5% average annual growth rate that characterised the mid-2000s, as highlighted in previous editions of the *Latin American Economic Outlook*. Although the slowdown is common across the region, some heterogeneity exists across countries. For instance, both the magnitude and the date of the fall in potential output growth (trend growth rate) differ across economies of the region (Figure 2.13).

Figure 2.13. **Potential output, GDP trend and GDP trend growth in selected Latin American economies**



Note: See OECD/CAF/ECLAC (2016) for estimation details.
Source: OECD/CAF/ECLAC based on national official sources.
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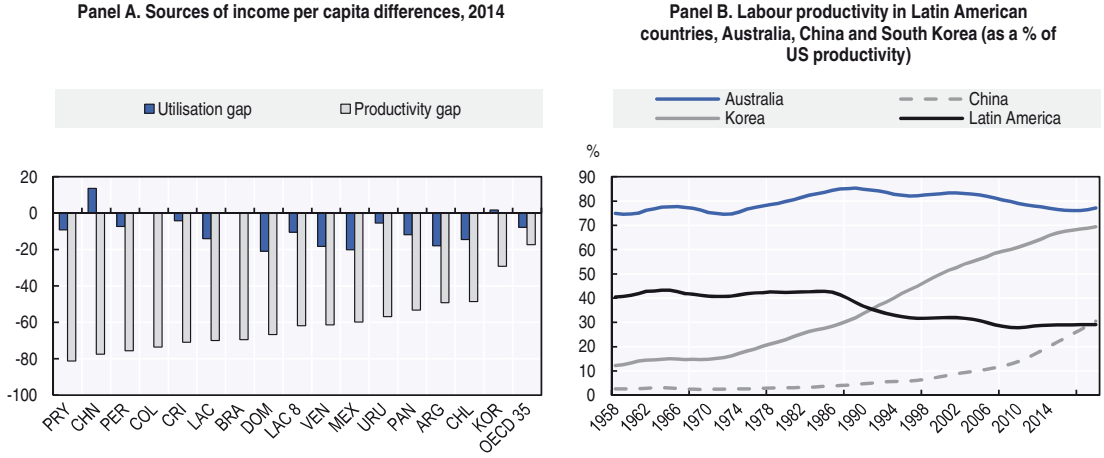
Part of the slowdown is the response of a cyclical retrenchment in investment, as highlighted in OECD/CAF/ECLAC (2016). However, part of the slowdown is also structural. On the one hand, the average investment rate in Latin America reached its lowest point since 2003. Investment accounted for only 19.5% of GDP in 2016, 20.3 percentage points below the average rate of emerging and developing Asia (IMF, 2017a). The regional

average hides a wide dispersion among countries as economies such as Colombia, Nicaragua or Panama invest clearly above the regional average. On the other hand, the region's low productivity and its inability to attain higher income levels is explained by the absence of a more profound process of structural change towards innovation and more knowledge-intensive production. Labour and capital do not easily mobilise from low-productivity firms to high-productivity firms in the region. Around 55% of the working population is employed in the informal sector. Even during expansions, the transition probability from informality to formality remains low (CAF, 2013). This is a major structural drag on productivity. Reallocating capital and labour from low-productivity firms, a key characteristic of informal firms, to high-productivity formal firms could increase total factor productivity between 45% and 127% in Latin America, depending on countries (Busso, Madrigal and Pagés, 2013). Furthermore, Latin American economies present a harder stringency of Product Market Regulation (PMRs) than OECD economies. This acts as a barrier to business dynamism, and labour and capital reallocation. The differences between Latin America and the OECD in PMR are mainly explained by the complexity of regulations and the administrative burdens on start-ups (Barbiero et al., 2015; OECD/CAF/ECLAC, 2016).

The scant contribution of productivity to growth in Latin America is at the heart of the growth gap between the region, the OECD and fast growing Asian economies. Low labour productivity in Latin America explains 70% of the GDP per capita gap between the LAC region and the upper half of OECD economies (Figure 2.14, Panel A). There are important differences across countries. In Paraguay, Colombia and Peru, the productivity gap explains over 75% of the income gap. In Argentina, Chile and Panama, the gap amounts to around 50%. Moreover, labour productivity, measured by GDP produced by an hour of labour, has been declining over the past decade in Latin America, relative to more advanced economies. On average, in 2016, labour productivity in Latin America was merely one-third of labour productivity of the US, even lower than 60 years ago. This is in stark contrast to the performance of high-growth countries in Asia, such as South Korea or more recently China, where relative productivity has surged in recent decades (Figure 2.14, Panel B).

Figure 2.14. **Labour productivity in Latin America, China and the OECD**



Notes: Panel A: Compared with the simple average of the 17 OECD member countries with the highest GDP per capita in 2014 at 2011 purchasing power parities (PPPs) (in mil. USD 2011). The sum of the percentage difference in labour resource use and labour productivity does not add up exactly to the GDP per capita difference since the decomposition is multiplicative. Labour productivity is measured as GDP per employee. Labour resource utilisation is measured as employment as a share of population. Panel B: Share of the US productivity, five-year moving average, PPP.

Source: OECD/ECLAC/CAF based on Feenstra, R., R. Inklaar and M. Timmer (2015), "The next Generation of the Penn World Table", *American Economic Review*, 105(10), 3150-3182, available for download at www.ggdc.net/pwt and Conference Board (2016), *The Conference Board Total Economy Database*.

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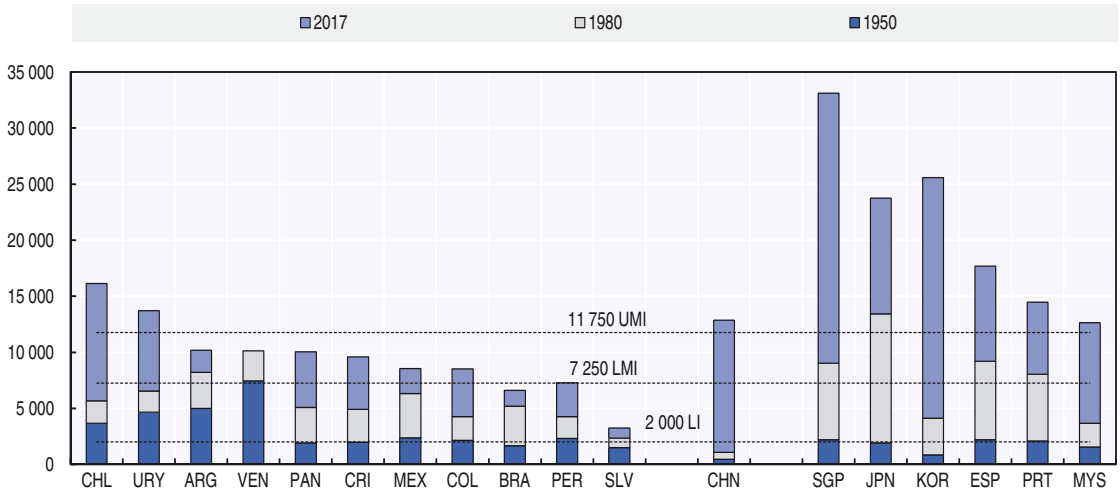
The region needs to address various bottlenecks to overcome the middle-income trap

As Latin American countries reached middle-income levels, growth exhibited a long-lasting slowdown (Felipe, Kumar and Galope, 2017). This is known as the middle-income trap (MIT): after the rapid growth registered at early stages of development, growth stalls as countries reach mid-income levels (Eichengreen, Park and Shin, 2011; Felipe, Abdon and Kumar, 2012; Zhuang, Vandenberg and Huang, 2012; Aiyar et al., 2013; OECD, 2013b). Growth in low-income countries occurs largely when labour is reallocated from low- to high-productivity activities and industries. On the other hand, at middle-income levels countries usually require new engines of economic growth based on capital- and skill-intensive manufacturing and service industries (Kharas and Kohli, 2011).

So far, only Chile, Trinidad and Tobago, and Uruguay have managed to escape the MIT in Latin America as shown in OECD/CAF/ECLAC (2016), following Felipe, Abdon and Kumar (2012) methodology (Figure 2.15). The trap has affected the rest of the region's economies, most of which have suffered recurring episodes of per capita income stagnation, particularly after the 1980s.

Figure 2.15. **Latin America and selected middle-income trap evaders**

GDP per capita, USD PPP 1990



Note: UMI = upper-middle income; LMI = lower-middle income; LI = low income.

Source: OECD/ECLAC/CAF based on Felipe, Abdon and Kumar (2012) and Felipe, Kumar and Galope (2017). Data extracted from International Monetary Fund, *World Economic Outlook Database* (April 2017) www.imf.org/external/pubs/ft/weo/2017/01/weodata/index.aspx and Madison (2010) database www.ggdc.net/maddison/.

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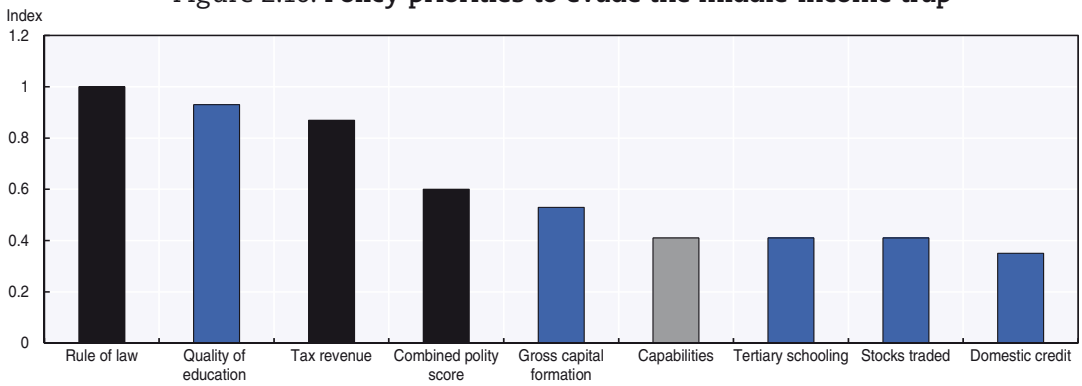
Strong institutions and trade play a key role in overcoming the middle-income trap. Weak institutions might not have an impact at low-income levels, but could dampen growth in middle-income economies (World Bank, 2017a). Further evidence suggests that economies that are successful in overcoming the MIT have rule of law, solid state capacities in the form of sufficient tax revenues and strong democracies (Figure 2.16). Similarly, more open economies have a higher probability of evading the MIT. In this case, countries' ability to export high added-value goods is key to transition from middle to high income. Other key characteristics of countries that have evaded the MIT are the quality of education, an adequate supply of skills, adequate investment levels and developed capital markets (Melguizo et al., 2017; Box 2.5).

Figure 2.16. **Policy priorities to evade the middle-income trap**



Note: Ranking of importance from left to right (Box 2.5).
Source: Melguizo et al. (2017).
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Box 2.5. **Policy priorities to overcome the middle-income trap in Latin America**

The empirical literature on development has identified a "middle-income trap" (MIT) as developing economies struggle to adjust to new sources of growth after reaching middle-income levels. For Latin America, this is an especially challenging scenario. Only Chile, Trinidad and Tobago, and Uruguay have become high-income economies in the last six decades. Meanwhile, several other LAC countries, already middle-income as early as 1950, stayed in that income range.

To determine the main policy priorities to overcome the MIT, Melguizo et al. (2017) undertake a linear discriminant analysis that contrasts the experiences of 76 emerging economies and OECD member countries (14 Latin American economies). They compare those that evaded MIT and those that have stayed there since the 1950s. Based on more than 200 000 estimations, their research identifies the top ten variables that best separate upper-middle income (UMI) and high-income (HI) countries evaluated at their "graduation" from the middle-income trap. These variables are rule of law, quality of education, tax revenues, age dependency, degree of democracy, total investment, capabilities (economic complexity index), value of stocks traded, domestic credit provided by financial sector and percentage of complete tertiary education (Figure 2.16).

The study emphasises that the current socio-economic and institutional features of each UMI country and past characteristics of some HI countries are more useful and relevant than others. Consequently, policy priorities differ across economies, and there is no unique development path. Reinforcing their "no one size fits all" argument, they include a synthetic control method for a select group of Latin American countries. In this way, they identify their main policy gaps according to their unique characteristics. This is particularly relevant in a context where budget constraints oblige focusing on a select group of policies that contribute to overcoming the middle-income trap.

Boosting productivity and potential output through trade

The link between trade, productivity and inequality

The relationship between trade and productivity has been examined extensively in economic literature, looking at both different benefits and potential downsides. Following the comparative advantage approach and endowments-based models, the "new trade" theory aimed at understanding the effects of trade structure on firm productivity

(Krugman, 1979). In this perspective, trade liberalisation can raise productivity thanks to the effects of higher competition from imports and a greater variety of intermediate inputs. Following this seminal work, the relationship between productivity and trade has been later explained in the literature through learning-by-doing models (Krugman, 1987), research and development (R&D) spillovers (Rivera-Batiz and Romer, 1991; Grossman and Helpman, 1991), the variety of intermediary inputs (Feenstra, 1994) and exposure to foreign markets (Clerides, Lach and Tybout, 1998).

More recently, the linkages between trade and firm-level productivity have been explored. These consider the effect of firm heterogeneity and the higher efficiency of exporters over non-exporters (Melitz, 2003). As a result of trade liberalisation, only the most productive firms will continue to expand their market share thanks to higher productivity and increasing competition in product markets. Meanwhile, less productive firms exit. More recently, the role of exports on entrepreneurship has been studied, particularly in the context of Latin America (Eslava et al., 2012; Fernandes, Lederman and Gutierrez-Rocha, 2013).

Other potential benefits from trade have been proposed to advocate for trade openness and the overall process of globalisation. Trade and growth are related: relatively open economies grow faster than relatively closed ones. Further, salaries and working conditions are generally better in companies that trade compared with those that do not (OECD, 2012). Trade can provide gains for households through reduced prices and increased choice. Also, trade-related activities, such as *outsourcing* and *offshoring,* can play a key role in boosting growth and raising salaries. Evidence suggests that reducing trade barriers could impact positively on jobs, real wages and exports. FDI-enhanced trade can also bring technological spillovers for domestic firms. In recent years, efforts for understanding the trade-productivity nexus have focused on other firm-level mechanisms. These include learning-by-doing, access to better inputs, organisational improvements at the firm, access to larger markets, and re-allocation or redistribution of resources (Carballo, 2017).

Today, the gains from increasing trade have been questioned, especially in OECD economies. There is the perception that trade can be beneficial for some, especially among certain income groups, but detrimental to others. Global inequality has declined, thanks to the strong income growth of the vulnerable and the middle class in developing and emerging economies, including most of Latin America (Milanovic, 2016). Trade has delivered unprecedented access of goods and services for households in low- and middle-income economies. At the same time, in some OECD member countries, the middle class has not experienced the same expected gains from trade in recent years (OECD, 2017e). Overall, it appears that the ability to reap the trade benefits to reduce inequality is dependent on country specific characteristics and circumstances (IMF, 2017b).

There is a growing gap in productivity and wages between exporting and non-exporting firms. These effects can be heterogeneous across firm size and productivity (Criscuolo and Timmis, 2017a). Moreover, expanding cross-border trade seems to benefit more the skilled, better educated and wealthier individuals in many countries. From the investment perspective, multinational enterprises (MNEs) can be excessively large for small economies and influence the countries' regulatory framework for their own interest. For example, MNEs can shape the investor-state dispute settlements (ISDS) provisions. Together with a mistrust towards unbalanced trade relationships in goods and services, financial interconnectedness can be seen as a detrimental effect and a factor for vulnerability.

There is also a concern, more pronounced in OECD member countries, that trade openness may cause a "race to the bottom" in labour standards (Head and Ries, 2003), environmental regulation and consumer protection (OECD, 2017e). In Latin America, the gains from trade have been more visible when considering the role of commodity exports in improving household revenues across the whole income distribution. Some sectors, however, did indeed lose owing to trade competition, particularly manufacturing.

All in all, the notion that trade systematically implies improvements in living standards deserves further reflection today. Therefore, it is important to provide better answers, not only for improving the region's trade performance, but also for the institutional frameworks where trade policies are implemented. A first step in this direction is to favour an environment where the benefits from trade can materialise through domestic policies. One approach, for example, would be reducing the costs imposed on trading firms, particularly small and young firms, so they can participate in international trade. This would involve ensuring access to efficient and affordable services that guarantee firm competitiveness, which is not the case in Latin America. A second step is to guarantee equality towards trade opportunities for all the population, which goes beyond labour market conditions. On the one hand, this involves active labour market and skills policies. On the other, regional policies could improve, for example, connectivity to local communities and reduce territorial disparities. A third step consists of improving the institutional frameworks for trade, which includes adopting multilateral rules, guidelines and codes. Broader co-operation agreements, including a wider range of issues beyond trade such as transparency, investment, movement of people and competition (the "progressive" provisions), will be essential (OECD, 2017e).

Navigating a more challenging scenario for trade and globalisation

The trade scenario for Latin America has turned increasingly complex. Although global trade has revived in the past year, it remains less robust than in pre-crisis decades. Furthermore, trade and globalisation have been under pressure as there is a growing concern around the world that the benefits from trade and globalisation are not shared by all and that this needs to be fixed (OECD, 2017e). New data sources suggest that people are questioning the achievements, usefulness and global architecture of trade and globalisation (Box 2.6). Overall, there is growing fear that these concerns might lead to a rise in protectionism.

Concerns on growing protectionism are on the rise in G20 economies, but evidence suggests to the contrary. An indication of countries' concern is the use of trade remedies. Between July 2013 and June 2016, World Trade Organization (WTO) members took 507 anti-dumping actions, 43 countervailing measures and introduced 36 safeguards (OECD, 2017f). Although the rhetoric on protectionism might be increasing, G20 countries have not significantly increased the number of new trade-restrictiveness measures over the past decade. Since 2009, G20 economies have applied on average seven new trade restrictive measures per month (compared to an average of six trade-facilitating measures). This is slightly higher than the average from October 2016 to mid-May 2017 of six new trade restrictive measures per month (WTO/OECD/UNCTAD, 2017).

Box 2.6. **Tracking globalisation in real time using Big Data**

The global trade slowdown and trade protectionism have become main concerns for many policy makers. Concerns mount as trade has been one of the main growth drivers over the past few decades. Its recent stagnation has raised questions on whether these are cyclical or permanent trends, and their potential impact on growth.

This box proposes a new way to measure the extent of trade protectionism and the recent global trade slowdown. The global trade trend is tracked in real time using Big Data analysis (Ortiz and Rodrigo, 2017) with information from the Global Database of Events, Language and Tone (GDELT) (Leetaru and Schrodt, 2013). GDELT is an open-source database that extracts and analyses digital news in broadcast, print and web media globally in over 100 languages on a daily basis. Using different dictionaries, several thousands of taxonomies

Box 2.6. **Tracking globalisation in real time using Big Data** *(cont.)*

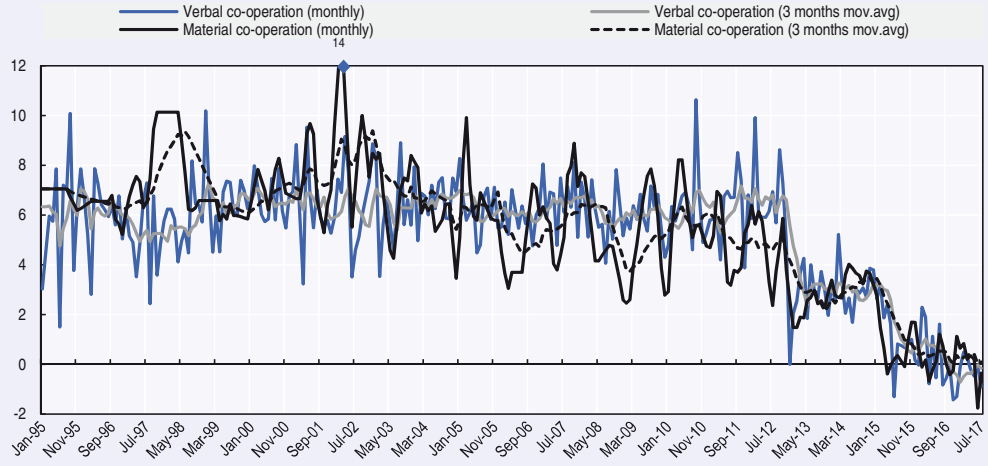
and themes are identified in the news pieces to classify the information. The algorithms used by GDELT also identify thousands of emotions, organisations, locations, news sources and events across the world as well as their average sentiment. Every processed event in GDELT is coded using the Conflict and Mediation Event Observations (CAMEO) event coding system developed by Schrodt and Yilmaz (2007). CAMEO is a broadly used coding scheme to systematise analysis of political and social events and divide them in a scale ranging from material and verbal co-operation to verbal and material conflict.

Using the CAMEO taxonomy in GDELT, BBVA Research developed the "Trade Support index" to track events related with verbal and material co-operation associated with the World Trade Organization (WTO) in the media. Verbal co-operation is associated with events categories that range from making a public statement to engaging in diplomatic co-operation (1 to 5 categories in the CAMEO taxonomy) where WTO is the actor. Material co-operation refers to events in CAMEO categories that range from engaging in material co-operation to easing restrictions (6 to 8 categories in the CAMEO taxonomy) where WTO is also the actor too.

The BBVA Research Trade Support index (from January 1995 to July 2017) measures the media sentiment of articles where verbal and material cooperative events relative to trade are identified. To analyse sentiment, GDELT use "directional" word lists measuring words associated with positive and negative tone as proposed by more than 40 dictionaries and translating each article into English. GDELT uses Natural Language Processing (NLP) techniques to compute the average "tone" of all documents containing one or more mentions to the events in question. The score ranges from -100 (extremely negative) to +100 (extremely positive), although common values range between -10 and +10, with 0 indicating neutral.

The results show that both the trade verbal and material co-operation have maintained a positive tone or sentiment until the recent period when both components have become more neutral. However, the trade material co-operation sentiment deteriorated gradually from the beginning of the century in 2003 and accelerated its fall in 2012, after the financial crisis erupted. At that point, verbal co-operation sentiment joined the sharp deceleration (Figure 2.17). Thus, although protectionism is in the spotlight after a worsening of trade support in 2012, some warning signals from the Material Co-operation index began earlier. The index also shows that it is a worldwide phenomenon, with the People's Republic of China and the US hit most severely by protectionism. Mexico and, particularly Brazil, have been the Latin American countries most affected by the rise of protectionism, according to the index.

Figure 2.17. **Global Trade Support Index in real time**



Source: www.gdelt.org and BBVA Research.

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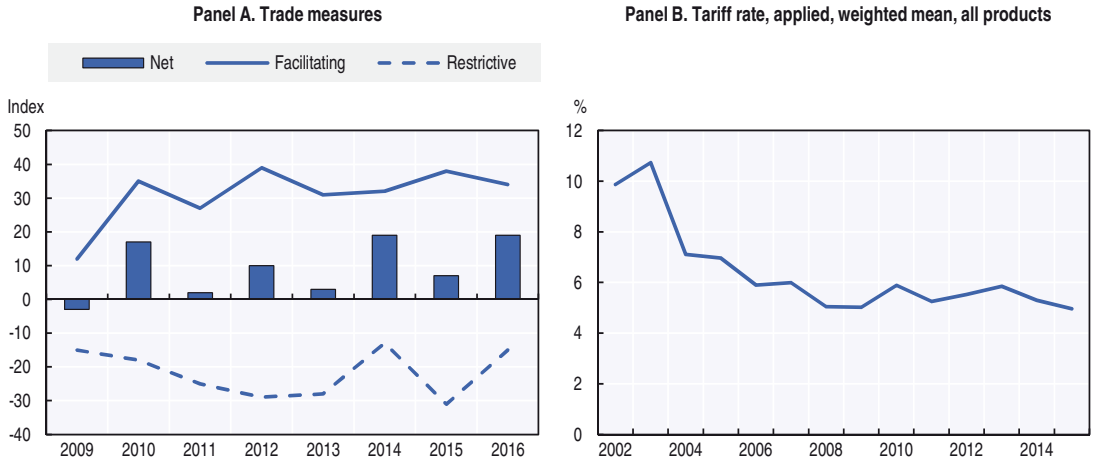
Against a challenging trade scenario, evidence suggests that Latin American economies have continued to open up to international trade. Since 2010, the three Latin American economies that form part of the G20 (Argentina, Brazil and Mexico) have applied more measures to facilitate than to restrict trade (Figure 2.18, Panel A) (WTO/OECD/UNCTAD, 2017). Brazil has been the most active of the three economies with respect to trade measures. However, Mexico follows a similar trend of facilitating more than restricting trade. Argentina's change in trade policy is also noticeable, with an increasing number of trade facilitating measures. The country recently removed export restrictions on soybeans and other products, and plans to phase out export taxes on a large basket of export products. Estimates on the elimination of export barriers for Argentina indicate an effect of 2%-4% in growth (Nogués, 2008). Similarly, the region has continued reducing trade tariffs. In 2010, on average, all products had an applied tariff rate of around 10%. That rate decreased to less than 5% in 2015 (Figure 2.18, Panel B) (World Bank, 2017b).

Figure 2.18. **Trade facilitating and restricting measures and tariff rates in Latin America vs world economies**



Note: Panel A estimated as the sum of trade facilitating and trade restrictive measures for Argentina, Brazil and Mexico. Panel B estimated as the simple mean of applied tariff rates (weighted by product) for Argentina, Brazil, Chile, Colombia, the Dominican Republic, Mexico, Peru and Uruguay.

Source: WTO/OECD/UNCTAD (2017) and World Bank (2017b), *World Development Indicators*.

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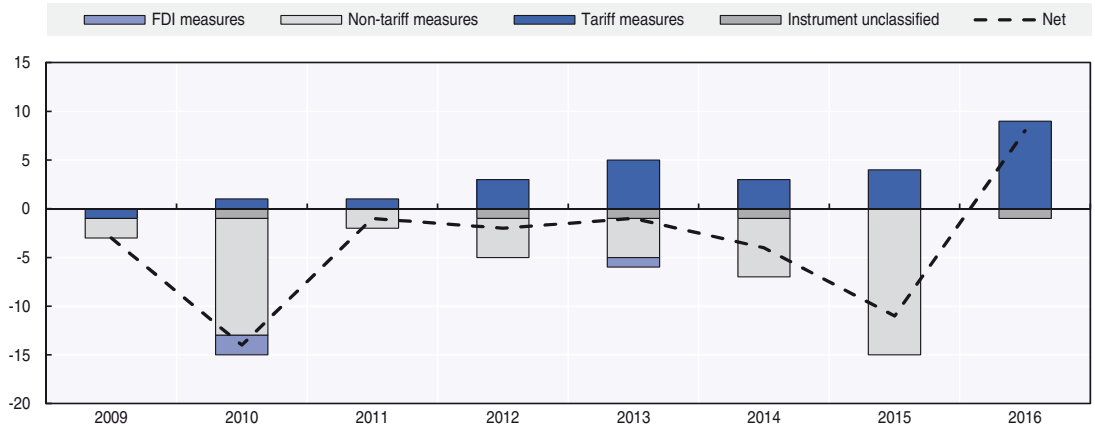
Among Latin American economies, there is no evidence of rising protectionism but non-tariff measures (NTMs) remain as a challenge for further trade openness and regional integration (Figure 2.19). The level of trade and investment measures adopted within LAC economies with their regional peers has remained relatively stable since 2009, with a slightly higher number of trade restrictive measures than liberalising, with the exception of 2016. Among Latin American economies, the majority of implemented trade and investment restrictive measures were NTMs (GTA, 2017).[5] NTMs, including standards, technical regulations and conformity assessment procedures, are not normally aimed at discriminating against imports. However, they can unintentionally undermine trade. In the region, the most prevalent NTMs are associated with non-export subsidies, tariff-rate quotas, local content measures and non-automatic import-licensing procedures. As noted later in this section, there is room for Latin America to improve trade integration by reducing NTM-related barriers and improving harmonisation. On the contrary, the majority of liberalising trade measures were tariff measures, where the region has made considerable progress in reducing tariff rates over the last two decades (Figure 2.18, Panel B).

Figure 2.19. **Net trade and investment facilitating and restrictive measures within Latin America and the Caribbean economies, by type of measure**



Note: Net refers to the sum of trade and investment facilitating measures minus restrictive measures for Argentina, Bolivia, Brazil, Chile, Colombia, Cuba, the Dominican Republic, Ecuador, Mexico, Panama, Peru and Venezuela. Estimates exclude trade remedies according to WTO classification (e.g. anti-dumping measures, countervailing measures and safeguard measures).

Source: OECD/ECLAC/CAF based on GTA (2017), *Global Trade Alert* (database).

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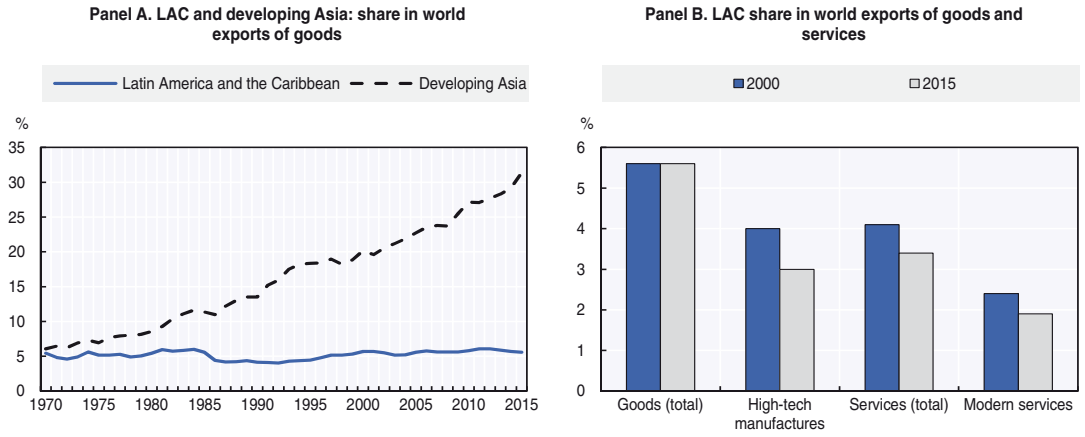
Trade performance must still be improved in Latin America and the Caribbean

There are signs that Latin America has been unable to reap the productivity gains from trade. It has underperformed both in terms of market share and added value over the last decades, according to various indicators. The share of LAC in world exports has stagnated since 1970. The region's participation in world merchandise exports has averaged 5.2% since that year, with minimal variations. It is also below the 6.4% participation of the region to world GDP over the same period (Figure 2.20, Panel A). Such stagnation contrasts with the performance of developing Asia, whose share of world merchandise exports was at similar levels to LAC in 1970 but has steadily grown to 31% in 2015. Moreover, since 2000, the LAC region has lost ground in high technology manufactures and services exports. This includes the so-called modern services such as legal, information and communication technology (ICT) and business (Figure 2.20, Panel B).

Figure 2.20. **Latin American exports as share in world exports**



Note: Developing Asia excludes Western and Central Asia.

Source: OECD/ECLAC/CAF, Panel A based on data from UNCTAD, UNCTADSTAT database. Panel B based on COMTRADE database (goods) and WTO (services).

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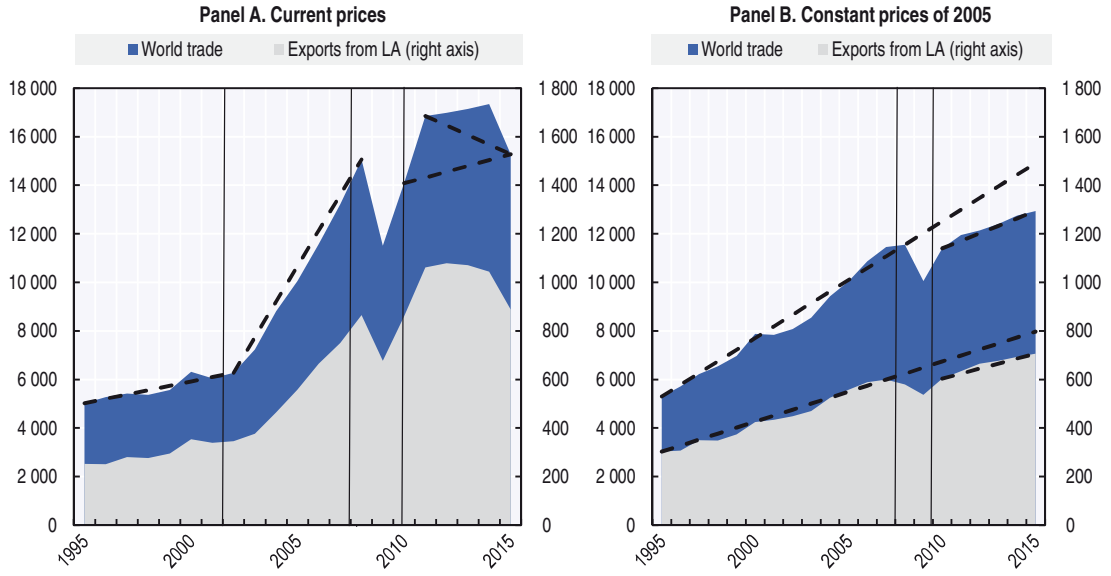
In recent decades, price fluctuations have heavily influenced export performance in Latin America. While price effects have also affected world trade, they have been more acute in the LAC region because of the weight of commodities in most countries' export baskets. For instance, while during 1995-2015 world trade grew 10.2% faster in current than in constant prices, the difference for Latin America was 17.8%. The boom in Latin American exports that preceded the trade collapse of 2008-09 resulted largely from a price effect. Regional exports presented a growth trend of 3.2% from 2009 to 2015 compared with 5.1% per year before the financial crisis (1995-2008) (Figure 2.21) (Giordano, 2016). This suggests the remarkable export growth observed before the financial crisis was mainly due to a hike in commodity prices. The series valued in current dollars (Figure 2.21, Panel A) confirms this analysis. Notwithstanding this, several commodity exporters in the region simultaneously experienced increases in trade volumes.

Figure 2.21. **World trade and Latin American exports**

Billions of dollars, 1995-2015



Note: World trade is defined as imports and includes the flows between Euro Zone countries.

Source: IDB Integration and Trade Sector with data from INTrade/DataINTAL, BACI, BLS, COMTRADE, CPB and UNCTAD.

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Latin America's export performance over the last 20 years points towards a global deterioration of its competitive position. Price incentives have led certain economies to become increasingly specialised in commodities, particularly in low value-added primary products, which constitute one of the least dynamic segments of global demand. Mexico and Central America, where industrial products were more prominent, are the exception. Between 2011 and 2015, the volume of exports of agricultural and mineral primary products grew at relatively high rates (5.1% and 4.9%, respectively). These rates were above those during the pre-crisis period in 2008 (4.5% and 4.6%, respectively). At the same time, exports of agricultural and mineral manufactures, which are more elaborate, fell from 4.7% to 0.7% and 1.3% to 0.1%, respectively. This exacerbated a trend for re-primarisation in the post-crisis period. In agriculture, Latin America holds a significant share of the global market (14.6% in agricultural primary products and 9.7% in

agricultural manufactures). However, these categories have experienced falling relative global demand during the last two decades (-2.0 and -1.7 percentage points, respectively). Furthermore, the trend towards re-primarisation has been pronounced. The region, for example, has a greater global share of lower value-added agricultural primary products (4.3 percentage points) compared with that of more elaborate agriculture manufactures (0.8 percentage points). In contrast, industrial manufactures were the only category that contributed positively to the region's competitive positioning. Latin America increased its global market share by 0.6 percentage points to 4.1% in 2015. The gain was mostly due to Mexico, which accounted for three-quarters of the market share held by the region in this product category. The mismatch between the evolution of global demand and regional export supply underlines the fragile and price-dependent trade performance for most countries. This, in turn, reinforces the need for a diversification agenda (Giordano, 2016).

Trade diversification and higher value added remains a challenge

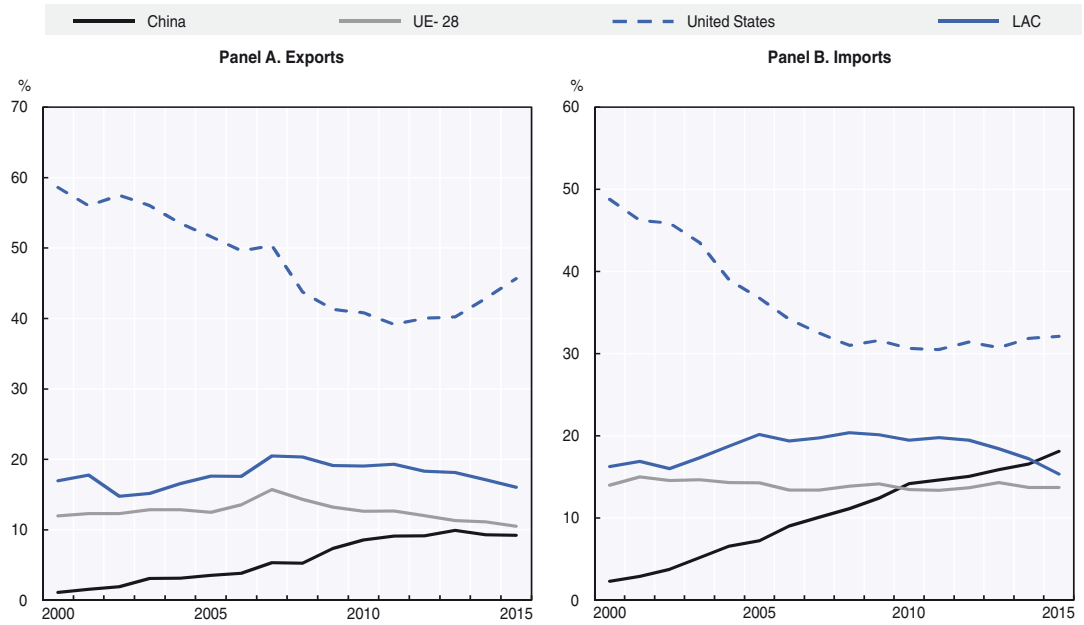
LAC's trade remains concentrated in a handful of its larger economies. Over the last 15 years, more than 70% of total exports and imports have been concentrated in five countries: Argentina, Brazil, Chile, Mexico and Venezuela. Furthermore, Mexico has remained the region's largest exporter and importer, followed by Brazil. In 2015, these two economies accounted for more than 62% of the region's exports and 57% of its imports. Argentina (6.2% of exports and 5.7% of imports), Chile (6.9% and 6.1%) and Venezuela (4.0% ad 3.2%) accounted for a smaller share. A comparison of gross exports with exports in value added for these countries in 2011 shows a similar concentration pattern.

In aggregate terms, LAC continues to trade with the same partners, but new relationships are emerging. Over the last 15 years, the US has remained the region's top trade partner for both exports and imports. However, China has recently emerged as a key partner for the region (OECD/CAF/ECLAC, 2015). While its share in LAC's exports has remained at around 10% over the last three years, China continues to gain ground as an import supplier (Figure 2.22). The share of the European Union in the region's trade has remained mostly flat. Meanwhile, LAC's share in world trade has fallen in recent years owing to the weak performance of intra-regional trade, especially in South America. The trade patterns of Mexico and of the rest of the region continue to be very different. For Mexico, the US remains the dominant trade partner, especially for Mexican exports. For the rest of the region, the main partner is the region itself (with almost a quarter of total exports and imports), followed by the US (with about a fifth of the total). China, which accounts for just 1% of Mexican exports, absorbs 15% of the exports from the rest of the region. By contrast, China is the origin of 18% of imports for both Mexico and the rest of LAC.

The diverging trends followed by South America and Central America reflect both sub-regions' different export patterns. Increased trading links with China and the rest of Asia exacerbated South America's already high dependence on commodity exports, against the background of the commodity supercycle of 2003-11. By contrast, Central American countries and the Dominican Republic have deepened trade and production links among themselves, as well as with Mexico and the US. The development of regional value chains has been supported by the Dominican Republic-Central American Free Trade Agreement (CAFTA-DR) and the Central America-Mexico Free Trade Agreement. Participation in manufacturing networks has allowed Central American countries (Costa Rica being the clearest example) to enter new niches and gradually diversify their exports.

Figure 2.22. **Share of selected partners in Latin America and the Caribbean merchandise trade**

Percentages



Source: OECD/ECLAC/CAF, based on COMTRADE.

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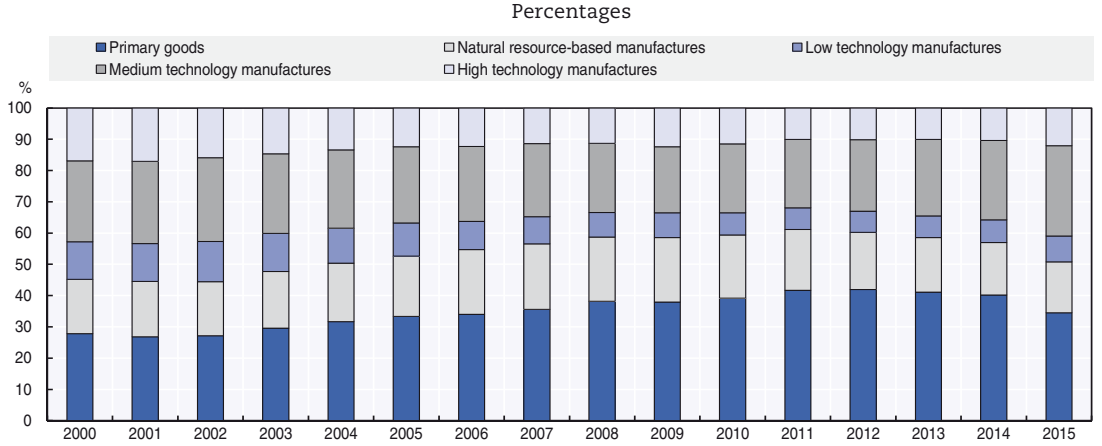
With respect to the region's export basket, the most important change since 2000 was the increased share of primary goods. It climbed from 28% to a peak of 42% in 2012 (Figure 2.23). This reflected high commodity prices during most of that period, but also increased exported volumes that responded to sustained demand from China. Since 2013, the end of the commodity supercycle and subdued Chinese demand reflected in a decreasing share of primary goods in the region's export value, reaching 35% in 2015. Medium-technology manufactures, the second most important export category for the region (and the top one for Mexico), have made an important recovery in recent years. After falling from 26% to 21% over 2000-09, their share in total exports has rebounded, standing at 29% in 2015.

Figure 2.23. **Composition of exports by technology intensity in Latin America and the Caribbean**

Percentages



Source: OECD/ECLAC/CAF, based on COMTRADE.

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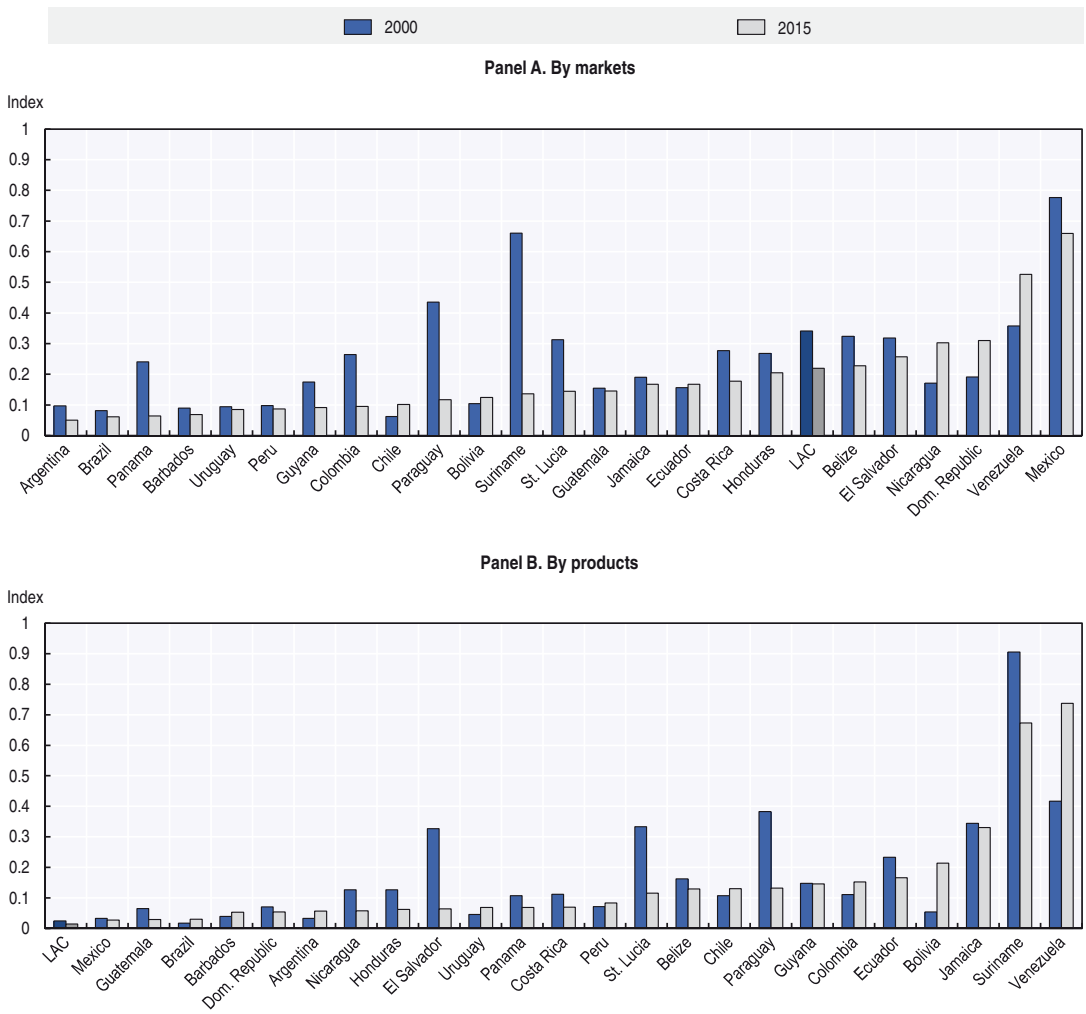
In the last 15 years, the region's exports have become considerably less concentrated in terms of market destination, but more concentrated by product. The Herfindahl-Hirschman index (HHI), a standard measure of trade concentration, shows that only 6 of 24 countries for which data were available decreased their concentration of exports by market over that period (Figure 2.24, Panel A). This mostly reflects the reduced share of the US market and the increased weight of China and other Asian economies. In terms of product concentration, the situation is less encouraging. Between 2000 and 2015, several LAC countries (mostly from South America) significantly increased their concentration index at the product level. This is true for both countries with fairly diversified exports (Argentina, Brazil and Uruguay) and those whose exports are concentrated on a limited range of commodities (Chile, Colombia, Peru, Bolivia and Venezuela). By contrast, all Central American countries, Mexico and the Dominican Republic reduced their concentration by product (Figure 2.24, Panel B).

Figure 2.24. **Export concentration by markets and products in Latin America and the Caribbean**

Herfindahl-Hirschman indices



Notes: Values for 2015 for Honduras, St. Lucia and Suriname correspond to 2014. For Venezuela, they correspond to 2013. Values for 2000 for the Dominican Republic correspond to 2001.

Source: OECD/ECLAC/CAF, based on data from COMTRADE.

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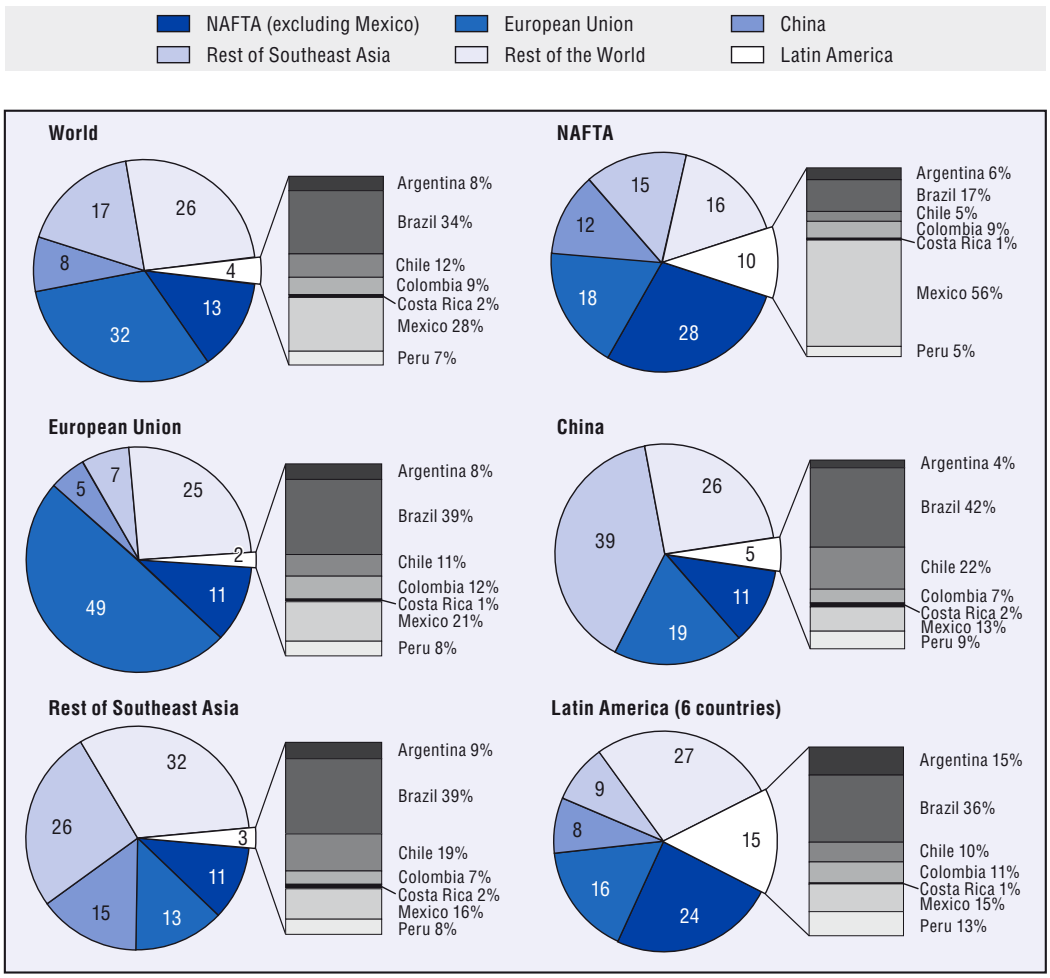
Latin America must speed up integration into regional and global value chains

Latin America's integration into GVCs has been weak. The region's participation as a source of foreign value added in world exports (forward linkages) remains negligible, while the share of foreign value added in Latin American exports (backward linkages) is considerably lower than that of other regions. The seven Latin American countries[6] for which data are available had a joint participation of only 4% as origin of the foreign value added embodied in world exports in 2014 (compared with nearly 3% in 1995) (Figure 2.25). The region's share is higher in NAFTA's exports (10% in 2014, compared to around 6% in 1995). This is largely explained by Mexico's forward linkages with its North American partners (particularly the US). Globally, Brazil is the region's main contributor of foreign value added into world exports (one-third of the region's total in 2014), followed by Mexico (with nearly 30%). This level of concentration is similar to that of gross exports, analysed previously in this chapter, which shows Brazil and Mexico as the region's largest exporters.

Figure 2.25. **Foreign value added in gross exports by geographical origin, 2014**

Percentages



Notes: The percentages in brackets next to the name of each exporting region indicate the share of foreign value added in the region's gross exports in 2014. Latin America (six countries) comprises Argentina, Brazil, Chile, Colombia, Costa Rica and Peru. Mexico is included in the NAFTA region.

Source: OECD/ECLAC/CAF on the basis of OECD/WTO (2015), *Trade in Value-Added (TiVA)* input-output tables (database).

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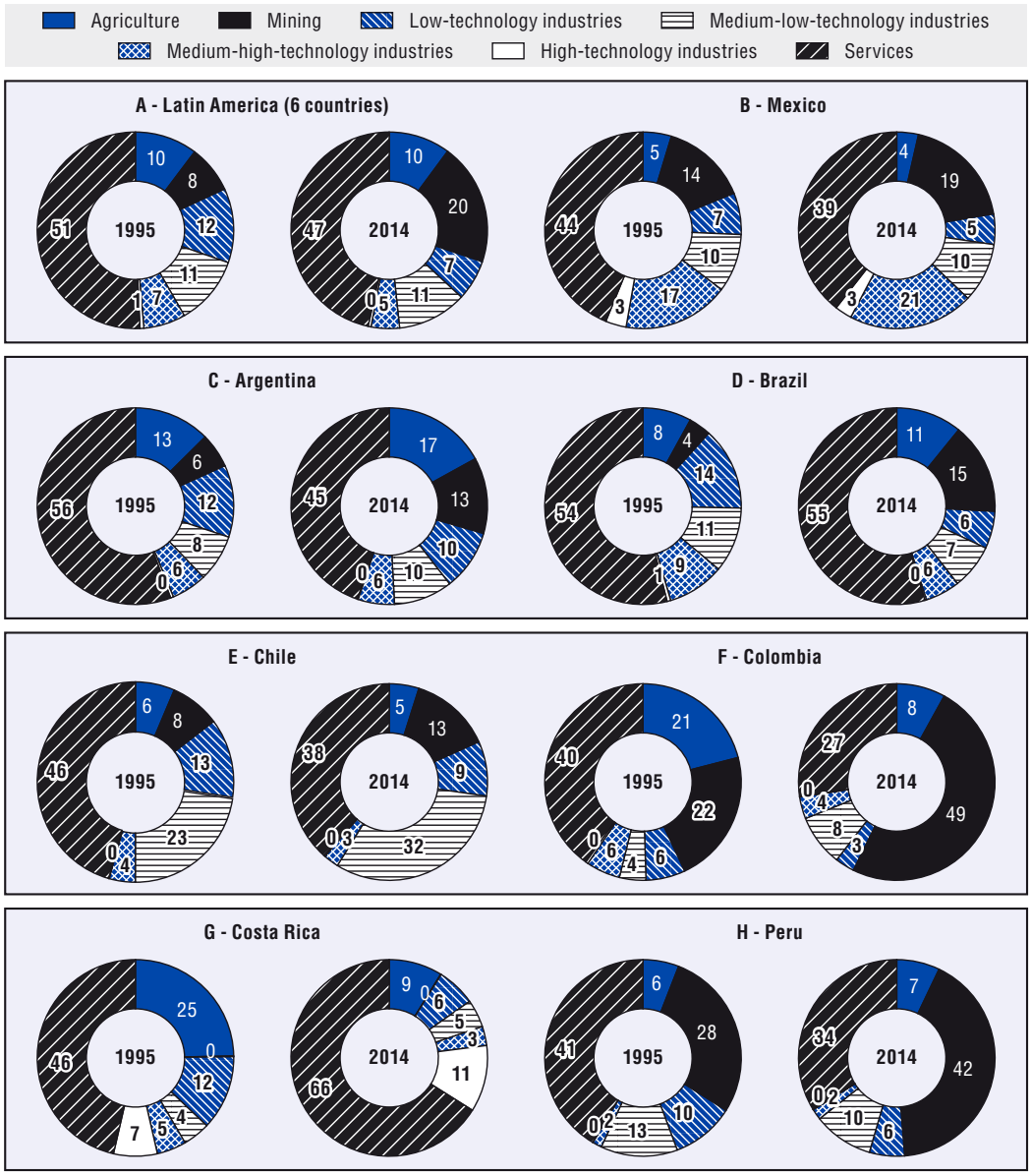
Along with low levels of forward linkages, Argentina, Brazil, Chile, Colombia, Costa Rica and Peru also have considerably lower backward linkages than other regions, particularly the European Union and Southeast Asia. In 2014, only 13% of the value exported by these six countries was generated in other economies. This compares with 19% for NAFTA countries and some 30% in the case of the European Union, China and the rest of Southeast Asia. However, within Latin America, Costa Rica and, to a lesser extent, Chile exhibit considerably higher levels of backward linkages than the other four countries (26% and 19% of gross exports, respectively, in 2014). Mexico, integrated into the NAFTA region, also has a relatively high share of foreign value added in its gross exports (33% in 2014).

Figure 2.26. **Domestic value added in third countries' exports by sector of origin in Latin America**

Percentages



Notes: Latin America (six countries) comprises Argentina, Brazil, Chile, Colombia, Costa Rica and Peru.

Source: OECD/ECLAC/CAF on the basis of OECD/WTO *Trade in Value-Added (TiVA)* input-output tables (database).

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Intra-regional links are particularly weak in Latin America, in contrast to the strong role of regional value chains in Europe, Southeast Asia or North America (OECD, 2015; Cadestin, Gourdon and Kowalski, 2016; Criscuolo and Timmis, 2017a). This pattern is reflected in the relatively low proportion of the foreign value added in Latin American countries' exports that originates in the region itself. In 2014, only 15% of the foreign value added embodied in exports from Argentina, Brazil, Chile, Colombia, Costa Rica and Peru was generated in the region (i.e. these six countries plus Mexico).[7] For Mexican exports, 45% of foreign value added came from the NAFTA region, while only 3% originated in the other previously mentioned Latin American countries. For the European Union, China and the rest of Southeast Asia, intra-regional value added represented around 40% or more of the total (Figure 2.25).

Latin American countries' participation in GVCs is also characterised by a high concentration of forward linkages in primary sectors (agriculture and mining) and low- and medium-low technology industries, in line with these countries' overall export patterns (Figure 2.26). In 2014, 30% of the value added from Latin America (six countries) in third countries' exports originated in primary sectors (mostly mining). Meanwhile, 18% was generated in low- or medium-low technology manufacturing sectors (in 1995 these shares were 18% and 23%, respectively). The contribution of services, although decreasing, remains significant (47% in 2014 for the Latin America [six countries] aggregate). This is particularly true for wholesale and retail trade, R&D and other business services, and, to a lesser extent, transport and storage. Costa Rica stands out in the region for a significantly larger participation of high technology industries (computer, electronic and optical equipment) in the country's forward linkages (11% in 2014).

Box 2.7. **Latin America's faltering manufacturing competitiveness: What role for intermediate services?**

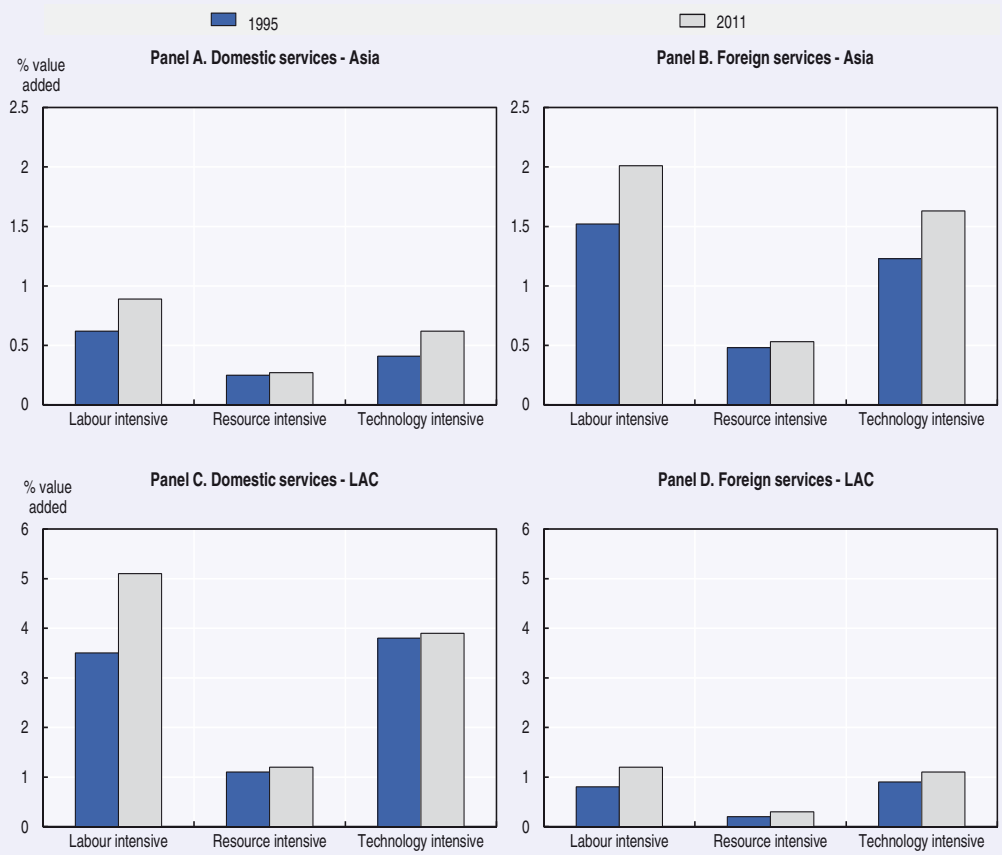
From 1990 to 2016, Latin America's share in global exports of manufactures stagnated around 5%. The region slightly gained market share in global trade in medium-tech manufactures, but lost in global trade of resource-based, low- and high-tech manufactures. This disappointing performance differs strongly from that of developing Asia (Association of Southeast Asian Nations [ASEAN], China and India), which increased its global exports share from 23% to 37% during the same period.

Latin America's underperformance in manufacturing trade is often explained by its growing specialisation in natural resources. However, the stagnant performance in global manufacturing exports could also be due to the insufficient incorporation of high quality domestic and foreign intermediate services in manufacturing. A growing literature shows that a country's manufacturing export performance depends critically on its degree of (business) "servicification". Evidence on OECD member countries shows that servicification is a key condition of successful manufacturing export performance and diversification. Logistics and information technology facilitate the movement of goods and information between segments, R&D, innovation and other intermediate services. They also improve the productivity of firms; contribute to the diversification, differentiation and value of products; overcome domestic market barriers; and outsource non-core inputs and services. Thus services play a key role in manufacturing-dominated GVCs. Baldwin, Forslid and Ito (2015) and Lodefalk (2015) studied the issue through international input-output tables, micro firm-level data and case studies. They confirm the growing value of added share of services in manufacturing production and exports in France, Germany, Sweden, the US and other OECD member countries. Manufacturing

Box 2.7. **Latin America's faltering manufacturing competitiveness: What role for intermediate services?** *(cont.)*

in emerging economies is increasingly connected to foreign services. However, there is no clear pattern for emerging economy domestic linkages between manufacturing and services (Criscuolo and Timmis, 2017b). Similarly, there is a knowledge gap with respect to the servicification of the mining sector and other resource-intensive sectors. Overall, few studies have been conducted in this area on the region.

Figure 2.27. **Content of domestic and foreign services in exports (percentage value added)**



Source: OECD/ECLAC calculations, based on WIOD Input-Output tables and TiVA (2017).
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Using input-output tables and case studies, Avendano, Bontadini and Mulder (2017) explore whether the incorporation of a range of services could revitalise Latin America's manufacturing export performance. In particular, they use the 2016 version of OECD's TiVA database, focusing on seven countries from the region (Argentina, Brazil, Chile, Colombia, Costa Rica, Mexico and Peru). Using data from between 1995 and 2011, the study compares domestic and imported intermediate services value-added contents of manufactures exports of the seven LAC countries and eight ASEAN countries (Brunei Darussalam, Cambodia, Indonesia, Malaysia, Philippines, Singapore, Thailand and Viet Nam). In addition to the total contents of services, it analyses business services that are of strategic importance to improve the manufacturing sector's international competitiveness.

Box 2.7. **Latin America's faltering manufacturing competitiveness: What role for intermediate services?** *(cont.)*

The study builds on the approaches of Evangelista, Lucchese and Meliciani (2015), Francois and Woerz (2008) and Wolfmayr (2008). It carries out panel regressions to test whether intermediate services intensities of manufacturing sectors help explain their export performance in terms of either global export market shares or other trade performance variables such as the degree of product diversification. The modelling considers control variables such as the unit labour cost, the share of each country in global patents per sector, openness of specific intermediate service sectors and direct exports of these services. It distinguishes between three groups of manufacturing industries: natural resource-intensive, labour-intensive ones and technology-intensive. It also compares the role of services in LAC and ASEAN. Preliminary results suggest the content of domestic and foreign services in Latin American exports is not necessarily too different from ASEAN countries. However, some intermediary services, in particular those associated with business services and logistics, are the most strategic for export performance of the manufacturing sector.

Structural factors, alongside trade and investment policies, explain the region's slow integration into global value chains

GVCs result from the fragmentation of production of goods and services into distinct stages in diverse countries. They have transformed world trade thanks to decreasing transport costs, advances in information technologies and trade liberalisation. Recent evidence points to the changes of the structure of GVCs (Ahmad et al., 2017).[8] They can play a role in the catch-up of firms, but are also heterogeneous across firms and countries (Criscuolo and Timmis, 2017a). With nearly 80% of total world trade and despite the recent slowdown in trade for intermediate goods, GVCs remain fundamental to countries' trade performance.

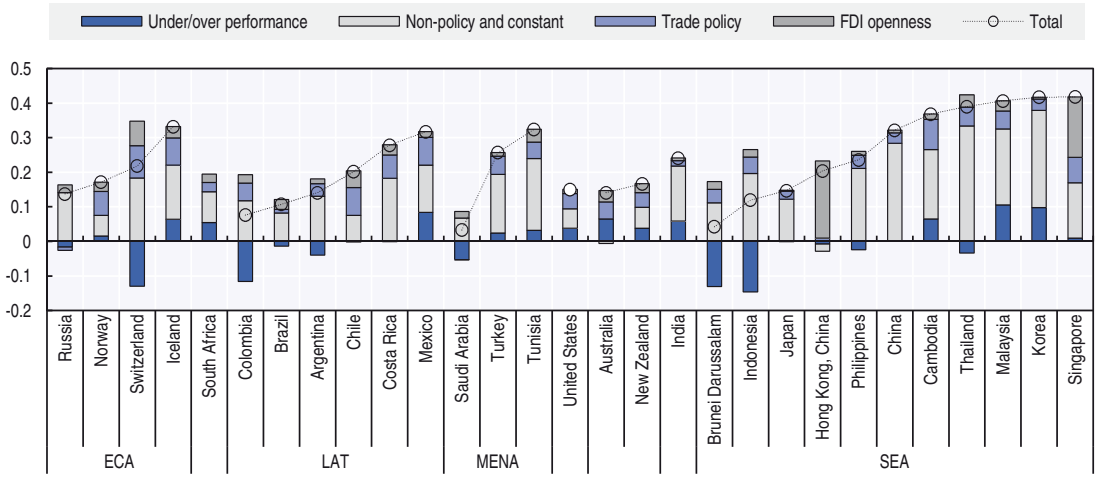
Despite some modest improvements, most Latin American countries remain on the periphery of global production networks. Latin America's participation in GVCs is considerably lower than those of other regions, mainly owing to the lower backward linkages. In addition to low GVC integration, the share of intra-regional trade in intermediate and final goods in Latin America is low compared with other regions. However, it is more present in intermediate than in final goods.

Structural factors, but also trade- and investment-related policies, are important for explaining the low integration of most Latin American economies into GVCs. Recent evidence on the determinants and economic effects of GVC participation in emerging economies offers some guidelines for improving Latin America's performance in global production networks. To the extent that efficient integration into GVCs is important for raising productivity levels, governments in the region are analysing how certain factors can facilitate this process.

Traditional determinants of GVC participation include geographical location, distance to manufacturing hubs, gross domestic product and market size. However, other policy-determined factors seem to be important as well. These include import tariffs (both domestic and with trade partners), engagement in preferential trade agreements (PTAs) and openness to inward FDI. The most important factors explaining GVC integration

into Latin America and other regions appear to be structural, but trade and investment policy also affect it (Kowalski et al., 2015; Cadestin, Gourdon and Kowalski, 2016; Figure 2.28). This also suggests some important differences within countries. While import tariffs (domestic and in export markets) are relatively low, the PTA coverage is better in some countries (Mexico, Chile, Costa Rica) than in others (Argentina, Brazil). Restrictiveness to foreign investment in some sectors seems also to undermine the capacity of some countries to integrate GVCs. Also, unobserved factors can boost or hamper GVC participation (Cadestin, Gourdon and Kowalski, 2016).

Figure 2.28. **Relative contribution and impact of policies on GVC integration, 2011**



Note: ECA refers to European and Central Asian countries, LAT refers to Latin America, MENA refers to Middle East and North Africa and SEA to South East Asia.

Source: OECD (2015); Cadestin, Gourdon and Kowalski (2016).

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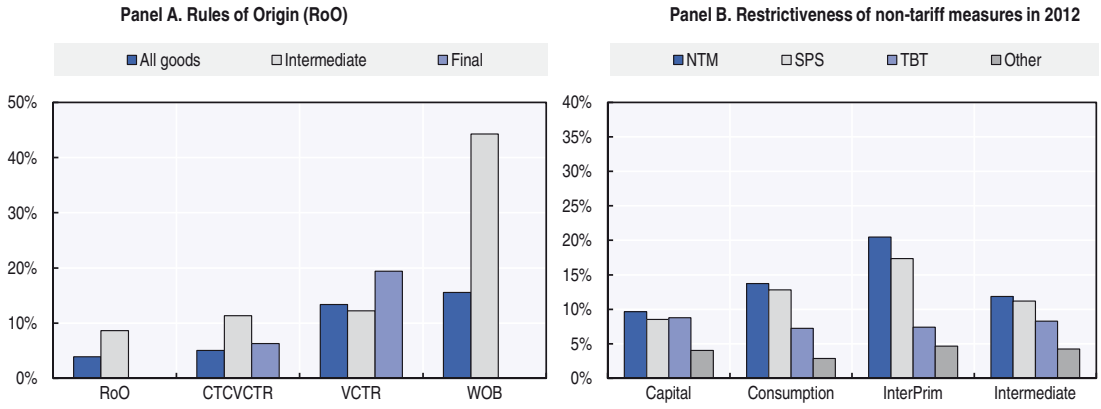
Logistics and infrastructure performance, trade facilitation and institutional quality are important factors for explaining integration of countries into GVCs. The impact of different policies on GVC integration has been studied in recent years, providing some further evidence on integration-enhancing factors. Geographically fragmented production processes are increasingly sensitive to trade costs. Less than 10% of trade costs can be attributed to tariffs, and between 10% and 30% to geographic and cultural factors. However, the bulk of indirect trade costs is related to trade procedures, maritime connectivity, access to ICT services (Box 2.7) and the regulatory environment. Latin America has some of the highest trade costs in the world (OECD/CAF/ECLAC, 2013; Cadestin, Gourdon and Kowalski, 2016).

The OECD Trade Facilitation Indicators (TFIs) provide a basis for governments to prioritise trade facilitation actions (Moïsé and Sorescu, 2013). A number of countries in the region (including Colombia, Peru, Mexico and Chile) have light regulatory burdens on firms, which are considerably higher in Venezuela and Bolivia. Protection of Intellectual Property Rights (IPR) shows a similar degree of heterogeneity in the region. With few exceptions (Panama, Chile, Uruguay) efficiency of customs procedures is low. With a more volatile demand from GVCs, and the need to adapt to changing market conditions, Latin American countries require appropriate logistics and infrastructure standards to respond.

The harmonisation and re-design of Rules of Origin (RoO) could considerably improve the participation of Latin American countries in global production networks.

Regulations often undermine the high density of intra-regional and extra-regional PTAs in Latin America. Recent evidence points to RoO as a sensitive factor (Powell, 2017). Rules of origin establish the conditions of a product to be eligible for preferential access to a PTA. From the perspective of GVCs, RoO have been found to have a negative effect for extra and intra-PTA value chain formation. On average, RoO are estimated to have tariff equivalents of around 9% for imports of intermediate products in the region (Cadestin, Gourdon and Kowalski, 2016). To overcome these effects, a more flexible approach to rules of origin has been useful, as exemplified by some countries in the region with higher levels of GVC participation (e.g. Mexico). A renegotiation of product-specific RoO and an improvement of the RoO architecture through amendments to certification, *de minimis* and cumulation rules can help improve flexibility. But this process can be time-consuming and costly. Another option would be to reduce tariffs on a most-favoured nation (MFN) basis. This is especially relevant since average MFN tariffs on intermediate products are below the 8.6% threshold, an estimated tariff equivalent of RoO (Cadestin, Gourdon and Kowalski, 2016). This may suggest that the average protection of MFN tariffs to intra-PTA providers is lower than the costs of compliance of RoO. Some agreements, including the Pacific Alliance, have already introduced more inclusive schemes, such as allowing full cumulation across PTA partners and cross-cumulation of RoO between overlapping PTAs.

Figure 2.29. **Estimated ad valorem equivalent of Rules of Origin and restrictiveness of non-tariff measures in Latin America**



Notes: RoO (Rules of Origin), CTC (change in tariff classification), VCTR (value content of technical requirement), WOB (wholly obtained rule), NTM (non-tariff measures), SPS (sanitary and phytosanitary measures), TBT (technical barriers to trade).

Source: Cadestin, Gourdon and Kowalski (2016), based on TiVA, CEPII and UNCTAD/World Bank (2017).

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To improve participation in GVCs, Latin American countries can address the effect of non-tariff measures (NTMs), including standards, technical regulations and conformity assessment procedures. Although regulations and standards are not supposed to discriminate against imports, evidence shows they can become more restrictive than necessary. While countries apply different standards and regulations to protect their domestic consumers, the use of diverging national standards can undermine the countries' capacity to participate in global production. Recent evidence suggests that NTMs can be detrimental for GVC integration into Latin America. Indeed, it argues that NTMs can be equivalent to a tariff of 20% for primary intermediary products and 12% for processed intermediates (Cadestin, Gourdon and Kowalski, 2016, Figure 2.29).

This could explain why countries in the region with restrictiveness through non-tariff measures tend to be less integrated into GVCs. Mutual recognition and the harmonisation of technical regulations or conformity assessment procedures can be effective facilitation mechanisms to reduce these costs and to promote convergence of standards in the medium term. International standard setting that takes into account different development models and national approaches will be essential in this process (OECD, 2017f).

The region can focus on specific sectors to better integrate into global value chains

Some sectors have more potential for Latin America to integrate into regional and global value chains. The development of textile and electronics, for example, can propel the inclusion into the automotive industry and thus into global and regional value chains. This sector is particularly promising as vehicle production has been outsourced to Argentina, Brazil and Mexico. Together, in 2015 these three countries accounted for 7.2% of global vehicle production (Ministry of Treasury and Public Finance, Argentina, 2016). Other economies such as Peru, Chile or the Dominican Republic have already taken steps to better integrate into the automotive industry. Peru is striving towards further developing capacities in areas such as tyres (rubber products) and textiles to increase linkages with the automotive chain. Chile is developing an industry in vehicle parts and the copper industry provides unexploited opportunities for more linkages with the automotive chain, especially with Mercosur. The Dominican Republic has highlighted footwear and leather-good clusters as areas of potential linkages with the automotive chain (OECD, 2016).

Other sectors could also present strong opportunities to integrate into GVCs beyond natural resource-based products. An analysis based on revealed comparative advantage (RCA) indices shows that Latin American countries' potential as sources of foreign intermediates for NAFTA, the European Union and Southeast Asia would go beyond natural resource-based products (Zaclicever, 2017). Table 2.2 presents the industries in which the main Latin American providers of imported inputs for the three GVCs (Argentina, Brazil, Chile, Costa Rica, Mexico and Peru), which accounted for around 90% of the region's gross forward linkages in 2011, have a RCA in those markets. In particular, Brazil, Costa Rica and Mexico show competitiveness in some of the more technology-intensive industries (e.g. motor vehicles; electrical machinery and apparatus, n.e.c.; or computer, electronic and optical equipment; depending on the country) (Zaclicever, 2017). However, this competitiveness has not necessarily translated into a significant participation of these industries in the region's forward linkages with GVCs. A similar analysis was conducted in the Pacific Alliance, where potential sectors for integration have been located in intermediate/capital goods (e.g. plastics, paper and cardboard), as well as consumer goods (e.g. perfume and cosmetics, cereals and flours, and food derivate products) (Hernandez et al., 2015).

Table 2.2. **RCAs in forward linkages with GVCs, 2010-11**

Exporting country	Factory North America	Factory Europe	Factory Asia
Argentina	Basic metals; textiles; agriculture; food products, beverages and tobacco; mining and quarrying; wood and wood products	Food products, beverages and tobacco; chemical products; textiles; agriculture	Agriculture; food products, beverages and tobacco; textiles
Brazil	Basic metals; motor vehicles; chemical products; agriculture; rubber and plastics products; pulp, paper and paper products; food products, beverages and tobacco; textiles; other non-metallic mineral products; mining and quarrying; wood and wood products	Agriculture; basic metals; food products, beverages and tobacco; mining and quarrying; pulp, paper and paper products; textiles; wood and wood products	Mining and quarrying; agriculture; pulp, paper and paper products; food products, beverages and tobacco

Table 2.2. **RCAs in forward linkages with GVCs, 2010-11** *(cont.)*

Chile	Basic metals; wood and wood products; agriculture; pulp, paper and paper products; food products, beverages and tobacco	Basic metals; mining and quarrying; pulp, paper and paper products; wood and wood products	Basic metals; mining and quarrying; pulp, paper and paper products; wood and wood products
Costa Rica	Computer, electronic and optical equipment; rubber and plastics products; agriculture; food products, beverages and tobacco	Computer, electronic and optical equipment; agriculture	Computer, electronic and optical equipment; electrical machinery and apparatus, n.e.c.; agriculture
Mexico	Motor vehicles; electrical machinery and apparatus, n.e.c.; other non-metallic mineral products	Computer, electronic and optical equipment; electrical machinery and apparatus, n.e.c.; other transport equipment; mining and quarrying	Basic metals; mining and quarrying; electrical machinery and apparatus, n.e.c.; motor vehicles
Peru	Basic metals; agriculture; food products, beverages and tobacco; wood and wood products	Basic metals; mining and quarrying; agriculture; food products, beverages and tobacco	Mining and quarrying; basic metals; food products, beverages and tobacco; wood and wood products

Notes: Industries are ranked, from highest to lowest, on the basis of their share in countries' gross forward linkages with the GVC.
Source: Zaclicever (2017), on the basis of input-output data from the OECD's ICIO tables, and trade data from the Centre d'Études Prospectives et d'Informations Internationales (CEPII), Base pour l'Analyse du Commerce International (BACI).

Skills-based sectors, in particular certain high-tech niches and services, are another area where the region could further integrate into GVCs. Improving basic abilities such as literacy, numeracy and problem-solving skills are essential to develop a service industry such as marketing, branding and customer service, as well as the tech industry (OECD, 2017g). For the same reason, it is also critical to refine skills that can benefit the professional environment, such as managing capacities and communication. Similarly, to specialise in the most technologically advanced industries, countries require workers to complement their cognitive skills with the development of appropriate social and emotional aptitudes such as communication and organisation. A country with a skills mix that is well aligned with the requirements of technologically advanced industries can specialise in these industries on average 8% more than other countries (OECD, 2017g). However, Latin America faces a wide skills gap, not only in technical skills, but also in communications and management. Colombia, for instance, has a deficit of 15 000 telecommunication and software engineering professionals, which could rise to 90 000 by 2018. In Peru, 67% of employers declare having trouble filling positions, especially those requiring language skills (Pezzini and Schleicher, 2015).

Regional integration, an effective policy to upgrade and diversify under a challenging global trade environment

The current economic context highlights the urgency for more efficient regional integration. Recent developments on trade agreements and consolidation of intra-regional trade in other regions, particularly Asia, highlight the need for an integration agenda in Latin America, in the form of open regionalism (Bown et al., 2017) or deep integration (OECD/CAF/ECLAC, 2015; IMF/World Bank/WTO, 2017). The end of the commodity supercycle, the sharp deceleration of regional growth, political changes in some key countries of the region, and concerns about a growing protectionism in some key markets have combined to bring a renewed sense of urgency to strengthening regional integration. There are several possible avenues to do so. One promising path is the possible convergence between the region's two largest integration agreements, the Pacific Alliance and Mercosur (Box 2.8). Combined, they account for more than 80% of the region's population and for 90% or more of its GDP, trade and FDI flows. This means that any agreements between them could act as a powerful catalyst of region-wide integration. The convergence process is still at an early stage and not expected to lead in the short term to any formal trade negotiations. Instead it will proceed in

an incremental way, starting with work on areas such as customs co-operation, trade facilitation (for both goods and services), cumulation of origin and digital certification of origin.[9]

Box 2.8. **Mercosur and the Pacific Alliance: A future rapprochement?**

The continent's largest trade platforms, Mercosur and the Pacific Alliance, represent over 90% of the region's GDP. This makes the prospect of integration not only a potential for growth, but also a boon for extra-regional trade negotiations. Established in 1991, Mercosur is a customs union originally compromised of four Southern-cone countries (Argentina, Brazil, Paraguay and Uruguay). Venezuela joined in the group in 2012 but its membership is suspended since late 2016. Mercosur allows intra-bloc duty free trade (except on the auto industry and sugar) and levies a common external-tariff (0-20%) on non-member countries. The Pacific Alliance, established in 2011 and composed of Colombia, Mexico, Peru and Chile, is a process of open and regional integration. It is based on a liberalising agenda in the areas of trade in goods and services, capital markets and investment. Moreover, some provisions have been adopted to ease short-term people flows migratory flows. In this context, the integration between the Pacific Alliance and Mercosur, which started to be discussed in April 2017, could propel LAC's participation in GVCs and regional integration forward and scale-up its role in the global trade arena. Working together, they could consolidate their respective platforms and strengthen certain areas.

Brazil and Argentina met in February 2017 to lay the groundwork for homogenising Mercosur's commercial measures such as the creation of common regulatory convergence. Meanwhile, the Pacific Alliance has made great strides in the area of trade facilitation. By interconnecting its members' electronic single windows for foreign trade, since July 2016, all four countries can electronically exchange phytosanitary certificates. Since May 2017, they have been able to digitally exchange certificates of origin. By 2018, the Pacific Alliance aims that all foreign trade transactions within the group be done digitally through the Customs Declaration. Moreover, the four countries are working towards the mutual recognition of their respective Authorised Economic operator schemes and expect to sign an agreement to that effect during the second half of 2017. The Pacific Alliance, however, lacks many common regulatory standards. This gap, combined with geographical obstacles and poor or lacking public infrastructure, hinders the ability of small and medium-sized enterprises (SMEs) to integrate into domestic, regional and global markets (Jarrín and Pica, 2016).

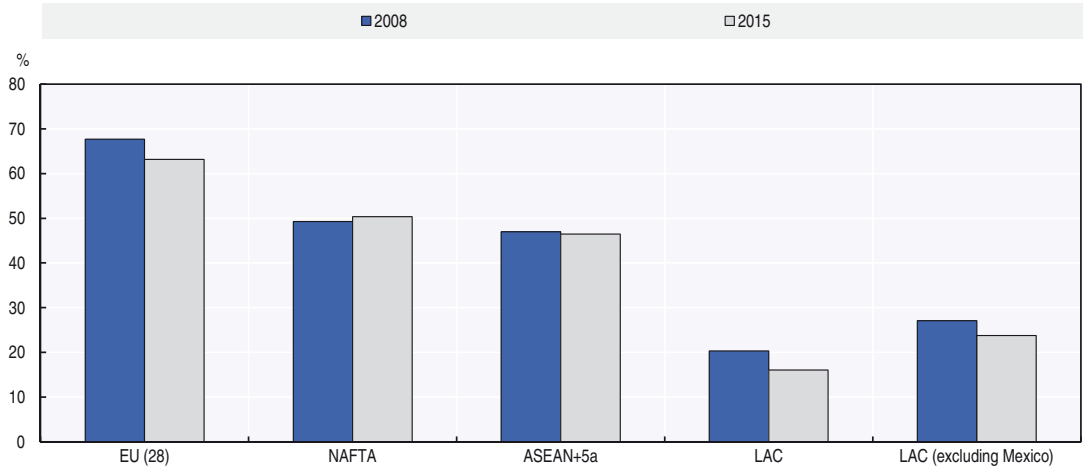
Against this background ministers and technical-level officials from both groups are meeting regularly to discuss possible co-operation in six areas: *i)* trade facilitation and single windows for foreign trade (VUCEs); *ii)* regional value chains; *iii)* cumulation of origin; *iv)* trade promotion and SMEs); *v)* non-tariff barriers; and vi) facilitation of trade in services.

Despite almost 60 years of efforts, LAC regional economic integration remains far from its full potential. Just 16% of total LAC exports are destined for the regional market. This is well below the intra-regional trade coefficients of the world's three major "factories" (Figure 2.30). Regional integration is also important for manufacturing, as its intermediate sourcing patterns tend to be particularly sensitive to distance. LAC's low level of intra-regional trade and generally scarce intra-regional production networks are a result of multiple factors. These include the region's vast size, geography, poor transport infrastructure,[10] the gravitational pull of the US economy on Mexican and Central American trade flows, and the similar commodity endowments of several South American

countries. Intra-regional trade and investment are further complicated by the high level of fragmentation of the regional market. Specifically, the institutional architecture of LAC economic integration is made up of several sub-regional mechanisms plus a large amount of mostly bilateral agreements linking members of those mechanisms. Trade integration should also call for the regional development of services inputs in natural-resource sectors. As members of a commodity-rich region, participating countries can further promote services tackling natural-resource industries, while at the same time favour product diversification.

Figure 2.30. **Share of intra-group exports in total exports**

Percentage



Notes: ASEAN + 5 includes China, Japan, Korea, Chinese Taipei, Hong Kong (China) and the 10 members of ASEAN.
Source: OECD/ECLAC/CAF, based on data from COMTRADE.
StatLink http://dx.doi.org/10.1787/888933650741

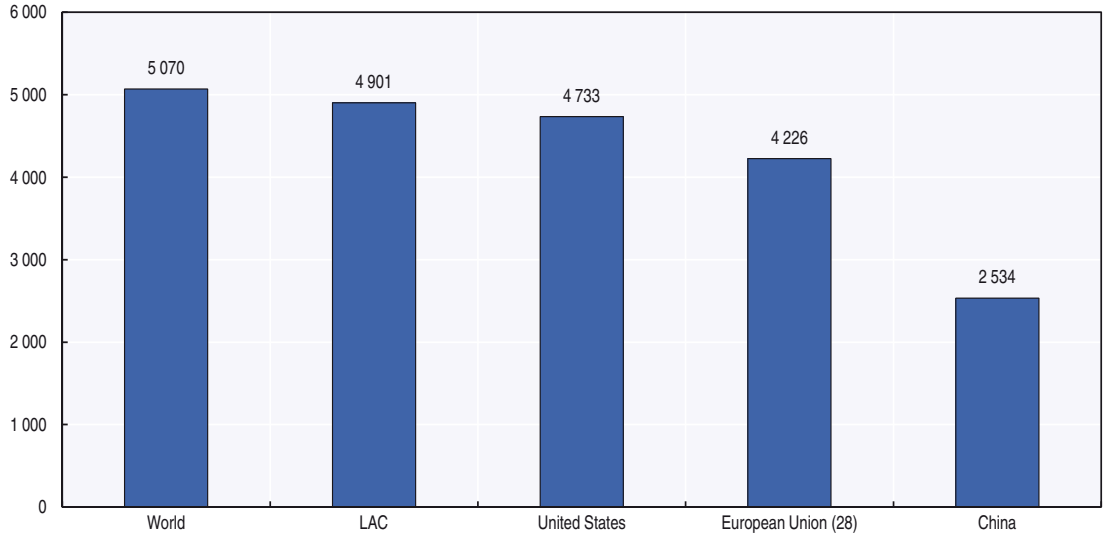
Despite these challenges, the region has made substantial progress in the removal of tariffs to intra-regional trade. The design of RoO is moving towards capturing the full gains associated with this liberalisation. Yet challenges remain in the removal of regulatory barriers. About 80% of intra-regional trade already benefits from trade preferences, a share that will increase in the coming years as the tariff phase-out schedules of the different agreements kick in. However, the remaining 20% includes some key bilateral relationships, most notably those of Mexico with Argentina and Brazil.[11] More importantly, the region as a whole has made little progress in the removal of non-tariff (regulatory) barriers to intra-regional trade and investment. These barriers include inconsistent technical, sanitary and phytosanitary standards; discrimination against regional suppliers in government procurement; and cumbersome customs procedures. Obstacles in the areas of non-tariff barriers and infrastructure development may represent greater obstacles to the formation of regional value chains than tariffs (Cadestin, Gourdon and Kowalski, 2016; Bown et al., 2017; ECLAC, 2017c). In short, the region remains far from being a single integrated area with a common set of rules for trade and investment.

The region needs to work further on harmonising rules of origin and regulatory frameworks for the exchange of goods, services and endowments for production (e.g. electricity) (Powell, 2017). It also requires adoption of international standards and export certifications, particularly in agro-food. Reducing Latin America's high-trade costs remains a challenge for regional integration, where the improvement of infrastructure, logistics and customs procedures is critical. Nearly 57% of Latin American exports consist of perishable or logistics-intensive products, three times more than the OECD average (OECD/

CAF/ECLAC, 2013). Other complementary policies can also strengthen regional integration efforts, particularly in the area of coordination of domestic capital makers (IMF, 2017c).

Tapping on the large unexploited potential offered by regional integration is probably the most effective policy response that LAC countries can adopt faced with a challenging global trading environment. There are several reasons for this. First, despite absorbing just 16% of the region's total exports, the LAC market accounts for much larger shares of manufacturing exports for most countries. Second, the regional market is the most conducive to export diversification, absorbing the highest number of exported products (Figure 2.31). Third, LAC remains the most important market (often the only one) for the region's SMEs, which in turn account for the large majority of its exporting firms. Fourth, because of the advantages offered by geographical proximity, language and cultural affinities, the region is also the most natural space for LAC countries to enter international value chains. Fifth, more dynamic intra-regional trade would reduce the region's high vulnerability to volatile commodity prices and to changing economic and political circumstances in other markets. Lastly, a more integrated regional market would enhance LAC's position in trade negotiations with extra regional partners.

Figure 2.31. **Number of products exported to selected markets in Latin America and the Caribbean, 2015**



Notes: Products are defined at the 6-digit level of the Harmonized Commodity Description and Coding System.
Source: OECD/ECLAC/CAF, based on data from COMTRADE.
StatLink http://dx.doi.org/10.1787/888933650760

A more integrated regional market would enhance LAC's position in trade negotiations with extra regional partners. Comply with existent agreements has been an objective with different platforms in the region, including the Pacific Alliance, Mercosur and the CAFTA-DR. Regional platforms such as Mercosur, the Latin American Integration Association (ALADI) and the Pacific Alliance can play an important role to promote coherence in the region's regulatory frameworks for trade and investment. These platforms can also maximise preferences from existing regional agreements; despite the proliferation of trade agreements, they have not been completely capitalised (IDB, 2016). By improving coherence, the region can reduce barriers to trade and be more coherent when negotiating with extraregional partners, in particular China and the European Union (OECD/CAF/ECLAC, 2015). A call for speedier progress on the regional integration agenda does not mean lessening efforts to improve the region's access to key extra regional markets.

Rather, regional and global integration can, and should, reinforce each other. For example, both the Pacific Alliance and Mercosur are simultaneously pursuing agreements with extra-regional partners and moving forward with their convergence efforts (Box 2.8).

Conclusions

LAC is expected to emerge from a two-year recession in 2017. External factors are contributing to this small rebound with the improvement in the global economy and the stabilisation of commodity prices. This recovery is not exempt from risks, as an environment of uncertainty and possible external and domestic shocks could derail it. In the short term, growth paths vary from one country to another, reflecting differences in exposure to external shocks and soundness of the domestic policy. The scope for demand policies to stimulate growth remains limited. However, some space for monetary policy is opening in some South American economies, thanks to lower inflation rates. The space for fiscal policy is limited as most countries need further adjustments to stabilise debt. In the medium term, estimates indicate that potential growth is lower than expected and most of the Latin American and Caribbean economies seem to be tangled in the middle-income trap. Low productivity growth is at the heart of low potential growth, with the region failing to undertake structural changes towards innovation, competition, and more knowledge-based economies.

Trade and deeper, more effective regional integration are channels to increase productivity and thus, potential output growth. Gains from trade can translate into more productive firms or broader choice for households. However, the potential effects of trade on inequality also need to be considered. Today, Latin America has ample room to look for a more diversified economy, upgrade the services content of exports and deepen regional integration. While the number of trade partners has increased, the region continues to trade mostly primary goods. With such trade structure, there is potential for promoting sectors that respond better to the demands of natural resource-intensive industries, particularly services. In a global context of lower trade of intermediate goods, the region's integration into global value chains is still weak and remains in the periphery of global production networks. Beyond well-known factors, such as lack of infrastructure development and the weak productive capacity, Latin America's limited integration to GVC's can be explained by policy-determined factors such as import tariffs, the use of preferential trade agreements and low openness to FDI. Similarly, GVCs are highly sensitive to cost. LAC has some of the highest trade costs, which are further increased through the lack of harmonised Rules of Origin and through non-tariff trade measures, including technical barriers to trade, phytosanitary conditions and other standards. Setting up regional and international standards will require acknowledging the different development agendas in the region.

Overall, the region faces the need to adopt institutional reforms to build the pillars of a growth model that promotes inclusion and can guarantee sustained socio-economic progress. This entails mainly expanding the potential output through increases in productivity, and adopting structural policies to overcome the middle-income trap.

Notes

1. For instance, the 2017 edition focused on fiscal policy to boost investment and inclusive growth (OECD/CAF/ECLAC, 2016). Similarly, the 2016 edition analysed the effects of a possible slowdown in China and the effects on the LAC region (OECD/CAF/ECLAC, 2015). The 2015 edition studied the effect on the region of temporary resource booms (OECD/CAF/ECLAC, 2014).
2. These results should not be seen as predictions, but more as illustrations of the potential impact of two extreme scenarios over the region.
3. The negative effect on mineral manufactures may be due to the long-term investments common in the sector, and result in a more inelastic supply response. For example, in the face of losses of competitiveness experienced in periods of appreciation, firms continue to export to cover high fixed costs.
4. An increase of 0.01 standard deviations in the variation of the real exchange rate produced a reduction of real exports of manufactures of 0.97%.
5. The Global Trade Alert (GTA, www.globaltradealert.org) documents acts from various states that affect foreign commercial interests in a publicly available online database (GTA, 2017). This initiative, run from the University of St. Gallen, Switzerland, was launched in June 2009. At that time, it was feared the global financial crisis would lead governments to adopt widespread 1930s-style beggar-thy-neighbour policies. Although global in scope, the GTA gives particular attention to the policy choices of the G20 governments since their leaders made a "no protectionism" pledge in Washington, DC in November 2008. As of July 2017, the GTA database includes entries for over 11 000 state acts. Each is classified using an extensive taxonomy, including timing of the action, instrument used and sectors or product affected.
6. Argentina, Brazil, Chile, Colombia, Costa Rica, Mexico and Peru are the Latin American countries for which information is available in the *Trade in Value-Added (TiVA)* database of the Organisation for Economic Co operation and Development (OECD) and the World Trade Organization (WTO), on which this subsection is based. The most recent year for which information is available is 2014.
7. Within Latin America (six countries), Brazil, Costa Rica and Peru show the lowest backward intra-regional links, having sourced from the region only around 8%, 11% and 13%, respectively, of the foreign value added in their exports in 2014. For Argentina, Chile and Colombia, the region's share was 22%, 28% and 18%, respectively.
8. See Ahmad et al. (2017) for a recent review on the use and interpretation of GVC indicators.
9. See "Meeting of Foreign Ministers Mercosur-Pacific Alliance: Joint Communiqué", Buenos Aires, 7 April 2017, at www.mrecic.gov.ar/en/meeting-foreign-ministers-mercosur-pacific-alliance-joint-communique
10. According to a recent World Bank study, almost 70% of the region's roads are unpaved, compared with less than 30% of unpaved roads in East Asia (Bown et al., 2017). Similarly, the quality of infrastructure in LAC is below that of export rivals (IMF, 2017b).
11. Mexico's trade with Argentina and Brazil is conducted on a non-preferential basis, with the partial exception of the automotive sector. In 2015, Mexico and Brazil started negotiations towards a comprehensive trade agreement that would liberalise trade in most goods and include commitments in areas such as services and government procurement. Negotiations towards a similar agreement were launched in 2016 between Mexico and Argentina.

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Chapter 3

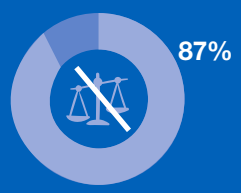
Institutions to make the state deliver in Latin America and the Caribbean

This chapter puts forward recommendations and highlights ideas and best practices that can guide policy makers in redesigning the institutional framework of the state in Latin America and the Caribbean. It is divided into four parts. The first one analyses the importance of improving the rule of law to overcome some of the main challenges for building inclusive institutions in a context of policy capture, corruption, criminality and impunity. The second section analyses the administrative capacities that need to be strengthened to make states more efficient and effective to deliver their functions. The third part focuses on modernising states by making them more innovative and fostering the connection with citizens through open government initiatives. The final part gathers the main conclusions and policy recommendations for the region.

Institutions to make the state deliver in Latin America and the Caribbean

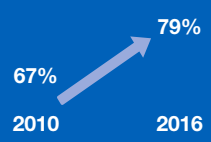
Weak institutions with weak capacities in LAC

Rule of Law



87% of countries in LAC **score negatively** on the Rule of Law Index

Perception of corruption



79% of Latin Americans find their government **corrupt**, 12 percentage points higher than in 2010

Civil Service Merit

LAC **increased its merit score from 33 to 45** (on a scale from 1 to 100) between 2004-15 on the Civil Service Merit Index

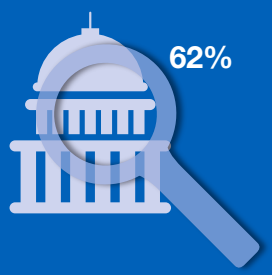
Women

The share of women in ministerial or leadership positions barely reaches an average of **23.8%**

New government tools are being adopted to make governments more open and transparent

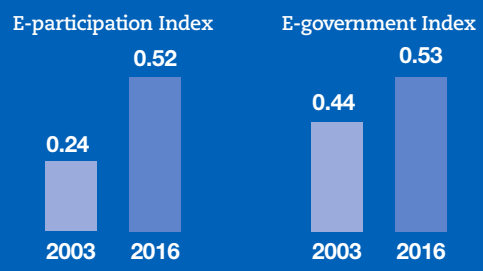
Open government

62% of LAC countries have adopted **national strategies on open government**



E-government / E-participation

Both **E-government and E-participation indexes** scaled from 0 to 1 show that **performance in LAC countries improved**



Latin America and the Caribbean (LAC) is characterised by a growing disconnection between citizens and the states. After more than a decade of socio-economic progress, recent years have been marked by a decline of trust in public institutions, a growing dissatisfaction of society with public services and a significant transformation of citizens' aspirations and social preferences. And all this in a rapidly changing global context, with new challenges and opportunities that are also shaping social expectations and perceptions, and represent another source of potential disconnection with public institutions.

This disconnection is to a large extent explained by the challenges faced by states in LAC. This is why institutions need to be rethought, to help states overcome failures, deliver their functions and better respond to citizens' evolving demands. States in LAC face different inter-related barriers that prevent them from fulfilling these objectives. First, groups and private interests interfere with the functioning of the state, often diverting it from serving the general public interest. Second, institutional capacities are generally weak. This is one of the main impediments to a well-functioning public sector and that favours the capture of public policy by private interests. And third, states usually lack strong channels of interaction with society, thus making it more difficult to understand citizens' demands. At the same time, states do not have mechanisms to innovate in the search for new responses to evolving aspirations.

This chapter argues for rethinking institutions to favour a state that delivers on its basic functions and services for citizens. In so doing, institutions would be better positioned to respond to the demands of society with the ultimate objective of rebuilding the social contract and promoting well-being for all.

First, the chapter argues that institutions in LAC need to be oriented towards building states that are more trustworthy, are based on stronger guarantees of the rule of law and that promote fair competition. The rule of law, and civil and property rights, are pillars of democratic institutions. They help prevent the spread of detrimental conduct such as elite capture, crime, corruption and impunity, all of which are serious problems in the LAC region.

Second, LAC states need to strengthen their administrative capacities. Governments need an effective bureaucratic arm with efficient procedures that can quickly adapt to changes in order to deliver its services. These improved capacities rely on the ability of states to recruit and attract competent and qualified civil servants. They also depend on governments' ability to upgrade management policies to develop long-term strategic plans and to co-ordinate across levels of government and across sectors, among other factors.

Third, public sectors need to be more innovative and responsive to growing demands and expectations. States must develop capacities for the effective use of information and communication technologies (ICTs) as a priority when rethinking institutional responses in the LAC region. Incorporating this vision requires developing the right incentives and regulations that allow experimentation and risk-taking. Moreover, modern states should profit from new technologies to deliver citizen-centric services and anticipate new demands. In this respect, digital tools have the potential to revamp public services. Streamlining or process redesign can make services accessible, effective, efficient and simple to use. In parallel, civil society can be empowered to have an oversight role of anti-corruption measures and the public policy cycle. This requires opening government channels of participation that strengthen the democratic process in the region.

The final section presents a set of conclusions and summary of policy recommendations to respond to these challenges.

Towards trustworthy states: strengthening the rule of law and regulatory systems

LAC's history sheds light on the emergence of early political, social and economic institutions in the region. Its initial institutions were arranged to be extractive monopolies to exploit local natural resources through labour-force coercion and provide benefits and protection to small groups or elites. These events sowed the initial seeds of mistrust in institutions among local populations. Independence movements that severed ties with foreign countries to create states did not reform these institutions to serve citizens. Rather, they preserved the interests of established elites through the use of force, perpetuating inequalities throughout the region (Nunn, 2009; Acemoglu, Johnson and Robinson, 2001; Acemoglu and Robinson, 2012).

The post-independence period was one of political instability that prevented the proper development of democratic institutions. The 20th century saw the rise and fall of authoritarian, oligarchic or military regimes, in which public entities served rent-seeking and clientelistic behaviour. These events, however, paved the way for the rise of newly democratised public institutions (Brinks, 2008).

The consolidation of democracy strengthened the relationship between citizens and the states through free elections. The possibility of alternating political power in government gives individuals the power to punish corruption and diminish the capture of states by elite groups by offering an equal space of participation. Since democracy is based upon the existence of checks and balances between state powers, strengthening the tools and institutions to enforce these principles effectively is fundamental. The executive branch should act autonomously and respond to people's demands through policies and programmes. Likewise, the legislative body should independently set the rules and norms that regulate the actions of society, including those by citizens, public servants and politicians. Finally, independent legal institutions that can enforce the rule of law effectively are critical. This will ensure equal application of the law and the prosecution of wrongdoing within government institutions and society. A well-functioning social contract relies on an effective fulfilment of these three pillars. The rule of law remains the basis for ensuring the respect of law and order throughout society and over time.

Most countries in LAC show insufficient levels of compliance with the rule of law

The rule of law is the capacity of the state to observe and enforce formal rules (i.e. laws) in an impersonal and systematic manner to government actors and citizens alike (World Bank, 2017a). Formal rules represent a central part of the institutional framework needed to support inclusive growth. They are mainly structured around constitutions, which are the higher-level rules that provide the overarching contract between the state and citizens. Updates and amendments to the constitutions proliferated in LAC after the wave of re-democratisation in the region 30 years ago (Brinks, 2008). States were reorganised into formal institutions that respected the separation of political and territorial powers, and the establishment of checks and balances. As a complement to constitutions, a set of core and auxiliary laws shape the institutional framework. These laws govern legal and economic interactions between and among individuals and the state.

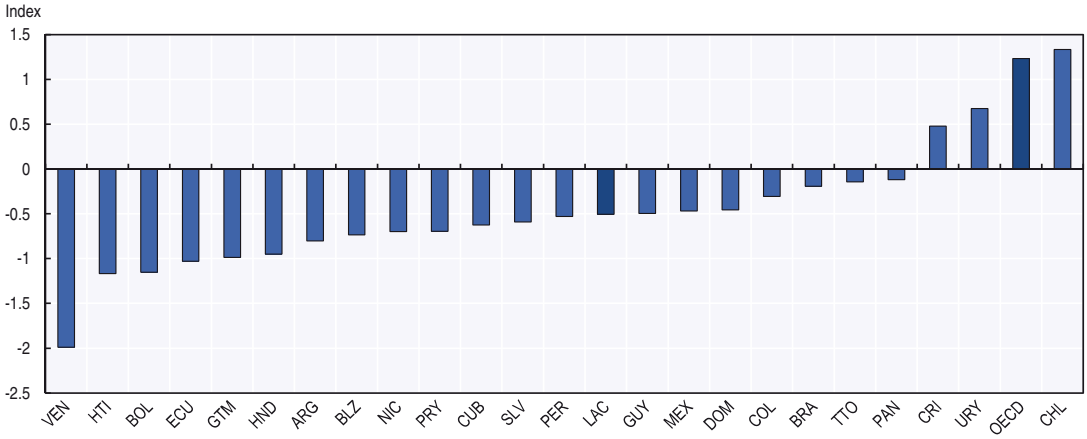
The rule of law is a core pillar for modern states. As a critical component for economic development and effective and trustworthy states, the rule of law supports both social relations and the relationships within state institutions themselves (O'Donnell, 2001). In this respect, a state that enforces the law is essential for guaranteeing an enabling environment for good governance and economic growth. Also, the law serves three critical governance roles. First, the law defines the structure of government by

delimiting its power – that is, establishing and distributing authority and power among the states' institutions, between the state and citizens, and among citizens. Second, laws and their appropriate institutions normalise interactions among individuals, shaping them to achieve economic and social outcomes. Third, the law provides substantive and procedural tools needed to promote accountability, resolve disputes peacefully and develop mechanisms to overhaul existing rules. Yet the existence of a set of formal laws does not guarantee their fulfilment (World Bank, 2017a).

The capacity of the state to comply with and enforce the rule of law is directly linked to the strength of legal institutions. These institutions must be able to enforce the division of powers between institutions, preventing them from overstepping their legal mandates. They must also be able to oversee compliance of elected officials and civil servants with legal proceedings and to give equal treatment to all citizens. Finally, they must be able to enforce civil and property rights among citizens.

Most LAC countries show insufficient levels of compliance with the rule of law (Melguizo et al., forthcoming). The majority score below 0 on perception of compliance with the rule of law, illustrated by the *Rule of Law Index* which ranges from -2.5 to 2.5 (Figure 3.1). Only Chile, Uruguay and Costa Rica score positively on this index, which gathers the view of citizens about the quality of contract enforcement, property rights, the police and the courts, as well as the likelihood of crime and violence. The perception about these issues is an indication of the trustworthiness of the state and shows to what extent people believe that institutions can enforce the law, determining their attitudes towards the respect of laws.

Figure 3.1. **Rule of Law Index in Latin American and Caribbean countries and the OECD, 2016**



Note: Estimate gives the country's score on the aggregate indicator, in units of a standard normal distribution, ranging from approximately -2.5 to 2.5.

Source: OECD/ECLAC/CAF based on World Bank governance indicators.

StatLink http://dx.doi.org/10.1787/888933650779

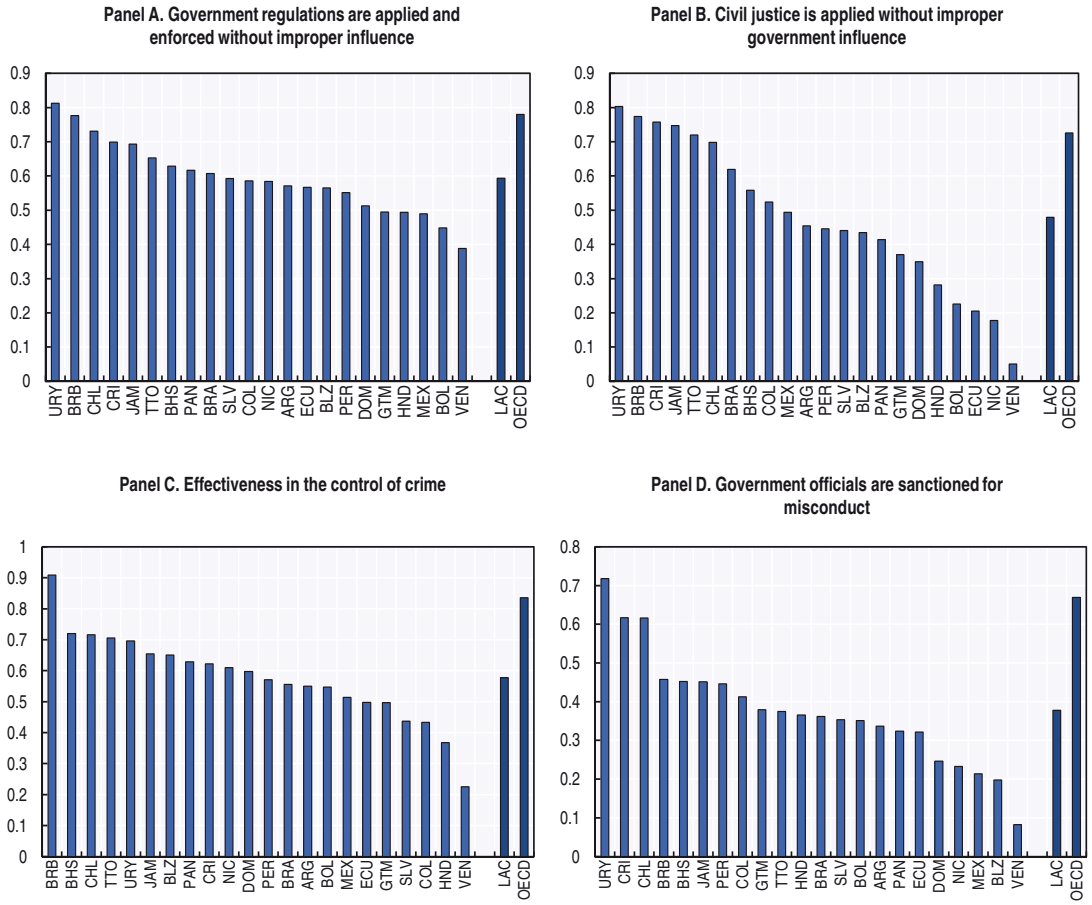
The region has weak legal institutions

Institutional failures directly affect poor enforcement of the rule of law in LAC and divert the state from servicing the public interest. The most salient failures are the large presence of corruption, crime, impunity, as well as the unequal application of the law to specific groups. These are three critical failures that illustrate weaknesses in legal institutions thus in the rule of law: differences in the capacity to influence laws and regulations (policy capture); failure to enforce the law within the state (corruption); and failure to enforce the law among society (crime).

In all of these dimensions, the perception of citizens in LAC is poorer than that of citizens in the OECD (Figure 3.2). Citizens in LAC perceive that interest groups improperly influence regulations and their enforcement (Figure 3.2, Panel A). In fact, when assessing whether individuals can resolve their issues effectively through the civil justice system, many perceive that the government meddles improperly in the delivery of civil justice; this, in turn, might affect the outcome of the ruling (Figure 3.2, Panel B). Both of these indicators can be considered proxies to measure the existence of power asymmetries and the impartiality of the institutions involved in the application and enforcement of the law.

The effectiveness of legal institutions to control crime and to sanction wrongdoings of government officials is also weak in LAC (Figure 3.2, Panels C and D). Based on the *Rule of Law Index* scaled from 0 to 1, the LAC region scores 0.26 and 0.29 below OECD averages on these dimensions, highlighting the severity of the deterioration on both indicators. There is large heterogeneity in all of these indicators. However, some countries consistently perform at the top, while another group is consistently ranked at the bottom.

Figure 3.2. **Perceptions of legal institutions' effectiveness, 2016**



Note: Each of these panels represents a component of the Rule of Law Index, 2016. Its scores are built from the assessments of local residents (1 000 respondents per country) and local legal experts. This ensures that the findings reflect the conditions experienced by the population, including marginalised sectors of society. Scores range from 0 (lowest) to 1 (highest).

Source: OECD/ECLAC/CAF based on data from the World Justice Project, Rule of Law Index, 2016.

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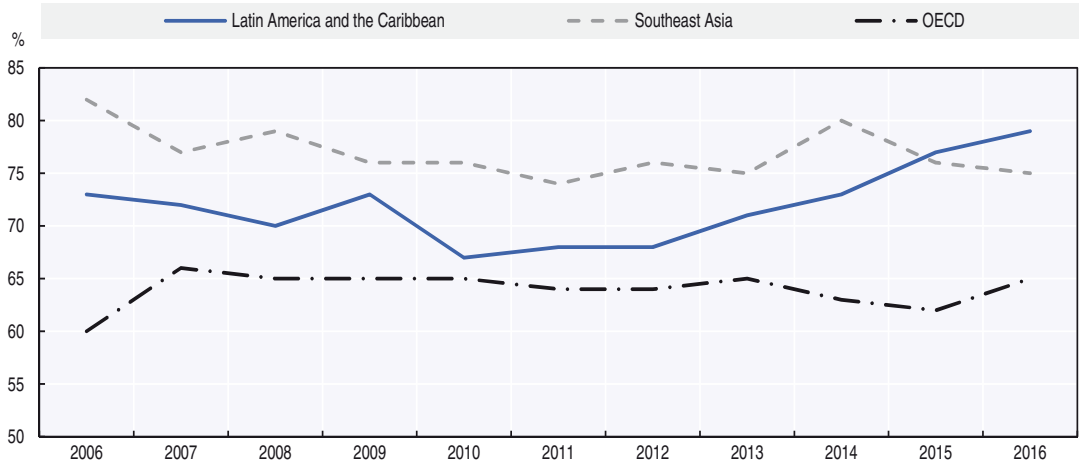
Weak enforcement sets the stage for policy capture, corruption and criminality

The prevalence of weak legal enforcement within formal institutions sets the stage for the capture of policy in LAC. Policy capture is the process of consistently or repeatedly directing public policy decisions away from the public interest towards a specific interest group or person (OECD, 2017a). The existence of interest groups in the political arena within a democracy undermines the effectiveness of policy making. Laws regulate power and by doing so they can limit policy capture. This is especially the case for laws that, when enforced, curtail bribery, illegal lobbying and political financing to sway public policy options.

Policy capture by vested groups has a perverse impact on society and economic growth. These types of practices tend to erode the democratic processes and hinder sustainable economic growth in many ways. Briefly, policy capture leads to misallocation of public and private resources resulting in rent-seeking activities, less efficiency at allocating resources and less productivity. By perpetuating or exacerbating social and economic inequalities, it can lead to blocked reforms or inadequately enforced policies. Policy capture is likely to decrease trust in government. It also entails health, environmental and security threats, e.g. by providing lower-quality services or neglecting safety (OECD, 2017a).

Corruption perception is high in LAC and since 2010, it has constantly increased. It even surpassed the average of Southeast Asia for the first time in a decade. Today, eight out of ten Latin Americans claim that their government is corrupt (Figure 3.3). The 2016 *Corruption Perception Index* also shows LAC as a region where perception of corruption among society is widespread. On a scale from 0 to 100, the region scores 55 points, much higher than average OECD member countries that score 31.

Figure 3.3. **Perception of corruption in government in Latin America and the Caribbean, Southeast Asia and the OECD**



Source: OECD/ECLAC/CAF based on Gallup (2017), *World Poll*, http://www.gallup.com/services/170945/world-poll.aspx.
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The pervasiveness of illegal practices such as corruption critically undermines the rule of law, a core requirement for the effective governance needed to realise full social and economic potential (World Bank, 2017a). Corruption reveals the use of the state and its institutions to gain private advantage. It does so by establishing favourable regulations, curbing competition or illegally appropriating public funds. Corruption

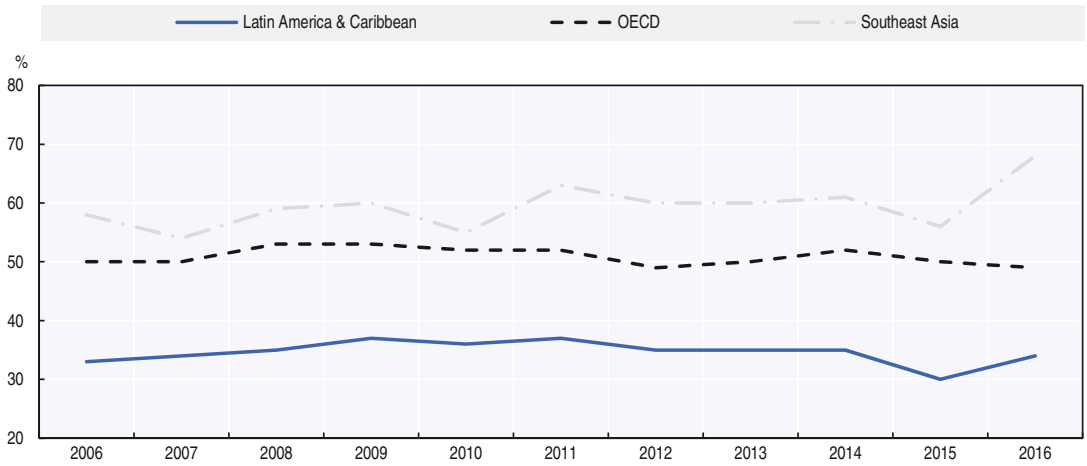
aggravates social and economic disparities. It allows undue influence of special interests to capture the public policy cycle and reduces the responsiveness and effectiveness of these policies, especially on marginalised groups. Corruption also limits fair and equal access to public services, such as education and health, that are critical to providing opportunities for social mobility.

Crime and impunity also indicate an important dysfunction in governmental institutions, particularly in the justice system. In 2014, three out of ten Latin Americans claimed that crime was the most important problem in their country. As a concern, according to the Latin American Public Opinion Project, crime surpasses unemployment, poverty and corruption (LAPOP, 2014). The problem may originate in ineffective institutions in the justice system. Indeed, fewer than 10% of homicides in the region are resolved. Further, an average of 60% of the prison population is in pre-trial detention (Jaitman and Guerrero Compean, 2015).

Supporting strong and independent judicial institutions is critical to strengthening the rule of law and building trust

In LAC, the judiciary is perceived as lacking independence or as being impaired by corruption and the meddling of political authorities. In fact, citizens' trust in the judicial system has been relatively low over the last decade (Figure 3.4).

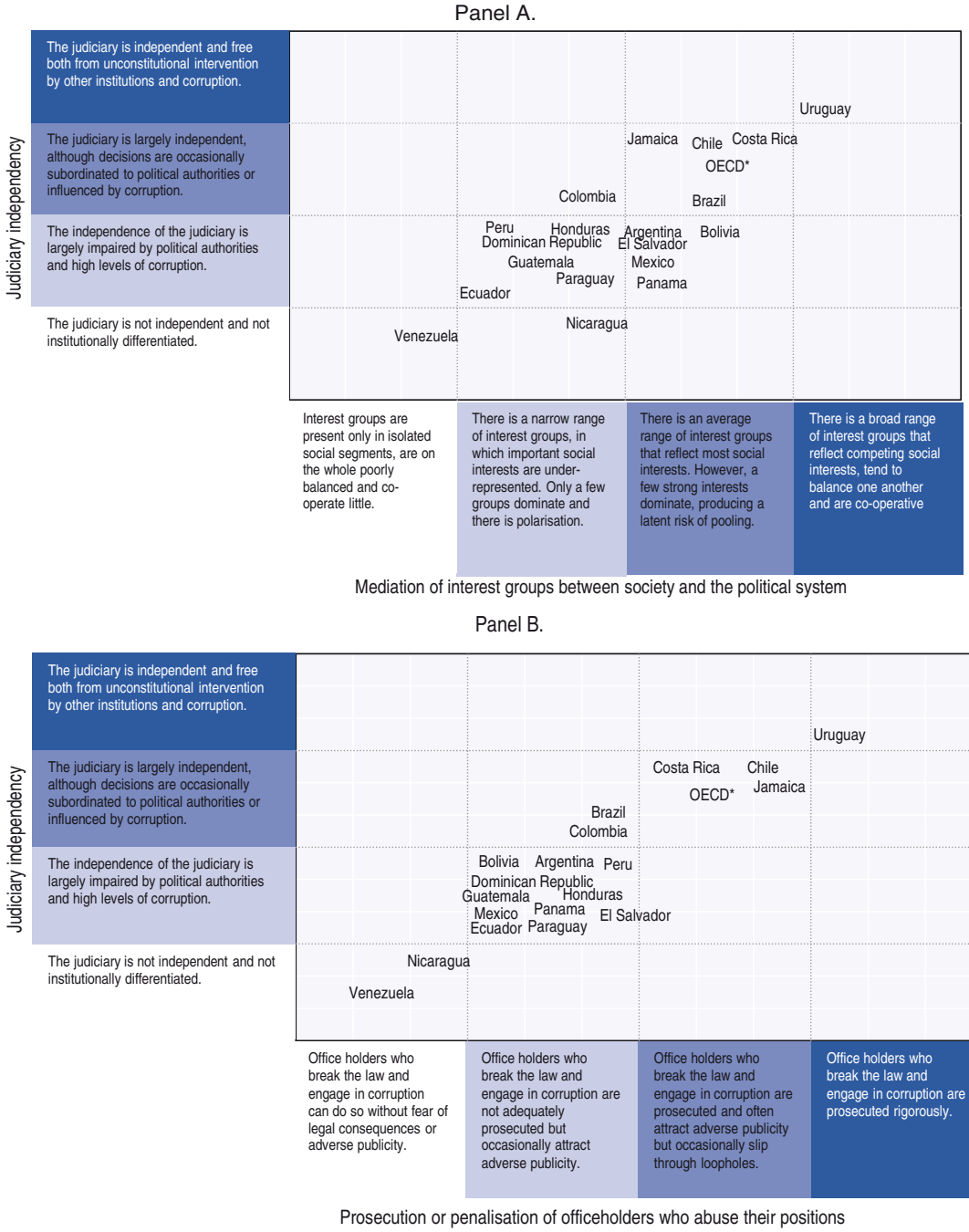
Figure 3.4. **Trust in judicial system in Latin America and the Caribbean, Southeast Asia and the OECD**



Source: OECD/ECLAC/CAF based on Gallup (2017), *World Poll*, http://www.gallup.com/services/170945/world-poll.aspx.
StatLink http://dx.doi.org/10.1787/888933650836

A few strong groups continue to dominate the political systems in LAC. This means that policy capture is ongoing, but shared among different groups (Figure 3.5, Panel A). Available data also indicates that office holders in LAC who abuse power are not prosecuted and that these wrongdoings are rarely reported publicly (Figure 3.5, Panel B). The pair-wise relationship between these variables suggests that improving the independence of the judiciary is linked to a wider variety of groups being represented in the public policy process and greater levels of prosecution of corrupt office holders. In both cases, the direction of the causality can flow either way. However, the independence and strength of the judicial power is necessary as it helps enforce property and civil rights, and prevent and control crime.

Figure 3.5. **Judicial independence, group representation in the political system and corruption**



Note: Country experts responded to the following surveys prepared and sent by the BTI project team: "To what extent does an independent judiciary exist?"; "To what extent are public officeholders who abuse their positions prosecuted or penalised?" and "To what extent is there a network of co-operative associations or interest groups to mediate between society and the political system?" Experts scored each question from 1-10, with higher scores implying better results in these dimensions. In some cases, some countries have been moved to avoid overlapping within squares.

* The OECD unweighted average corresponds to available data from the following countries: the Czech Republic, Estonia, Hungary, Latvia, Poland, the Slovak Republic, Slovenia, South Korea and Turkey.

Source: OECD/ECLAC/CAF based on BTI (2016), *Transformation Index*, www.bti-project.org/en/index/

Fostering strong, independent and effective legal institutions is critical to hinder policy capture, corruption and impunity in LAC. To tackle these perverse practices, checks and balances need to be strong, and the judicial power independent from interference and corruption.

To support a strengthened judicial system, the development of a network of institutions that reinforce compliance and raise accountability within the state is a necessary step. Opening government institutions to internal and external oversight is a move towards more transparent and accountable institutions. Journalists and other non-governmental organisations (NGOs) have played a critical role in denouncing the bending of rules within government institutions or inequalities in the application of legal frameworks. Recently uncovered corruption scandals illustrate the importance of these external institutions in the region. Meanwhile, information and communication technologies (ICTs) are amplifying the reach of these scandals. In any case, the combination of both factors is crucial in the fight against corruption (Box 3.1). The uncovering of corruption cases in the region is also a symptom of stronger institutions and independent judicial systems – a process initiated 25 years ago through judicial reforms. For instance, the *Lava Jato* scandal underway in Brazil was possible because of a widespread judicial reform undertaken in 1988 that created an independent prosecutor's office, lifetime tenure and protection against political retaliation (Ambrus, 2017).

To fight corruption effectively, countries need to develop a coherent integrity system which mainstreams integrity throughout public policies, strengthens both the prevention and enforcement of anti-corruption policies, and promotes measures of open government and transparency. LAC countries are undertaking anti-corruption measures, however these are often isolated and do not take into account the broader context. And initiatives for transparency must go hand in hand with effective scrutiny and accountability mechanisms (OECD, 2017b).The OECD *Recommendation of the Council on Public Integrity* sets forward different lines of action in this direction, including for anti-corruption.

The potential of integrity measures for development is large in LAC, as acknowledged by the OECD, which has made a number of recommendations specifically targeted at some Latin American countries. For instance, in Mexico, the creation of a coherent integrity system would be better achieved by integrating anti-corruption policies into key national strategies such as the National Development Plan (OECD, 2017c). In the case of Colombia (OECD, forthcoming), strengthening the internal control system within public institutions would help establish an integrity culture.

Box 3.1. **Corruption in LAC: The good news within the bad news**

Corruption scandals are perhaps among some of the most recently mentioned news about LAC countries. The first impression both for Latin American citizens and the international community is the prevalence of illegal practices in the heart of the political systems throughout the region. These recent scandals have aggravated the corruption perception in Latin America (Figure 3.3).

The scandals range from the Panama and Paradise Papers to the record USD 3.5 billion Odebrecht settlement in Brazil in December 2016. 2016 was a good year in the fight against corruption in the region (Transparency International, 2017). These uncovered illegal practices were unprecedented, putting the wealthy and the powerful in the spotlight as never before. In Brazil, the Petrobras' case (*Lava Jato*) contributed to the impeachment of President Rousseff; the Panama Papers revealed secret companies that served to evade taxes in their LAC base of operations; and Odebrecht gave big bribes to politicians in many countries to win large contracts (Ebrard, 2017 and *The Economist*, 2017).

Box 3.1. **Corruption in LAC: The good news within the bad news** *(cont.)*

The impact of the digital era on fighting corruption was, however, not reported. Indeed, big data and open data contributed to the discovery of these cases. The Panama Papers case was a massive leak of data that included 11.5 million documents, or 2.6 terabytes of data, from about 215 000 offshore bank accounts and shell companies (Santiso and Roseth, 2017). The International Consortium of Investigative Journalism (ICIJ) provided reporters with the data-mining expertise needed to make the documents transparent. Data analytics start-ups such as Linkurious extracted the metadata and helped connect the dots through data-visualisation tools. Storing the information in the cloud enabled almost 400 reporters worldwide to work together on the same project (Santiso and Roseth, 2017). Similarly, in Brazil, open data had an important role in the investigations. Data related to budget and public finances in government transparency portals were crucial for detecting some of the irregularities of recent cases.

Structural changes to enhance oversight and the participation of lateral civil institutions are needed in Latin American society to prevent corruption. Still, the revelations of some big corruption cases might already represent steps in the right direction. These cases are showing increasing independence of the justice systems and the functioning of checks and balances, which are both crucial pillars for a well-functioning democracy. They also show that new technologies are having an important impact in the evolution towards better institutions. And they demonstrate that LAC is profiting from these new opportunities to reveal perverse practices within the public sector and promoting a culture of legality.

Regulations must be improved to support fair competition and build trust in the public sector as a service provider

One of the most common practices distorting fair competition is collusive behaviour in public procurement. Collusion or cartel is the general term used to define agreements between companies that should be competing in the market but decide not to do so. Instead, they fix prices for goods and services, allocate markets or customers and/or restrict output. These agreements operate in secrecy and can be difficult to detect. As a result of these agreements, consumers (including governments) pay higher prices and get lower quality goods or services than in a competitive market. This kind of practice can affect the public sector (and citizens eventually) through the distortion of public procurement processes. The failure to achieve "value for money" has a negative impact on the range and depth of services and infrastructure that a state can provide to the most disadvantaged in society who rely the most on public services. Moreover, this kind of activity diminishes public confidence in the government and the market, ultimately inhibiting a state's economic development (OECD, 2011).

In particular, bid rigging, a specific type of collusive and cartel behaviour, has negative economic consequences and diminishes the quality of services or goods provided to citizens. Bid rigging occurs when firms collude instead of genuinely competing against each other to win a tender (OECD, 1998). The practice can take many forms, including cover bids, bid suppression, market allocation and bid rotation (OECD, 2009). It may result in overcharges of 20% or more in OECD economies. In view of these effects, substantial efforts should be devoted towards reducing these practices in LAC countries.

Price rigging or fixing practices by private agents can also have a detrimental impact on citizens. This occurs through lower quality or overpriced services or more generally, through lower productivity and economic growth. Competition between firms leads to

increased productivity and economic growth. Policies promoting competition, access to markets and entry of new firms are linked particularly to improving productivity and well-being (Cole and Ohanian, 2004; Lewis, 2004). Furthermore, policies that lead to markets operating more competitively, such as enforcing competition law and removing regulations that hinder competition, result in faster economic growth (OECD, 2013a).

OECD's guidelines for fighting bid rigging in public procurement promote real competition as a key element to combat collusive practices and promote productivity and growth. The guidelines gather some good practices to help countries both identify and fight this illegal behaviour. For example, tender processes for public procurement should be genuinely designed and implemented to promote the participation of qualified firms. Therefore, knowledge of market characteristics is one of the most important steps. Requirements should be defined clearly, as well as the criteria for evaluating and awarding the tender (OECD, 2012). These guidelines are relevant for Latin American countries since guaranteeing good practices in this respect would benefit competition and productivity.

The OECD recently made recommendations to promote a better institutional framework of competition authorities in Colombia and Costa Rica (Box 3.2). Effective competition policy requires the competition authority to have a strong institutional and regulatory framework. The independence and effectiveness of competition authorities are key elements to facilitate companies' contribution to economic activity and to foster the well-being of all citizens.

Box 3.2. **Independence and effectiveness of competition authorities in Costa Rica and Colombia**

Costa Rica

The level of independence of the Costa Rican Competition Authority (COPROCOM) should be enhanced (OECD/IDB, 2014). COPROCOM is an agency with formal technical autonomy within the Ministry of Economy, Industry and Commerce (MEIC). However, its inclusion within MEIC implied a certain degree of budgetary and administrative dependency. In addition, the minister's role in the appointment and removal of COPROCOM's Technical Support Unit executive director could jeopardise the authority's independence. Regarding operational issues, given that commissioners work part-time, COPROCOM is understaffed. The authority's budget is low compared with other economic regulators in Costa Rica and similar competition agencies in the region. This could have a negative impact on its effectiveness.

Following the OECD's recommendations, Costa Rica issued a legislative proposal. The draft law would establish a competition tribunal to replace COPROCOM. This tribunal would be created within MEIC, but with functional, administrative and financial independence. Its budget and financing would come from direct transfers from the state budget, merger control fees, donations and receipt of 30% of all fines. Tribunal members would be appointed for six-year terms following an open public competition by the Council of Ministers. The tribunal would be solely responsible for the appointment of its president and of its technical staff. It would also have its own legal status. As such, it would not be dependent on the Attorney to defend its decisions in court.

The tribunal would comprise three permanent full-time members and two substitutes. All members would have to be experienced and impartial professionals. The draft law also sets up a support technical body, the *Secretaria General de Competencia*. A secretary general appointed by the tribunal for a six-year term and subject to the direction of the tribunal would manage this support body. The *Secretaria* will not be part of the general civil service, and is subject to its own specific regulation and staff rules.

Box 3.2. **Independence and effectiveness of competition authorities in Costa Rica and Colombia** *(cont.)*

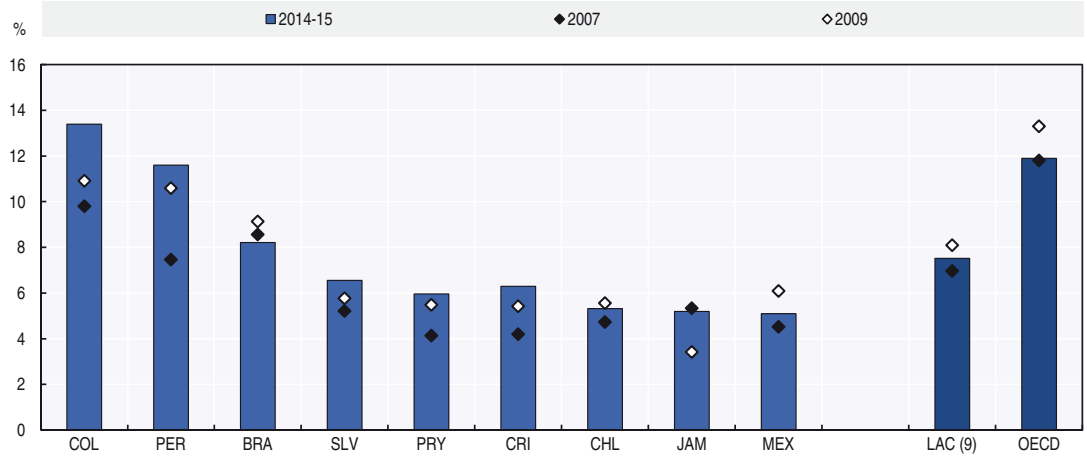
Colombia

Since September 2015, the institutional framework of the Superintendence of Industry and Commerce (SIC) has improved thanks to further independence of its superintendent. Previously, the president could appoint and remove the superintendent at will. The superintendent did not serve for a fixed term of office, which could interfere with the agency's independence (OECD, 2016a). In 2015, to address that lack of independence, Colombia passed legislation that provides for a fixed term for the SIC's superintendent coinciding with the president's four-year term; the president can now only remove the superintendent for cause. The Competition Committee concluded this was a practical solution to the problem of assuring political independence for the agency.

In LAC, public procurement represents close to 8% of gross domestic product (GDP) (Figure 3.6). In some countries such as Colombia and Peru, public procurement is more than 10% of GDP, close to the OECD average of 11.9% of GDP (OECD, 2016b). Public procurement is a crucial government activity to channel delivery of services to citizens. Yet private sector companies can affect the effectiveness of public procurement through price rigging. Such practices risk creating inefficiency and waste in the large and stable volumes of purchases by governments.

The creation of central purchasing bodies (CPBs) as centres of procurement expertise and the development of e-procurement solutions are transforming traditional practices in LAC. These new practices permit knowledge sharing across relevant procurement actors in a more structured way. They also enhance different capabilities across all levels of government, including regional and local counterparts. Latin America has several examples of CPBs that have considerably improved in the past years such as *Colombia Compra Eficiente* or *ChileCompra*. However, challenges remain to increase their effectiveness (OECD, 2017e, 2016b).

Figure 3.6. **Government procurement as percentage of GDP, 2007, 2009 and 2014 or 2015**



Note: Data for Colombia, Costa Rica, Mexico and the OECD average correspond to 2015.

Source: OECD (2017e), *Government at a Glance 2017*, http://dx.doi.org/10.1787/gov_glance-2017-en; OECD (2016b), *Government at a Glance, Latin America 2017* http://dx.doi.org/10.1787/9789264265554-en.

StatLink http://dx.doi.org/10.1787/888933650855

Box 3.3. **How well are stakeholders involved in the regulatory policies in Latin America?**

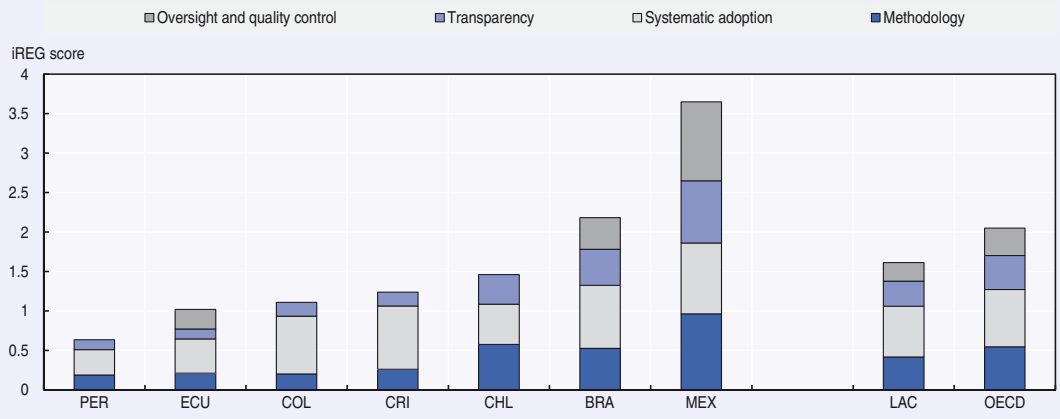
Regulation is a critical tool by which governments seek to foster economic growth and social well-being. Countries in Latin America are increasingly investing in processes and institutions that support quality of regulations.

A composite indicator on stakeholder engagement in developing subordinate regulations was developed based on information on regulatory practices collected from countries in Latin America. This followed the established methodology of the OECD Indicators of Regulatory Policy and Governance. The indicator measures the adoption of good practices to engage with interested parties when developing new regulations. These include different methods and openness of consultations, as well as transparency and response to comments received.

It consolidates information in four equally weighted categories: i) *systematic adoption* records formal requirements and how often these requirements are conducted in practice; ii) *methodology* that gathers information on the methods used in each area, e.g. the type of impacts assessed or how frequently different forms of consultation are used; iii) *oversight and quality control* that records the role of oversight bodies and publicly available evaluations; and iv) *transparency*, which records information that relates to the principles of open government, e.g. whether government decisions are made publicly available.

The analysis of seven Latin American economies in the region (Brazil, Chile, Colombia, Costa Rica, Ecuador, Mexico and Peru) shows that these countries have taken steps to improve their regulatory governance framework by investing in processes and institutions that support inclusive and evidence-based policy making. However, important gaps remain in most countries in terms of the implementation of key tools. These tools include consultation with stakeholders, regulatory impact assessment and *ex post* evaluation. Strengthening the institutional oversight of the regulatory process will be critical to ensure the consistent implementation of these tools in the future (Querbach and Arndt, 2017; Figure 3.7).

Figure 3.7. **Composite indicator: Stakeholder engagement in developing subordinate regulation in selected Latin American economies**



Note: The figure displays the total aggregate score across the four separate categories of the composite indicator. The maximum score for each category is one and the maximum score for the aggregate indicator is four. The more regulatory practices as advocated in the 2012 OECD Recommendation on Regulatory Policy and Governance a country has implemented, the higher its indicator score. The data on LAC countries reflect the situation as of 31 December 2015. Data cover 34 OECD member countries and reflect the situation as of 31 December 2014.

Source: *Indicators of Regulatory Policy and Governance* (iREG) for Latin America 2016; *Indicators of Regulatory Policy and Governance* (iREG) 2015.

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The OECD has delivered specific recommendations to promote competition and reduce the risk of bid rigging in procurement procedures. In 2009, the OECD Competition Committee developed the Guidelines for Fighting Bid Rigging in Public Procurement. In 2012, the OECD Council adopted the Recommendation of the Council on Fighting Bid Rigging in Public Procurement. It calls on governments to strive for public procurement procedures that are designed to promote competition and reduce the risk of bid rigging. Colombia and Mexico, for example, should create a specialised department dedicated to market analysis for all contracting procedures; improve the electronic bidding system and the regulatory framework on tender procedures; increase information sharing and communication among public entities; prepare detailed, useful market studies; and provide training to public servants.

The cases of Colombia and Mexico provide in-depth analysis and specific recommendations on how to improve tender processes. In 2013, Colombia signed an agreement with the OECD to review its procurement legislation and practices. It aimed to verify if the country was in line with the OECD's 2012 recommendations. Following a review, the OECD made additional recommendations (OECD, 2014a) such as: increasing the use of public tenders, consolidated purchases and reverse auctions; preparing detailed and useful market studies; reducing disclosure of competitively sensitive procurement and bidding information; increasing information sharing and communications among the SIC, the newly established National Public Procurement Agency (NPPA) and government purchasing officials; and finally, expanding training activities sponsored by the SIC and NPPA.

Similarly, for Mexico, the OECD recommended: creating a specialised department dedicated to market analysis for all contracting procedures; limiting the use of exceptions to open tender procedures; managing the information flow towards third parties in a way that avoids unnecessary disclosure of sensitive information; expanding efforts to consolidate purchases and take better advantage of framework agreements; implementing a strict approach for joint bids and subcontracting; setting conditions under which a contract may be split to avoid market sharing; opening the market to foreign bidders and enhancing the participation of small and medium-sized enterprises; prioritising electronic bidding systems to make procedures more efficient and collusion more difficult; establishing closer co-operation with the Mexican competition authorities: the Federal Commission for Economic Competition (COFECE, in Spanish) and the Federal Telecommunications Institute (IFT in Spanish); setting up regular training on collusion for procurement officials; establishing a system to report suspicions of bid rigging; and developing a complete, comprehensive and easily accessible electronic record of the procurement documents.

Towards a better administration: public sector reform to ensure effective governance

LAC countries need institutional reforms to strengthen the administrative capacities of the state and support good governance. Good governance processes depend on the capacity of the central government to undertake a leading role for transiting the country towards its long-term vision. Additionally, the state requires a well-trained and capable bureaucracy and better management practices to establish an adequate environment for result-oriented planning, investments and policy making. These capacities are needed at all levels of government to ensure that coherency in decision making and long-term planning translates into development that reaches all layers of society equally. Finally,

the adoption of ICTs can facilitate administrative processes and contribute to developing innovative solutions within governments and in partnership with civil society. Appropriating digital tools can significantly contribute to making state processes more efficient and effective to deliver better services and regain citizens' trust.

The Centre of Government is critical to improve decision-making processes

The Centre of Government (CoG) is a critical component for ensuring good governance capacities and addressing citizen demands. The CoG refers to the organisational units that provide direct support to the head of government (president or prime minister) and perform key cross-cutting functions (Table 3.1). For example, the CoG strategically manages the government's priority goals and co-ordinates the ministries and agencies that contribute to those goals. It monitors implementation of priority programmes and overcomes obstacles when performance is lagging. In addition, it manages the politics to enable the approval and implementation of priority programmes, and communicates results to the public (Alessandro, Lafuente and Santiso, 2013; OECD, 2016b). The CoG requires the capacity to shape a strategic vision, to secure its coherence and to make it operational (OECD, 2015a). It ensures that ministries and other government institutions align their interventions to achieve the intended policy goals. It also organises and supports the head of government's decision-making process to deliver on established priorities.

Table 3.1. **Role of Centres of Government in addressing public management issues**

Issue	Role of the Centre of Government
Citizens increasingly demand better public services and results from government institutions.	Establishing and communicating priority goals (being selective); ensuring budgetary alignment, monitoring progress continuously and unblocking obstacles that affect performance.
Most priority issues are multidimensional and cross-cutting; they cannot be properly addressed by vertical ministerial silos.	Co-ordinating and brokering solutions, bringing together the relevant ministries and agencies to make decisions and design and implement policy.
Government activity expands into new policy areas.	Supporting and advising the chief executive in managing a complex government structure, especially if policy making is fragmented or decentralised.
A continuous news cycle can divert the government's attention from priorities.	Keeping a systematic focus on strategic priorities, aligning the government's message.

Source: Alessandro, Lafuente and Santiso (2014), *Governing to Deliver: Reinventing the Centre of Government in LAC*, https://publications.iadb.org/bitstream/handle/11319/6674/Governing-to-Deliver-Reinventing-the-Center-of-Government-in-Latin-America-and-the-Caribbean.pdf?sequence=1.

Most presidents and prime ministers in LAC relied on three fundamental channels for decision making: Cabinet meetings (93% of countries), direct bilateral contacts with ministers (80%) and advisory groups (46%) (Table 3.2). Cabinet meetings provide opportunity for all relevant stakeholders to express their views and to inform all appropriate information to aid in decision making.

Table 3.2. **CoG's policy discussion channels**

	Bilateral contacts with ministers	Groups of advisors	Cabinet meetings
Argentina	●	○	●
Chile	●	●	●
Colombia	●	●	●
Guyana	○	○	●
Costa Rica	●	●	●
Guatemala	●	○	●
Haiti	●	●	○
Honduras	●	○	●
Mexico	○	●	●
Panama	●	●	●
Paraguay	●	●	●
Peru	●	○	●
Dominican Republic	●	○	●
Trinidad and Tobago	○	○	●
Uruguay	●	○	●
LAC total			
● Yes	12	7	14
○ No	3	8	1
OECD total			
● Yes	19	17	23
○ No	9	11	5

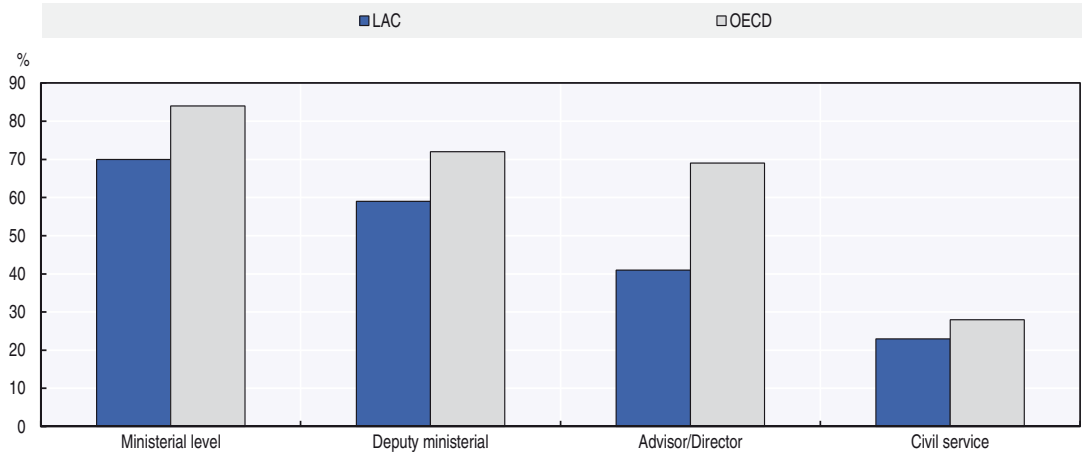
Source: OECD (2016b), *Government at a Glance, Latin America 2017*, http://dx.doi.org/10.1787/9789264265554-en.

A whole-of-government approach – emphasising co-operation and co-ordination – is crucial in LAC, particularly in a context of increasing decentralisation of administrative capacities and responsibilities. Lack of adequate co-ordination can lead to serious inefficiencies such as overlaps between different institutions. This, in turn, causes confusion and wastes important resources. It can also lead to bureaucratic conflicts and hinder resolution of problems (Alessandro, Lafuente and Santiso, 2014).

The large majority of countries in LAC have bodies to co-ordinate government institutions. This co-ordination exists at the level of ministers (70% of countries), deputy ministers (59%), other political level (41%) and at the civil service (only 23%) (Figure 3.8). In the OECD, there are relatively more countries with co-ordination bodies, but the diminishing trend with the political level persists. Within countries of the OECD, co-ordination exists at the level of ministers (84% of countries), deputy ministers (72%), directors (69%) and at the civil service (38%) (Alessandro, Lafuente and Santiso, 2014).

Governments around the world have sometimes also sought to reinforce their Centre of Government to drive performance improvements by creating Delivery Units (DUs). Pioneers of this trend in LAC include Brazilian states such as Minas Gerais and Pernambuco, which developed their models between 2003 and 2008. Chile's DU also functioned from 2010 to early 2014. Since 2013, more than 14 governments in the region have adopted delivery management models both at the national and sub-national level (Box 3.4.).

Figure 3.8. **Policy co-ordination at different levels in LAC and OECD member countries**



Source: Alessandro, Lafuente and Santiso (2014), *Governing to Deliver: Reinventing the Centre of Government in LAC*, https://publications.iadb.org/bitstream/handle/11319/6674/Governing-to-Deliver-Reinventing-the-Center-of-Government-in-Latin-America-and-the-Caribbean.pdf?sequence=1.

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Box 3.4. **Delivery units achieve top priorities: Peru, Colombia and the City of Buenos Aires**

Several governments in Latin America and the Caribbean (LAC) have been strengthening their Centre of Government through the adoption of "delivery" management models. They have taken inspiration from successful experiences in the United Kingdom, United States, Malaysia and other countries. This trend also seems to be an upgrade from results-based budgeting, which was more popular a decade ago. It focused mainly on budget execution in LAC whereas "delivery" prioritises actual results for citizens.

DUs aim to facilitate the government's delivery of top priorities. They are inspired by similar principles (highly selective, focused on implementation) and follow similar lessons learned (small unit empowered by the president or prime minister, low profile, early start-on). However, these models have not been homogeneous given their roll-out in different institutional contexts. The most popular choice of DU calls for stronger CoGs to strengthen the functions of strategic management (micro-planning for top priorities) and monitoring and improving government performance. Three of the most interesting cases are summarised below.

Peru: The DU is mapped to the Presidency of the Council of Ministers. Its initial task was to transform aspirational statements by the president and the prime minister in seven policy areas into concrete objectives. They had specific key performance indicators, critical intervention activities to achieve the targets, and a plan to ensure effective implementation of the interventions. The DU ran workshops with pertinent stakeholders to ensure full ownership. It also helped stakeholders craft the delivery strategies for each area to achieve its goals. From June 2017, all strategies were in place and the DU had organised stock-takes (follow-up meetings between the ministers and the prime minister) for most priorities to facilitate decision making and problem solving.

Box 3.4. **Delivery units achieve top priorities: Peru, Colombia and the City of Buenos Aires** *(cont.)*

Colombia: The DU was introduced under the Ministry of the Presidency at the beginning of President Santos' second term in 2014. It had three main objectives: i) to lead the planning and delivery of presidential goals such as lifting 1.5 million Colombians out of poverty; ii) to support the government's 21 sectors to identify and plan the achievement of one goal for each of them by the end of the term, which were made public; and iii) to lead vertical co-ordination to implement regional initiatives in key departments. As of 2017, the DU's relevance in the first two tasks has been decreasing. Once the planning phase was completed, each sector took charge of its own goals, lowering the value added of the DU. In addition, the success of the peace process superseded other priorities, which changed the DU's mandate.

City of Buenos Aires: The DU, introduced in December 2015, complemented an eight-year-old management model with detailed planning and monitoring of all the city's projects. The DU's main innovation was the identification and publication of commitments between the mayor and citizens following criteria such as feasibility and impact. The first set of 20 commitments was publicly announced three months after taking office. It includes outcome indicators such as the reduction of traffic fatalities by 30% and the doubling of students with higher levels of performance in mathematics. Other commitments were output-related such as achieving seven paediatric visits in the first year of a child's life and the completion of several public works. In 2016, the mayor added 15 more commitments. Public accountability seems to be the key driver of the model: an impressive online tool updates government performance on all commitments on a regular basis. The mayor reports back to citizens with detailed performance data on an annual basis.

Source: Inter-American Development Bank.

Progress towards merit-based hiring in the public service must be continued

The administrative capacities of the state are limited by the quality of its public servants. Competences, skills and abilities of civil servants determine whether institutions can function effectively and efficiently. Thus, public employees are one of the most valuable assets of institutional governance. By performing the essential tasks of government, they keep institutions moving. Moreover, policy implementation and its results depend highly on public servants performing these tasks impartially and with integrity (Santiso et al., 2014).

Human resource management in the public sector has a strong influence on the quality of public administration. Good managerial practices include merit-based recruitment of civil servants that ensures impartiality of the civil service. Systematic performance evaluations of civil servants and incentives for training or education programmes for public employees also make a great difference in a state's administrative capacities. These processes determine the productivity of the public sector and the efficiency with which bureaucracies respond to citizens' demands.

The recruitment of civil servants determines the endowment of human capital in the long term. As a result, it can be decisive for ensuring a high quality public administration. Three features of human resources management are crucial for ensuring a merit-based recruitment. First, an open recruitment to fill vacancies established by law must be available to all candidates with the required qualifications;

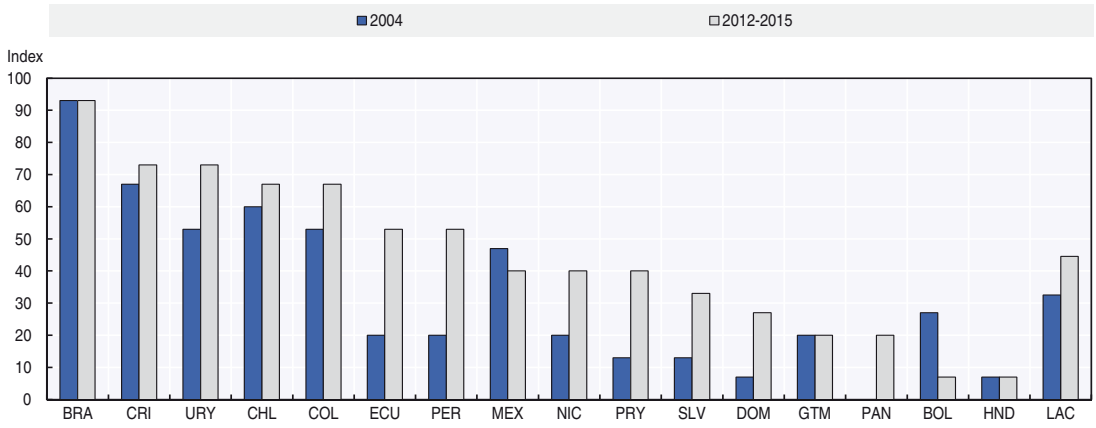
these are established according to suitability for the post and technical considerations, not arbitrarily. Second, the necessary safeguard mechanisms and procedures should be in place against arbitrariness, politicisation, patronage and clientelism throughout the entire hiring process. Third, dismissals or terminations of employment that affect professional positions must not be motivated by a change in the government's political leanings (OECD, 2016b). These practices align public employees' skills and capacities to a position's requirements and demanded level of responsibility. They also protect employees from wrongful or politically motivated termination.

In most LAC countries, public institutions lack a formal professional civil service and experience a high proportion of political appointments among public servants (OECD/ECLAC, 2012). Between 2004 and 2012-15, LAC countries made significant progress towards merit-based processes to hire public servants (Figure 3.9). However, they continue to underperform on civil service merit scores. On average, the LAC region increased its merit score by 12 units on the *Civil Service Merit Index*, jumping from 33 to 45 on a scale from 0 to 100. Only Mexico and the Plurinational State of Bolivia (hereafter "Bolivia") showed deterioration in their recruitment process. All countries could improve as the majority score under 70 out of 100.

Figure 3.9. **Civil servants' recruitment and quality**

Civil service merit index (2004, 2012-2015)

Scale 0 to 100, with 100 being the best possible score



Source: OECD (2016b), *Government at a Glance, Latin America 2017*, http://dx.doi.org/10.1787/9789264265554-en.
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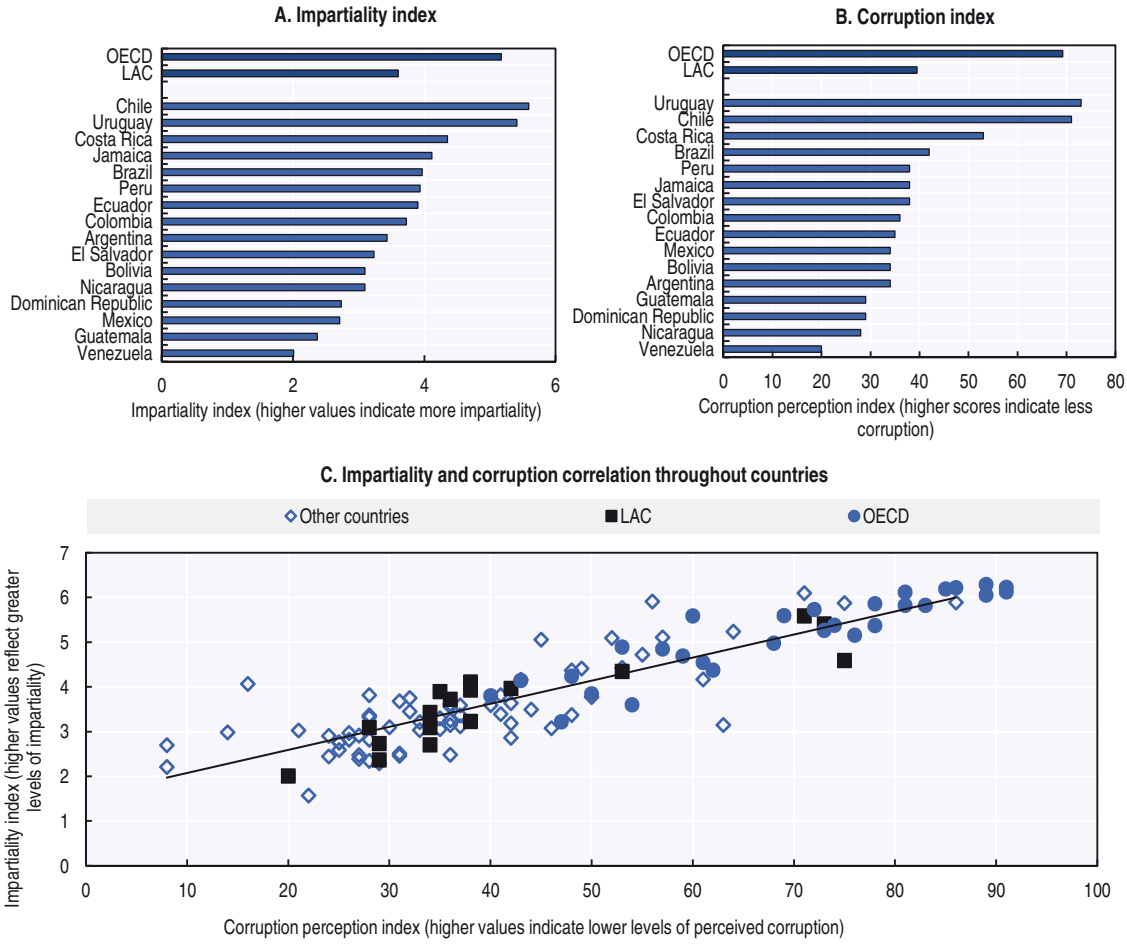
Impartiality of public administration is generally below OECD levels

In the LAC region, with the exceptions of Chile and Uruguay, impartiality is below OECD levels. Impartiality of public administration and merit-based selection processes are related to each other. Together, they help ensure that open, transparent and competitive hiring practices are in place. The level of impartiality of public institutions is also a critical dimension of a state's capacity. Impartiality is indeed a key concept underlying quality of government (Rothstein and Teorell, 2008). It reflects the responsibility of the government bureaucracy to provide services, adhere to rules, and implement and execute the law in a manner that is free of fear or favour and that is fair and impartial for all (Van Houwelingen et al., 2015). This requires civil servants who apply the norms and processes according to the law, as well as an independent judicial system.

Impartial public administrations increase citizens' trust in the public sector and in government in general, boosting confidence towards institutions. Indeed, impartiality of public administration is positively and significantly correlated with lower levels of

corruption, as scored by the *Corruption Perception Index* at a global scale (Figure 3.10). This correlation remains significant when only LAC countries are sampled (Figure 3.10, Panel C). Put differently, people who perceive the public administration as being impartial will also perceive governments as being less corrupt.

Figure 3.10. **Ranking and correlation between impartiality of the public administration and corruption perception, 2017**



Note: Level of correlation is 0.9007, significant at a 0.05% level. The indicator for corruption is the Corruption Perception Index calculated by Transparency International. It ranges from 0 to 100, with lower values showing more corruption. The correlation is done at a global scale including all countries for which data are available. For Latin American countries, the correlation remains significant at a 0.05% level with a value of 0.9244. The impartiality index ranges from 0 to 6 with higher values corresponding to more impartiality.

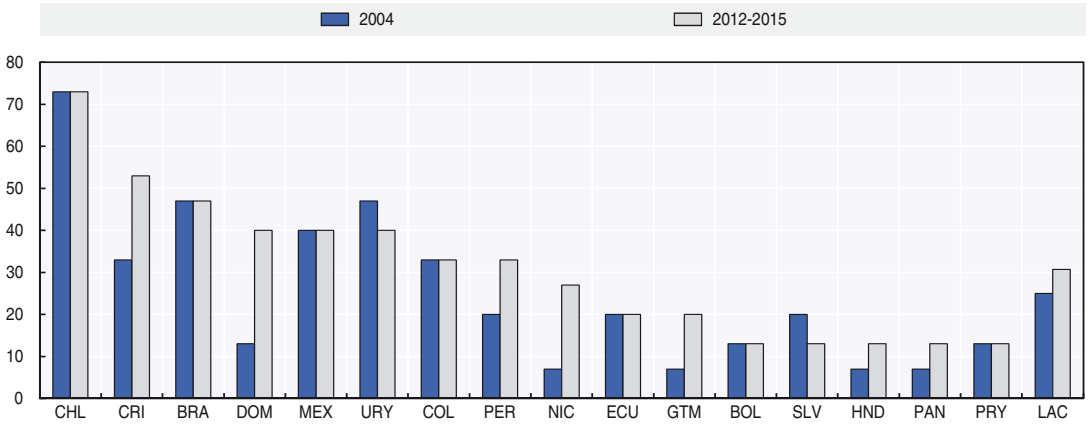
Source: OECD/CAF/ECLAC based on the *Quality of Governance Database*, Cross-section data, 2017.

StatLink http://dx.doi.org/10.1787/888933650931

LAC countries are still strengthening performance appraisals (Figure 3.11), which contribute to improving staff performance and motivating public employees. Throughout the region, most countries have improved the evaluation systems between 2004 and 2012-14, except for Bolivia and Uruguay. This *performance appraisal index* includes three critical aspects: assessment and definition of guidelines and standards of expected performance; monitoring of personnel performance throughout the management cycle; and completion of staff appraisals compared with standards of expected performance (OECD, 2016b). Despite improvements, most public administrations in LAC continue to score under 50 out of 100 and the average of the region reaches only 31 on a scale from 0 to 100.

Figure 3.11. **Performance appraisals (2004, 2012-2015)**

Scale 0 to 100, with 100 being the best possible score



Source: OECD (2016b), *Government at a Glance, Latin America 2017*, http://dx.doi.org/10.1787/9789264265554-en.
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LAC governments need to incorporate digital, innovation and data skills in the public sector. Today's challenges are demanding new technical skills and applied knowledge from civil servants. Digital abilities, as well as some behavioural and cognitive skills for innovation, are crucial for successfully meeting rapidly evolving demands. The digital transformation of governments and public services has important effects on operations. This, in turn, affects the relationship between the state and citizens. The transformation implies a shift towards a demand and data-driven strategy, requiring new forms of partnerships and engagement, new skills and accountability models for the public sector (OECD, 2017f).

In Chile, the *Laboratorio de Gobierno Experimenta* programme takes a learning-by-doing approach to build civil servants' innovation capabilities. Skills targeted by the Laboratorio include people-centred research and design, co-creation, and collaboration and integration of multiple approaches (OECD, 2017f). More specifically, it helps a selected group of participants to address concrete institutional challenges. It does so by strengthening their skills related to different elements of public sector innovation.

Encouraging creative and productive behaviour within the public sector can also increase its appeal. Human resource managers should support public servants who come up with new approaches to service delivery. A creative work environment requires technical abilities, but also creativity and associative thinking. People can be naturally motivated, but the organisational culture and management also play a role (OECD, 2017g).

Fighting discrimination in the public sector can attract skilled and talented employees

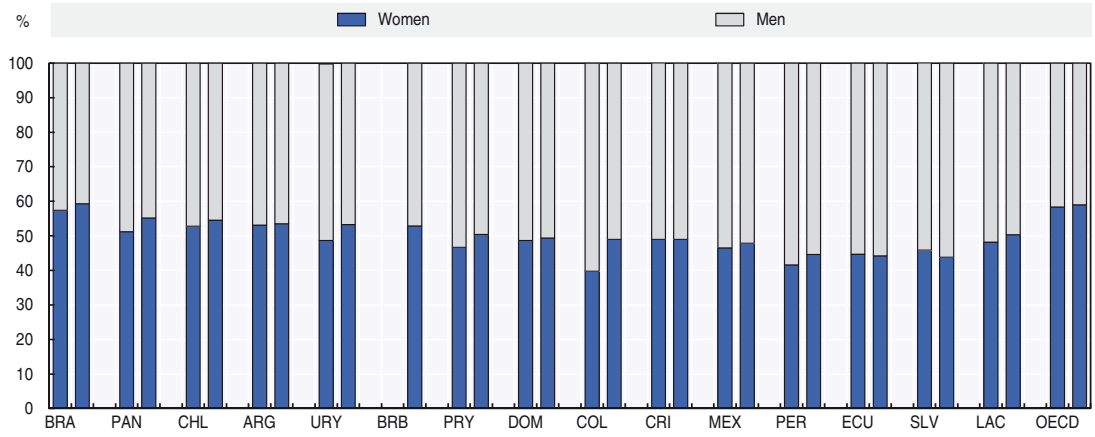
Promoting practices that help fight against discrimination in the public sector (gender, race, political affiliation) should be a top priority for governments in the region. A positive work environment attracts talented and skilled employees. Merit-based recruitment can enhance productivity in the public sector by matching candidates' abilities to required tasks. It would contribute to ensure a fair selection process that renders high quality public administrations. Further, it would help safeguard the required degree of technical expertise to design and implement public policies. Strategic policies that encourage and support the re-skilling, training and development of new competences of public employees can also make public service attractive.

Gender equality is increasingly a policy priority for LAC countries. The strong increase in female labour force participation is among the most salient socio-economic

changes in the region in the last half century (Gasparini and Marchionni, 2015). Indeed, male labour force participation remained roughly unchanged at around 95%. However, between 1992 and 2012, the participation rate for prime-age females climbed from 53% to 65%. Yet the gap is far from being closed. In fact, since 2002, the rate of women participation in the labour market has strongly decelerated.

Latin American women and men are almost equally represented in the public sector, reaching 50.3% and 49.7% of the employment rate, respectively (Figure 3.12). The representation of women in the public sector improved between 2009 and 2014. It is nevertheless quite worrisome that the share of women in ministerial positions barely reaches an average of 23.8% (Figure 3.13). This shows that even though women are constantly increasing their representation in the public administration, they might be staying at lower positions. It further suggests that women are still underrepresented in leading positions in the public sector and are less likely to actively shape policy decision-making processes.

Figure 3.12. **Share of public sector employment filled by women and men, 2009 and 2014**

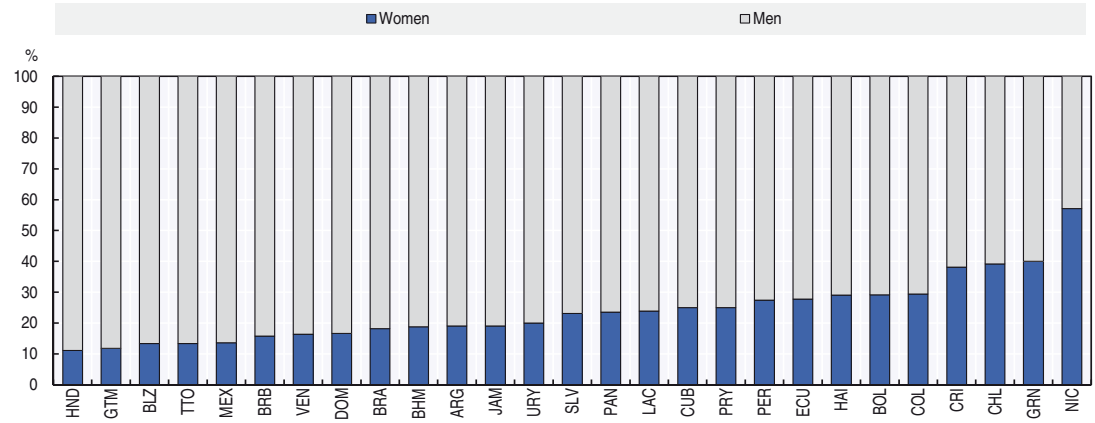


Note: Data for Brazil, Chile, Mexico, Costa Rica and Colombia correspond to 2015.

Source: OECD (2017e), *Government at a Glance 2017*, http://dx.doi.org/10.1787/gov_glance-2017-en; OECD (2016b), *Government at a Glance, Latin America 2017*, http://dx.doi.org/10.1787/9789264265554-en.

StatLink http://dx.doi.org/10.1787/888933650969

Figure 3.13. **Percentage of women in ministerial positions, 2016**



Source: ECLAC (2017) – *CEPALSTAT database*, http://estadisticas.cepal.org/cepalstat/WEB_CEPALSTAT/estadisticasIndicadores.asp?idioma=i.

StatLink http://dx.doi.org/10.1787/888933650988

LAC countries have made progress to strengthen public management

LAC countries have taken actions in the past decades to strengthen their public management cycles and increase the delivery of results for citizens. The concept of results-based management or managing for development results emerged in LAC in the early 2000s. It has since gained great traction.

Managing for Development Results (MfDR) focuses on performance indicators to improve outcomes and long-term impacts. The MfDR approach aims to improve the effectiveness of public management by switching focus from inputs and processes to measurable results. Essentially, it gives priority to strategic foresight and builds plans and decisions around tangible results by strengthening monitoring and evaluation. The five pillars that underpin this approach are results-oriented planning, results-based budgeting, public financial management, project and programme management, and monitoring and evaluation systems.

Governments in LAC have undertaken major efforts to improve medium and long-term national planning capacity, medium-term budgeting, programme budgeting and several financial management instruments. These efforts reflect a desire to gain greater control over public spending and to focus on strategic objectives. Available data show that Peru, Costa Rica, Honduras, the Dominican Republic, Belize and Ecuador have experienced the most progress with respect to planning systems (Kaufmann, Sangines and Garcia Moreno, 2015).

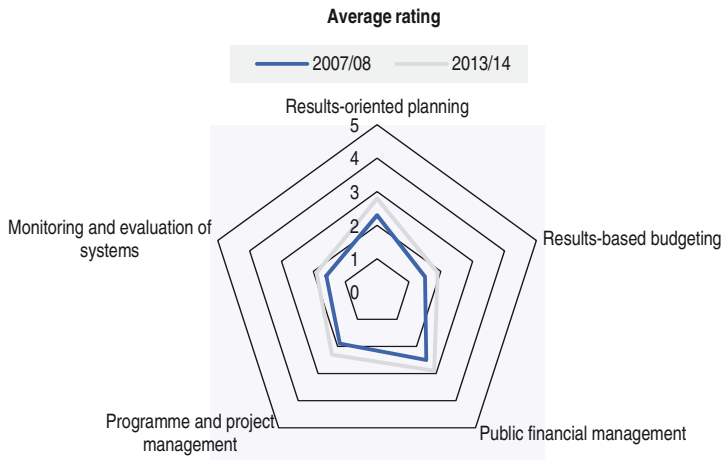
LAC governments have made less progress, however, in the areas of evaluation of spending effectiveness, aligning incentives to achieve institutional objectives and implementing evaluation systems. Where such efforts have been pursued, such as in Costa Rica, the National Evaluation System serves basic accountability requirements. However, it is rarely used as input to inform future decision making (OECD, 2015a). These capacities should produce information on performance to inform decision making. If they continue to fall short, it may jeopardise progress within the public management pillars.

Overall, the region has advanced on all five pillars of this policy management strategy (Figure 3.14). However, country-level analysis reveals mixed progress. All countries analysed improved their scores, although to varying degrees. In 2007, governments in Belize, Guyana, Jamaica, Nicaragua, Paraguay, and Trinidad and Tobago had the lowest scores (under 1.5, on a scale of 0 to 5, in which 5 is the optimal score) on the *MfDR Index*. They have all taken significant steps to improve their national public management systems.

Likewise, in recent years, some countries with intermediate scores (between 1.5 and 3), especially the Dominican Republic, Ecuador and Peru, have undertaken major reforms and are advancing rapidly. The group of countries with the highest scores (over 3) – Brazil, Chile, Colombia and Mexico – have a substantial lead over the rest, displaying a more balanced development in the five pillars of MfDR. They show stronger practices in the areas of results-based budgeting and monitoring and evaluation (M&E,), which tend to be the weakest aspects for most countries in the region. Mexico for instance, has incorporated M&E practices at both the national and subnational levels (Box 3.5).

Colombia has developed one of the region's most advanced M&E systems. The *Sistema Nacional de Evaluación de Resultados* (SINERGIA) is today led by the Direction of Public Policy Monitoring and Evaluation within the National Planning Department and the Presidency. Through the elaboration of an impressive set of diverse indicators, clear guidelines and targets, SINERGIA provides continuous performance information on whether and how all different entities are meeting public policy objectives, therefore informing future policy decisions (OECD, 2013b).

Figure 3.14. **Management for development results score, LAC average, 2007/08 vs. 2013/14**



Source: Kaufmann, Sanginés and García Moreno (2015), *Building Effective Governments in LAC*, http://dx.doi.org/10.18235/0000016.

StatLink http://dx.doi.org/10.1787/888933651007

Box 3.5. **Sub-national monitoring and evaluation: Jalisco, Mexico**

The State of Jalisco, in Mexico, has developed innovative processes and advances on monitoring and evaluation (M&E) in recent years. The monitoring system (MIDE) and the evaluation system (EVALUA Jalisco) were created in 2008 and 2013, respectively. They aimed to guide government's actions to achieve results and improve conditions for Jalisco's development. Both programmes operate with a high degree of public information, transparency and are based on accountability, open data and citizen co-creation.

MIDE Jalisco is the acronym for the Development Indicators Monitoring strategy, operated by the Planning, Administration and Finances Secretariat (SEPAF, in Spanish). It monitors progress on the achievement of quantitative goals set in Jalisco's State Development Plan (SDP). Other monitoring performance systems consider indicators from all levels of the value chain (inputs, activities or products). For its part, MIDE Jalisco is oriented exclusively to indicators that measure outcomes and impacts. It contains 27 long-term indicators that measure the aggregate social impact on development in six key areas. It also has 133 mid-term indicators that measure direct impacts on the population. And it has 194 complementary indicators that provide short and mid-term information on implementation of public policies.

EVALUA Jalisco formally started as a public policy evaluation strategy, and was gradually integrated into the results-based budgeting model. Co-ordinated by the General Department for Monitoring and Evaluation of SEPAF, it includes identification, publishing and monitoring of programmes and public policies. It also features training and technical advice for developing skills to improve evaluation conditions. Finally, it centralises co-ordination and monitoring of external evaluations, and uses evaluative evidence.

Both programmes are aligned with the objectives of the SDP. Their platforms, available on the Internet, aim to incentivise citizen participation and accountability on topics previously not scrutinised by citizens. MIDE and EVALUA have fostered collaboration between public servants, external experts, citizens and opinion leaders to improve indicator selection and goal setting through Technical (for EVALUA) and Citizen (MIDE) Councils.

Box 3.5. **Sub-national monitoring and evaluation: Jalisco, Mexico** *(cont.)*

MIDE and EVALUA have had a positive impact in four main areas:

1) Improvement of the institutional capacity for policy evaluation: A public servant team was created to co-ordinate the evaluation work inside each one of the 40 institutions of the internal evaluation units. This team, along with the Central Unit at SEPAF, defines and directs the annual evaluation plan. It also monitors the external research and the commitments for improvement originating from recommendations of the evaluation. This process strengthened the capacity of the Jalisco government.

2) The use of quantitative evidence for improving government actions: by the end of 2016, the government had received 300 recommendations from external sources, 181 of which became specific commitments for improvement. Most of the commitments related to correcting activities or processes of the programmes; 11% reoriented the design and operation; and 8% modified the types of support given by each programme evaluated.

3) Data-based decision making: Periodical monitoring of targets has allowed Jalisco's officials to adjust strategies and policies where results are not being achieved, increasing the efficiency of the government.

4) Increased accountability and citizen participation: MIDE and EVALUA are available online, allowing citizens to monitor the public programmes, increasing the government's transparency and accountability.

Over 2013-16, among other results, MIDE Jalisco and EVALUA Jalisco strategies received 15 awards as good practices, including from CLEAR, the OECD, the World Bank and the Inter-American Development Bank.

Source: Inter-American Development Bank based on Jalisco.gob.mx, https://seplan.app.jalisco.gob.mx/mide/panelCiudadano/inicio.

Sub-national levels of government require strengthening institutional capacities

Most Latin American governments have decentralised decision-making and budgetary powers. Decentralisation, a key aspect of public sector reform, consists of transferring a range of political, administrative and fiscal powers, responsibilities and resources from the central government to elected sub-national governments (OECD, 2017h). The process is associated with increasing the state's effectiveness and reducing territorial disparities. Decentralisation is often considered as a means to improve public-spending effectiveness based on the idea that sub-national governments have better information on local spending needs and preferences, and as a result are better positioned to deliver public goods to citizens (OECD, 2013b).

Although LAC countries remain more centralised than most of their counterparts in the OECD, there is a latent need to strengthen the administrative capacities at the sub-national level. Decentralisation processes took place even though countries still faced critical differences in capabilities across regions within countries. Usually, some peripheral or border areas are less developed than central or federal levels of government. This mismatch between the capacities and responsibilities of local institutions undermines decentralisation by affecting implementation, integration of policies and, ultimately, service delivery. Mismatching regionalisation across policy sectors undermines the design and implementation of co-ordinated and adequately targeted efforts in social programmes. This phenomenon has occurred in both federal countries such as Argentina and Brazil and unitary countries such as Colombia or Peru (OECD/ECLAC/CIAT/IDB, 2017), as well as the Dominican Republic (OECD, 2017i).

Decentralisation works efficiently when a number of conditions are met. These are linked to adequate capacities at sub-national governments, sufficient resources to meet new responsibilities, balance in the way various policy functions are decentralised, and effective co-ordination instruments and monitoring systems at the central government level. Likewise, decentralisation processes entail at least two main challenges in terms of governance. First, successful decentralisation processes depend on the institutional and fiscal capacity of the sub-national bodies to which power is transferred. Second, policy dialogue and co-ordination between levels of government are crucial to long-term sustainability. However, there is no single optimal level of decentralisation, either for the central public-policy sector or for the entire public administration. This is because sharing and applying competencies remain strongly context-dependent. They depend on many internal and external factors, including the overall economic performance and institutional environment of the given country (OECD, 2013b). Notwithstanding, clarity in the roles and responsibilities attributed to each level of government remains a critical driver for success (Allain-Dupré, forthcoming).

Fiscal and political decentralisations in most LAC countries have faced significant challenges. The budgets of local governments have significantly increased in the last decade and a half. However, local governments have failed to generate their own revenue, resulting in vertical budgetary imbalances. Instead, sub-national governments have relied heavily on transfers from the central government that often undermine already weak fiscal capacities and the effectiveness of public service delivery (see Chapter 4).

Decentralisation also leads to greater administrative, financial and/or socio-economic interdependence between the central and sub-national governments. Weak co-ordination and co-operation practices at the political and administrative levels can greatly undermine efforts to achieve policy coherence (OECD, 2013b). In this context, multi-level governance reforms – that reshape and improve interaction between public authorities given a new, mutually dependent context – become fundamental to ensuring coherent and effective policy decisions (OECD, 2017h).

Multi-level governance is a way to overcome existing gaps in decentralised countries. Co-ordination failures can lead to serious inefficiencies such as overlaps between different institutions. This, in turn, can cause confusion and misallocation of important resources, bureaucratic conflicts and problems being passed from one agency to another without resolution (Alessandro, Lafuente and Santiso, 2014; OECD, 2017i). Additionally, the "gap approach" argues greater coherence in public action is essential to achieve public-policy outcomes such as efficiency, equity and sustainability. Thus, a whole-of-government approach, emphasising co-operation and co-ordination, is crucial. Strong CoGs can support greater co-ordination between sub-national and national level institutions to better ensure more effective policy and service delivery. This is especially the case when CoGs are complemented by effective dialogue mechanisms that bring together relevant actors from different levels of government.

Regional development should enhance inclusive growth

LAC countries need to take a more comprehensive approach in managing growth and development of their cities and rural areas. Many of the LAC countries have very diverse regions that are at different stages of development. Chile, Mexico, Peru and

Brazil have very high levels of disparities in GDP per capita by OECD standards. In the OECD regional database, seven of the eight countries with the highest levels of territorial inequalities are from LAC.

Overall, LAC countries need policies focusing on boosting regional development to achieve a territorial equilibrium of inclusive growth. In Brazil, for instance, there is a latent need to overcome the multi-dimensional fragmentation of policies. A number of interesting programmes, especially in poverty reduction (e.g. the *Bolsa Familia*), are fragmented and lack a co-ordinated whole-of-government and regionally designed approach (OECD, 2013c). In Peru, rural areas contribute significantly to the national economy, but are not performing to their potential (OECD, 2016c). Colombia has high and spatially concentrated income disparities, which may hinder national performance in the medium term (OECD, 2014b).

Administrative processes can benefit from digital technologies

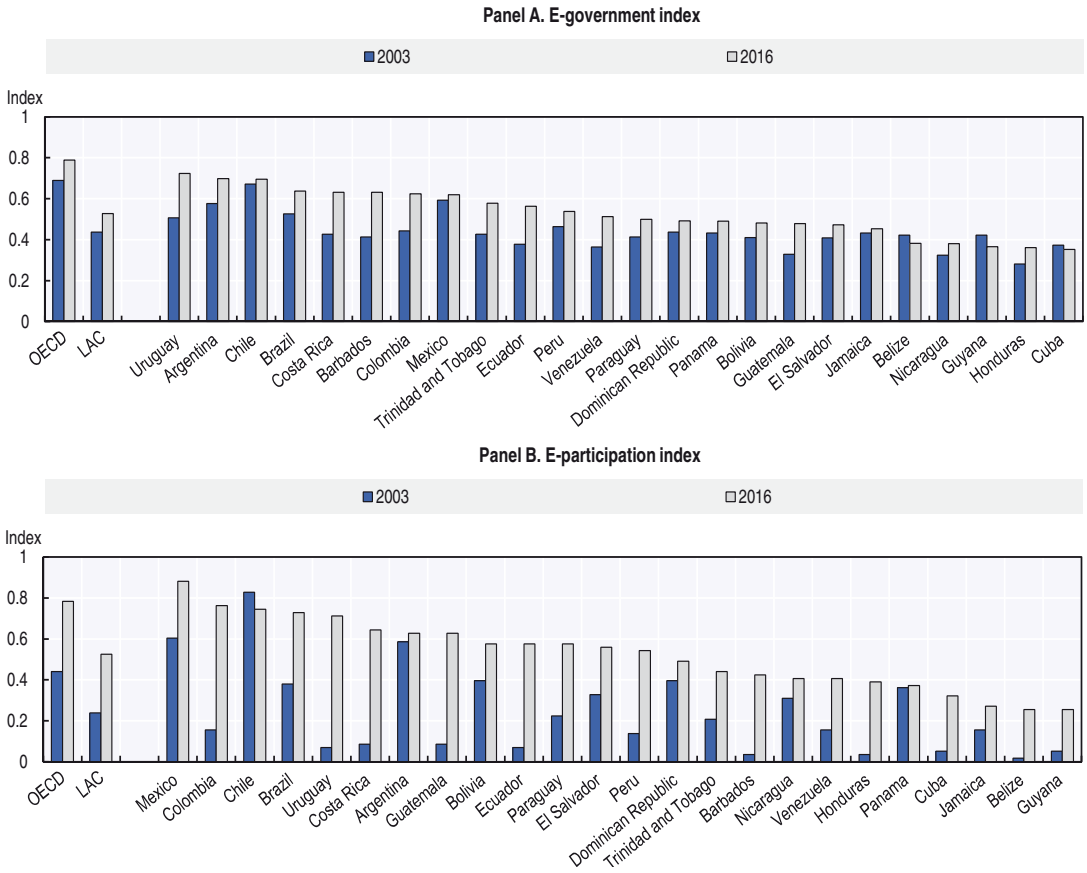
Adopting ICTs in the public sector has the potential to streamline administrative processes to deliver better services. Digital governments are drivers to produce better services and foster value creation, while creating open, participatory and trustworthy public sectors. In this respect, improving the public sector's use of broadband and ICTs can serve a double purpose. On the one hand, it contributes to more effective and responsive public services, while enhancing interaction between citizens and businesses. On the other hand, it enables the public sector to build more direct relations with its constituents and develop more transparent, accountable and participatory forms of governance in a cost-effective way.

LAC governments have improved their use of technology to deliver services, but gaps remain related to three challenges. Countries need to integrate government data. They need to simplify the back-office processes required to provide services. And they must continue the improvement of services through the re-use of data, performance metrics, high-level oversight and impact evaluations. Inasmuch as governments use data as a strategic asset to boost public sector intelligence, they can improve services as well as their capability to develop sustainable and inclusive policies (OECD, 2016d).

Performance in online services, telecommunication capabilities and educational levels to take advantage of information technologies has improved in LAC as measured by the *E-government Index* (EGDI) developed by the United Nations. This index focuses on the dimensions of e-information, e-consultation and e-decision making, assessing engagement of citizens in use of digital government services (United Nations, 2017).

The scores of both *E-government* and *E-participation Indexes* show that performance in LAC and OECD member countries improved in 2016 relative to 2003 scores with the former's performance below the latter. The *E-government Index* score improved from 0.44 to 0.53 in LAC and from 0.69 to 0.79 in the OECD economies, on a scale from 0 to 1. On the same scale, the *E-participation Index* scores increased from 0.24 to 0.52 in LAC and from 0.44 to 0.78 in OECD countries (Figure 3.15). These changes suggest that the up-taking and demand for online government services have been higher than the improvement of the services themselves. This exposes the need for a systematic and consistent approach to achieving sustained public sector productivity improvements in terms of digital government.

Figure 3.15. **UN E-government and E-participation Indexes**



Note: The E-government and E-participation Indexes range from 0 to 1, with higher values corresponding to higher performance.

Source: United Nations E-Government Surveys 2003 and 2016, United Nations, https://publicadministration.un.org/egovkb/en-us/reports/un-e-government-survey-2016.

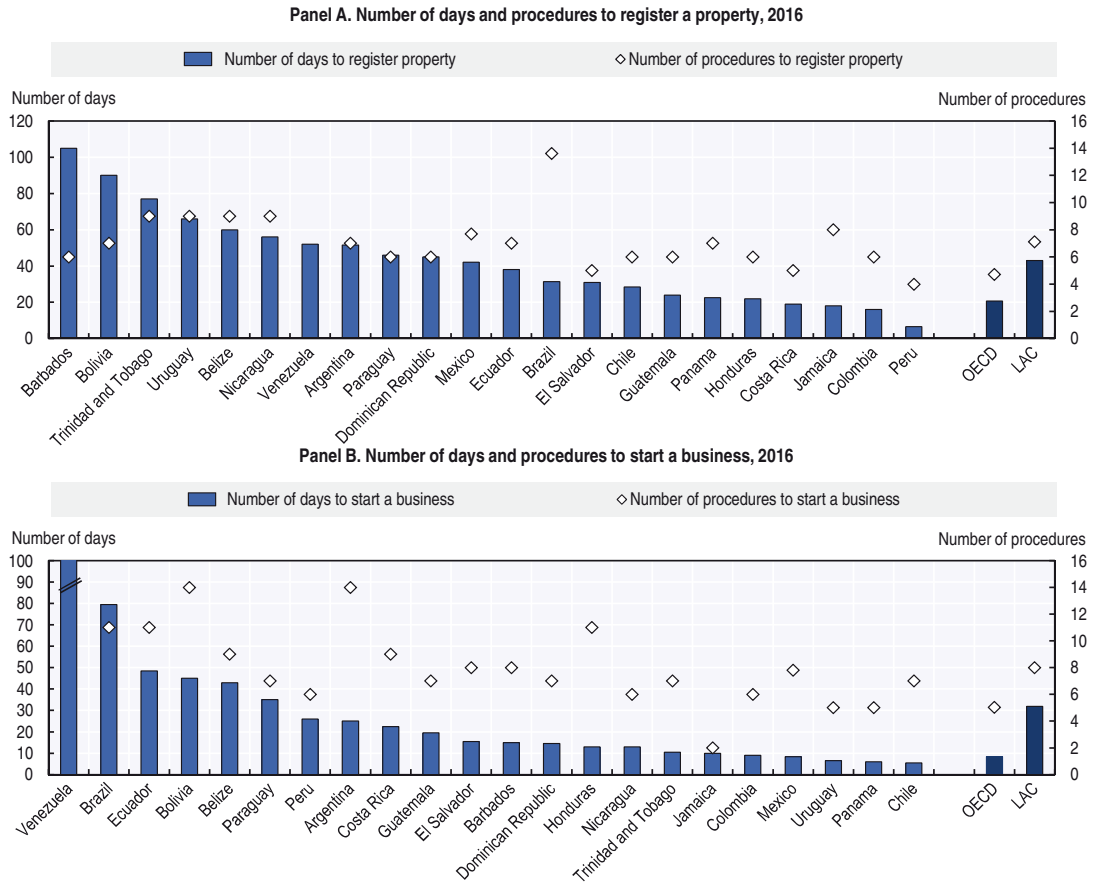
StatLink http://dx.doi.org/10.1787/888933651026

Citizens are dissatisfied with many government services

According to a survey in Chile, Ecuador, Panama, Paraguay, Trinidad and Tobago and Uruguay, LAC citizens are dissatisfied with transactional public services encompassing a wide variety of services. These services range from applying for public programmes, licences or permits to fulfilling obligations such as registering property and businesses, and filing and paying taxes (IDB, 2017). Citizens' experience with public services is a key determinant of satisfaction and trust levels in governments (OECD, 2017g).

Transactional services in LAC are bureaucratic, fragmented, and normally lengthy, with citizens having to interact with different public institutions on several occasions (IDB, 2017). For example, the number of procedures required to register property in LAC is similar to OECD countries, but takes twice the time to complete. The same is true for individuals or enterprises trying to start a business. It takes 8 procedures and 32 days to start a business in LAC compared to 5 and 8 in OECD economies (Figure 3.16). This highlights an area in which LAC countries stand to make quick gains by using digital tools to improve on the deliverance time of these services.

Figure 3.16. **Length of time and interactions of property and business registration in LAC and OECD, 2016**



Source: OECD/ECLAC/CAF based on World Bank (2017b), *Doing Business*, http://www.doingbusiness.org.
StatLink http://dx.doi.org/10.1787/888933651045

Eliminating redundant and paper-based transactions and setting up one-stop windows that improve the quality of services and facilitate citizens' interaction with governments are effective approaches to improving the delivery of services (OECD, 2017i; OECD, 2016b; OECD, 2014c). Building inter-institutional platforms for information consultation and verification in LAC greatly improves the user's experience. Improving transactional services can make institutions more productive and dramatically increase citizens' favourable perception of governments. To this end, improving public services should focus on reducing costs, saving time, efficiency and ease of services. They should provide professional, impartial and competent services as these are the characteristics citizens value the most in public services (IDB, 2017). Successful experiences include those of European countries. In 2012, the European Commission estimated that all European public administrations using e-procurement procedures could save an aggregate of at least EUR 100 billion per year and that e-government could reduce costs by 15 to 20% (European parliament 2015).

"Chile Atiende", for example, centralises services for citizens. This programme builds on the needs of citizens and strives to simplify interactions between the state, citizens and businesses. It can track interactions, offering services based on individual preferences and characteristics. Prior to this innovation, citizens interested in a state-provided service had to identify which institution delivered the service and where

its offices were located. They then had to contact them to find out the requirements to access the service. This entailed costs for the citizen in terms of time and money (OECD, 2017b).

Digital tools are a core component of public sector modernisation efforts and a strategic asset for policy making and delivering improved services. However, digital tools and ICTs should not substitute for efforts to redesign good processes and public sector co-ordination. At the same time, processes can be redesigned to take full advantage of the possibilities of ICTs, especially when rekindling processes in a citizen-centric manner (Box 3.6). Digital-by-default strategies have proved to have positive impacts in Europe. Services that are digital-by-default are designed from the beginning to be so compelling that everyone who can use them will choose to do so. This means that the vast majority of transactions will be handled electronically. In its Government Digital Strategy, the UK estimates that about 18% of its population will need help through an "assisted digital service". The European Commission estimates that at the EU level, a digital-by-default strategy could save around EUR 6.5 billion annually (around 0.04% of the EU-28 GDP) (European parliament 2015).

Likewise, co-ordination among different government institutions is critical to simplify any service. Effective co-ordination is hard to achieve and may depend on each government's capacity. Notwithstanding, co-ordination calls for three specific components: *i)* articulating and communicating the specific objectives the new processes strive to reach; *ii)* consulting to find out the opinion of relevant stakeholders and to incorporate their input during redesign; and *iii)* securing high-level political support and policy awareness (OECD, 2014d).

Governance frameworks ensure that digital government translates into transparent, efficient, inclusive and long-term benefits for citizens. These frameworks should engage all key actors and political support from the outset. Moreover, governance frameworks should set strategic priorities and long-term policy outcomes from the beginning, thereby aligning decisions on projects across the public sector with the government's overarching priorities. Many of the benefits of digital government policies rely on coherent policy frameworks and their effective implementation. Clear and defined goals will also contribute to foster collaboration across and within public agencies and departments. As more data and records are produced, collaboration and exchange on data, their ownership and purpose become more relevant. This, in turn, provides opportunities to optimise, automate and simplify procedures within and across institutions, ultimately leading to the reduction of expenditures and transactional costs in the long run. Furthermore, as public resources are freed from having to maintain individual registers and datasets they can be reallocated to more productive tasks (Ubaldi, 2013; OECD, 2016d).

Ensuring coherent use of digital technologies by promoting the use of compatible technologies and proper update of ICT frameworks across policy areas and levels of government remains a challenge for LAC countries. Beyond the use of digital tools to deliver citizen-centric services, governments can no longer afford to separate efficiency from societal policy objectives. To that end, they need digital technologies to support policy design, implementation and evaluation (OECD, 2016e). They must pursue these goals while developing and reinforcing capacities to manage and monitor digital strategies and assess their outcomes. This process goes beyond the deployment of technologies. It encompasses a technical knowledge in the acquisition of ICTs and well-structured governance with strong leadership. Further, it demands rethinking services to empower all citizens, not only those who are technologically savvy or connected.

Box 3.6. **Colombia: The importance of clear language**

Unclear or complicated language in government communications creates costs for citizens and government officials. Often citizens cannot access government services or programmes because they do not understand what they need to do, the paperwork required or their eligibility for it. Most of the time, this happens because government communications are lengthy and difficult to understand. They are filled with legal and technical language that is not clear or easily understood by the average citizen. In many cases they pay high fees to accountants, lawyers and others to do the paperwork. Or they must travel multiple times to agencies to clarify their doubts. It also generates costs for government officials who may spend time clarifying, reviewing and rejecting incorrect forms. This results, at a minimum, in inefficiencies for both citizens and the government. It can also indirectly violate citizens' rights denying them access to the services to which they are entitled.

The National Planning Department of Colombia, through its National Citizen Service Programme, launched the Clear Language Strategy in 2014 to address this issue. The programme seeks to improve the relationship and trust between citizens and the government by simplifying and clarifying the language used in public documents, forms and letters. This strategy, as part of Colombia's commitments with the Open Government Alliance, has been developed and implemented so far in 115 public institutions in the country.

The strategy has three main tools:

- Simplification labs: a methodology to simplify the documents of entities whose programmes and services have the most impact on citizens' lives. In these labs, citizens and public officials analyse forms and communications in focus groups. They propose changes of language, format and other elements to make them easier to understand and more accessible.
- The Clear Language guide for public officials and the ten steps to communicate using clear language infographics: These guides present the consequences of not having clear language, including costs to citizens. They provide practical recommendations to facilitate communications between the government and citizens, providing clear and actionable advice and writing strategies.
- The Clear Language Course: Composed of four sections that present the main aspects of clear language in its written, verbal and structural forms. The course is intended to build capacity among public officials.

To date, this strategy has simplified more than 100 forms, documents and letters. In this way, the government seeks to improve trust in the public sector, promote social inclusion, guarantee that citizens have full access to their rights, increase participation and promote transparency.

Source: Inter-American Development Bank based on National Planning Department (2015).

Towards a new connection with citizens: Fostering open and transparent states

The increasing disconnection between citizens and public institutions in LAC, illustrated by the erosion of levels of trust and satisfaction with public services, is explained by state failures and weak capacities complemented by a lack of strong channels of interaction with society. This leaves policy makers with limited information, even

more so in a context of rapid technological change and increased interconnectedness that transforms aspirations at a fast pace. Better understanding citizens' needs, experiences and preferences can result in better targeted services, including for underserved populations often at little extra cost (OECD, 2017g).

A way forward is through open government and transparent governments that empower citizens through participation mechanisms. ICTs and digital tools are important instruments to deliver improved cost-efficient and effective services to citizens in all areas of policy making, as previously stressed. Governments can also become more responsive through the use of open and big data to deliver user-driven services, anticipate future demands and create value within and outside government. All of these elements require a meticulous governance framework to ensure co-ordination, collaboration and capitalisation of the benefits of open governments.

New models, namely open data and big data analytics, are emerging to address citizen demands

Citizens' expectations and demands in LAC are dynamic and evolving, challenging the traditional models through which states address and deliver services. Improving the administrative capacity of the state solves part of the problem. However, institutions are still faced with a conundrum. They must uncover the best way to address citizens' current and rapidly evolving demands. And they must respond to them in an innovative and effective manner with little or no room for costly trial and error.

While no easy and all-encompassing solutions exist, several powerful tools offer viable alternatives. These include opening governments to outside participation, fostering the reuse of data within and outside the public sphere and using ICTs. Indeed, many countries and cities are already developing innovative alternative practices in the public sector. For example, they are developing labs for government innovation, using technology to digitalise forms and procedures and using open data and big data analytics to improve public policies.

Open data and big data analytics are flourishing, but not yet embedded in government

Open data initiatives are flourishing in LAC. Open data are usable disclosed data that can be reused and distributed without restrictions of any kind (ECLAC, 2014). Open data are a pillar of open government, a management strategy with potential to strengthen democratic governance by giving citizens a participatory role (Naser, Ramírez-Alujas and Rosales, 2017). Other open government pillars are transparency, accountability and comprehensive governance frameworks to enable citizen participation. Each of these pillars enables benefits on its own. This section, however, focuses on open data as a driver of potential innovation, value creation within and outside of government and as an enabler of more impactful policies.

As many as 8 of 13 LAC countries acknowledged the central or federal level of government had a comprehensive strategy on open government data (OGD). Similarly, a majority of countries (ten) have developed a national OGD portal (Table 3.3). Results also showed that only 54% of LAC countries consulted on users' needs for data release. Data re-use support and promotion initiatives among countries also vary. For instance, the organisation of co-creation type events (e.g. hackathons) is slightly more common than training activities for civil servants to build capacities for data analysis and re-use (OECD, 2016b).

Table 3.3. **Government support to open government data initiatives, 2015**

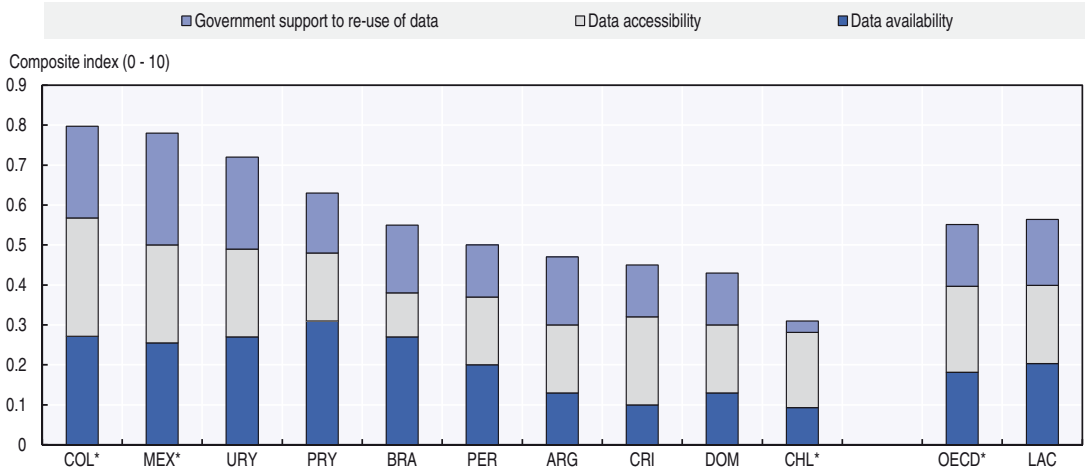
Country	Strategy/ Infrastructure		Consultations	Data re-use support and promotion		Data accessibility on the national portal			
	Single central/ federal OGD strategy	Existence of a national OGD portal	Regular consultation of users' needs for data release	Organisation of co-creation type events (e.g. hackathons)	Training for civil servants to build capacities for data analysis and re-use	Data released in CSV format (machine readable)	Systematic provision of metadata	User feedback section	Possibility to receive notification when datasets are added
Argentina	Yes	Yes	Yes	Often/Generally	Sometimes	Often/Generally	Yes	No	No
Brazil	No	Yes	No	Often/Generally	Sometimes	Often/Generally	Yes	No	No
Chile	Yes	Yes	No	Often/Generally	Sometimes	Often/Generally	Yes	Yes	No
Colombia	No	Yes	Yes	Often/Generally	Sometimes	Often/Generally	Yes	Yes	No
Costa Rica	No	Yes	Yes	Sometimes	Sometimes	Often/Generally	Yes	Yes	No
Dominican Republic	Yes	Yes	No	Sometimes	Sometimes	Often/Generally	Yes	No	No
El Salvador	No	No	No	Missing data	Missing data	Not applicable	Not applicable	Not applicable	Not applicable
Guatemala	Yes	No	No	Missing data	Missing data	Not applicable	Not applicable	Not applicable	Not applicable
Mexico	Yes	Yes	Yes	Often/Generally	Often/Generally	Often/Generally	Yes	Yes	No
Panama	Yes	No	No	Missing data	Missing data	Not applicable	Not applicable	Not applicable	Not applicable
Paraguay	Yes	Yes	Yes	Often/Generally	Sometimes	Often/Generally	Yes	Yes	Yes
Peru	No	Yes	No	Sometimes	Sometimes	Often/Generally	Yes	No	No
Uruguay	Yes	Yes	No	Often/Generally	Often/Generally	Often/Generally	Yes	Yes	Yes
LAC total 13									
Yes	8	10	7				10	6	2
No	5	3	6					7	11
OECD total									
Yes	25	29	24				20	21	10
No	5	1	6				8	7	18

Source: OECD (2016b), *Government at a Glance, Latin America 2017,* http://dx.doi.org/10.1787/9789264265554-en.

An open data culture is improving within government institutions in the LAC region. The OECD index on open government data assesses governments' efforts to implement open data in three areas. These comprise data availability; accessibility on the national portal; and governments' support to innovative re-use of public data and stakeholder engagement, based on OGD principles (Ubaldi, 2013). Colombia, Mexico, Uruguay and Paraguay are the highest ranking countries. On average, LAC countries (0.56) perform slightly better than the OECD countries (0.55) on a range from 0 to 1. Both regions score similarly on data availability, accessibility and government support to the re-use of data (Figure 3.17). However, the fact that a larger share of LAC countries did not develop a central national portal for accessing and reusing OGDs should not be overlooked (OECD, 2016b).

Open data availability and adequate co-ordination between public and private parties offer solutions to public policy problems. Through "Autoservicio.uy" in Uruguay, for example, data availability can lead to co-creation and co-ordination between government (the Ministry of Health) and civil institutions (DATA Uruguay). The collaboration can bridge asymmetries of information in the public and private health-care sector and improve citizens' decision-making process. The platform provides timely information on public and private health practitioners, including waiting periods, prices and user satisfaction. The data are presented in a friendly and intuitive manner to facilitate citizen uptake and use (Naser, Ramírez-Alujas and Rosales, 2017).

Figure 3.17. **Open, useful, reusable government data (*OURdata* Index), 2016**



Note: Data marked with an asterisk for OECD, Chile, Colombia and Mexico refer to 2017.

Source: OECD (2017e), *Government at a Glance 2017*, http://dx.doi.org/10.1787/gov_glance-2017-en; and OECD (2016b), *Government at a Glance, Latin America 2017*, http://dx.doi.org/10.1787/9789264265554-en.

StatLink http://dx.doi.org/10.1787/888933651064

Improving open government data to foster value creation is a pending challenge for the region. Latin America and the Caribbean's OGDs are still not as relevant in the creation of value as those in OECD economies (OECD, 2014c). One of the reasons for this underperformance is the existing gap of available OGD in the region. LAC countries do not always provide data (free, re-usable and machine-readable data) that can be analysed and re-used. Furthermore, civil servants lack training to build capacities for data analysis and reuse of data as a means to improve innovation within the public sector (see Table 3.3). Regular consultations with society and the private sector are also absent. These activities can ensure directing efforts towards producing data that will benefit or satisfy a real demand.

Some LAC governments are taking action to promote the reuse of data towards the creation of public value. There are different ways in which governments can promote co-creation events. According to the OECD Open Government Data Survey 2.0, hackathons, code sprints, apps challenges and software development contests for the creation of apps and widgets are among the most frequently used practices by OECD countries to spur open government data reuse. In Colombia, the e-Government Innovation Centre and the "*Urna de Cristal*" enable a variety of stakeholders, including public sector, academia, NGOs, private sector and entrepreneurs, to solve public issues together in creative ways (OECD, 2017j). In Mexico, the government leads the "*Retos Públicos*" initiative that brings it together with social and business innovators to re-use data and develop solutions to specific policy and public service delivery issues. It publishes calls for proposals online on the central open data portal www.datos.gob.mx and awards public funds to develop selected projects. The final mobile applications, showcased on the portal, are available for free download. Line ministries such as transport (SCT), education (SEP) and environment (SEMARNAT) are actively involved in the initiative. It also engages public bodies such as the National Council for Culture and Arts (CONACULTA) and the Consumer Protection Agency (PROFECO) (OECD, 2016f).

Major efforts are needed to bolster impact evaluations on open government initiatives in LAC to ensure they deliver "value for money". Impact evaluations are essential to ensure that open government initiatives achieve their goals and remain cost-efficient

alternatives to bridge the gap between citizens and governments. These evaluations can also improve the design of future projects. Currently, they are scarce in the region. All LAC countries surveyed reported monitoring their open government initiatives. However, only Costa Rica, the Dominican Republic, Guatemala, Mexico, Panama and Uruguay evaluated the impact of such initiatives (OECD, 2016b).

The potential of big data analytics is promising for the region

LAC produces and collects large volumes of data, and needs to use them more effectively. The region generates data through open government initiatives, government agencies and the advent of the Internet of Things. At the same time, improvements in data storage and the speed of production velocity have aided data collection. These data can positively impact different areas of public policy. Many examples exist of how large volumes of data have led to create value, determine quality of research, prevent the epidemic of diseases, prevent crime and determine real-time roadway traffic conditions.

Big data enable moving from descriptive to predictive methods that can help the public and private sectors to anticipate or prevent instead of react or remediate (Ubaldi, 2013; ECLAC, 2014; and Davies, 2016). Big data are a collection of datasets, structured and unstructured, generated at great speeds. They are so large and complex that analysis requires (non-traditional) advanced database management tools and data processing applications (OECD, 2015b). Indeed, "big data" initially referred to data for which the large volume became difficult to manage and process.

The analysis of big data is providing cost-effective solutions to improve public services and development outcomes in many fields in LAC. Its use has produced tangible results in various sectors of the LAC region. In Brazil, big data analytics reduced the incidence of dengue by 98% in 2014. The use of hospital information had helped identify hotspots that were later prioritised through geo-referencing (ECLAC, 2014). Transportation is also benefiting from ongoing data analytics carried out in this area. Data produced by SUBE in Argentina and other initiatives in Bogota are exploiting these data to improve traffic flows and provide better public transportation services.

Applications of big data can also improve the government's spending efficiency and combat tax evasion. The process of data cross-referencing from different registries can lead to better focused social expenditures, particularly of conditional cash transfer programmes or subsidies. In Argentina, the design and implementation of an algorithm to identify individuals based on their most salient characteristics produced savings close to USD 120 million (around 0.06% of total tax revenues in 2015) between 2014 and 2015 on subsidies paid in respect of transportation and energy (Pessino, 2017). Likewise, big data offer the potential to identify tax evaders by cross-referencing lifestyle patterns reflected on social media with tax liabilities. This process can lead to individual audits by the tax administration. Proper mechanisms should be enforced to safeguard individuals' right to privacy, however. These processes through which individuals can be cross-referenced are not always readily available in all countries.

Public, private and non-government agencies around the world are embracing these innovations. They use them for problem solving, searching for new and better models and the creation of value. Certainly big data can be used to analyse and monitor outcomes of interventions and to anticipate demands and improve the allocation of public resources. However, measurement errors, inter-temporal trends, seasonality or other problems can lead to bias in the analysis and reach wrong conclusions. The great predictive capacity of models based on big data is based upon correlations between variables without attempting explanations, let alone addressing issues of causality (ECLAC, 2014).

In the LAC region, the civil service has evolved during the last decade (IDB, 2014), but technical gaps in core functions remain that can prevent the effective use of these data. The gaps in the LAC civil service are both related and not related to ICTs. Training is not among the main components within the open government data agenda. Therefore, governments in LAC need to attract individuals to the civil service with a solid knowledge of computer science, application-programming interfaces (API), modelling, statistics, analytics and mathematics. Only in this way can it capitalise on the potential benefits of big data.

Innovation labs promote creativity and citizen participation

National and sub-national administrations in the LAC region have created public innovation labs within an open government agenda to respond to greater demands of participation, open data, transparency and co-creation to deliver better public services (Acevedo and Dassen, 2016). These labs are typically small units within core public institutions. They perform activities not traditionally associated with traditional public sector institutions. As such, they offer a viable alternative to capitalise on opportunities offered by technology and recent advances in the social sciences. The labs have the flexibility and ability to assemble multidisciplinary teams and reach out to users and other stakeholders. This provides valuable input into designing cost-effective, risk-taking small pilot projects that respond to citizens' needs.

By definition, these labs are focused on innovation. Yet they can pursue this goal while being fiscally responsible and minimising public backlash for failure. Indeed, tolerance for failure is embedded in innovation labs' culture. A survey of innovation lab directors found that 86% of innovation labs included failure, either explicitly or implicitly, within their government mandates (Acevedo and Dassen, 2016).

Innovation labs employ a user-centric approach to deliver tailor-made solutions to meet service requirements (IDEO.org, 2015). Labs' objectives and methods reflect a focus on leveraging the views of citizens in the policy processes. Methods such as *human-centred design* or *design thinking* are increasingly being used to provide solutions to governments' needs. These methods put users in the centre of the policy design and use creative tools to foster innovation in interventions offered to people.

The iterated experimentation of reduced-scale pilots is a critical activity within innovation labs. However, rigorous testing before scaling them is still very rare (Acevedo and Dassen, 2016). Tested projects aim to produce enough robust information to have service delivery agencies across government to adopt the lab's products. However, innovation labs do not have their own operational responsibilities or deliver any public service directly. As a result, embedding these labs among agencies responsible for the delivery of public services continues to be a challenge.

In LAC, innovation labs usually promote collaboration and citizen engagement. Most are created as a special component of open government agendas. Some labs created engagement platforms such as *mi Quito*, *mi Medellín*, *Bogotá Abierta* or *Ágora Rio*. In addition to promoting the inclusion of citizens' views, Latin American labs tend to work across multiple sectors, including the public and the private sectors, NGOs and academia.

Innovation labs have spread around the region, devoted to different objectives depending on the most tangible issues in each country. The Social Innovation Lab in Uruguay, for example, focuses on innovation for open government (Box 3.7). It usually helps public institutions to digitise and implement complex procedures. The lab follows the premises of human-centred design and co-creation of public value. To that end, design takes into account user perspectives, adapting results to their needs and preferences.

Box 3.7. **Innovation labs: The cases of Uruguay and Rio de Janeiro**

Uruguay established its Social Innovation Lab in 2015 within the Agency for e-Government and Information Society (Agencia para el Gobierno Electrónico y Sociedad de la Información, or AGESIC). It supports a key presidential objective: 100% availability of administrative procedures and public services online.

The lab was tasked with simplifying complex procedures and services through digitisation. Integrating components traditionally associated with design thinking, it begins with participatory observation and interviews with typical users and public servants in charge of each procedure. After identifying the main problems in each case, the lab hosts a workshop. A collective discussion (including both users and public servants) generates an ideal online procedure. After this, the developer's team creates a prototype that is tested and redesigned as needed. As of 2017, the lab helped digitise 33 bureaucratic procedures considered complex by service delivery agencies.

The effectiveness of the lab is due to various factors, including its institutional position and support from leadership. It began as a support unit for implementation of a presidential objective. This position allowed the lab to rapidly expand its service across different government agencies (which not all labs can easily do). Furthermore, its membership with AGESIC opened the door to collaboration with other organisations. AGESIC, an agency that has developed strong networks across government, is usually considered an effective and trustworthy support entity.

In Brazil, Rio de Janeiro's policy innovation ecosystem is marked by a complementary approach involving several agencies. Until the recent change of the mayor in December 2016, Lab.Rio supported city agencies with open government and citizen engagement initiatives; PENSA undertook complex data analytics; and the Operations Centre did real-time monitoring of city data.

Although different in nature and objective, these three agencies complemented each other. Belonging to the Chief of Staff Office, PENSA was in charge of improving monitoring and planning through the use of diverse and often non-conventional data. The unit put together – and continuously integrated – datasets from diverse city agencies, as well as from companies and organisations such as Waze, Twitter, Tim and Open Street Maps. These data were later cross-analysed to find patterns and associations that could guide policy innovations and inform planning. These analytics were then applied to the reduction of dengue, the improvement of transit, the reduction of water and energy use, the estimated return on investment for transport infrastructure and other issues.

In a similar vein, the Operations Centre runs a geo-referenced information platform that compiles layers of data from diverse sources. These sources include traffic, climate and Twitter, as well as more than 1 000 surveillance cameras, 500 inspectors and other public servants, among many others (Schreiner, 2016). The centre offers the infrastructure for centralised management to handle major events and emergencies. Digital and other widely-used apps offer citizens real-time information and direct communication channels.

Lab.Rio brings the state closer to civil society, creating mechanisms for citizen participation and stimulating digital debate about policy issues. The lab classifies its more than ten initiatives on a participation scale that includes the stages of information, consultation, engagement, collaboration and empowerment. By 2016, more than 165 000 people had interacted with government using the labs' platforms.

Source: Inter-American Development Bank based on Acevedo and Dassen (2016).

The demand for transparency is driving the move towards open government

Open government can be an effective instrument to encourage transparency, accountability, oversight and citizen participation. It is defined as "a citizen-centred culture of governance that utilises innovative and sustainable tools, policies and practices to promote government transparency, responsiveness and accountability to foster stakeholders' participation in support of democracy and inclusive growth". These strategies also improve public sector innovation and render policy-making processes more representative, inclusive and effective (OGP, 2017; OECD, 2016g).

Open government agendas in LAC have recently proliferated, although these openings vary from country to country. In most LAC and OECD member countries, the demand for transparency within the public sector has been the main rationale behind open government agendas. Other countries pointed to the need for open channels to enable citizens to participate in the policy-making process. Only Panama cited the necessity for accountability within the public sector to explain its agenda (Table 3.4).

Table 3.4. **Objectives of open government (2015)**

Country	Main objective
Argentina	○
Brazil	●
Chile	●
Colombia	●
Costa Rica	●
El Salvador	○
Guatemala	●
Mexico	■
Panama	♦
Paraguay	●
Peru	●
Dominican Republic	○
Uruguay	●
OECD 35	● (30)
LAC 13	
●	8
○	3
■	1
♦	1
Legend	
♦	Improve public sector accountability
●	Improve the transparency of the public sector
○	Improve citizen participation in the development of public policies
■	Other

Source: OECD (2016b), *Government at a Glance, Latin America 2017,* http://dx.doi.org/10.1787/9789264265554-en.

Movements and organisations that promote and assess open data initiatives have gained traction around the globe. These institutions work in collaboration with governments, the private sector and civil society to measure perceptions of corruption through surveys (Transparency International, 2017), disclosure of information and citizen engagement in the public policy-making process.

The adoption of comprehensive open government strategies is gaining political terrain in LAC. In fact, 62% of LAC countries have adopted national strategies on open government,

while the remainder acknowledge lacking a comprehensive strategy in this area (OECD, 2016b). Furthermore, 16 LAC countries have signed the Open Government Declaration, a multilateral initiative from the Open Government Partnership. It aims to secure concrete commitments for promoting transparency, fighting corruption and empowering citizens. Of the 16 signatories, 11 have already presented second or third-generation action plans, highlighting their commitment to the initiative (World Justice Project, 2016). Despite these political commitments, open government roll-out is still in the making, and its impacts on social and economic developments remain to be seen (OECD, 2014c).

Availability of public information could be further improved

Despite commitment to transparency as the main rationale behind open government strategies in many LAC countries, public information availability can be further improved (government laws, legal rights and public data). The *Open Government Index*, which ranks 102 countries on their government openness, showed that publicised laws and government data in LAC lag behind other assessed features such as right to information, civic participation and complaint mechanisms (Table 3.5).

LAC countries also need to raise people's awareness of their right to access public records. As well, they need to improve the responsiveness to requests for public records, specifically with respect to timeliness, pertinence and relative cost. The region fares better on indicators that gauge societies' ability to comment on government policies, sign petitions, hold peaceful demonstrations and voice concerns about public policies, along with their capacity to make complaints about public officials or services (World Justice Project, 2016).

Table 3.5. **Latin America and the Caribbean: Open Government Index 2015**

	Publicised laws and government data	Right to information	Civic participation	Complaint mechanisms	OGI
Chile					0.68
Costa Rica					0.68
Uruguay					0.65
Argentina					0.56
Brazil					0.56
Colombia					0.56
Mexico					0.56
Belize					0.55
Panama					0.55
Peru					0.55
Dominican Republic					0.52
Ecuador					0.51
El Salvador					0.51
Jamaica					0.51
Honduras					0.49
Guatemala					0.48
Bolivia					0.45
Nicaragua					0.44
Venezuela					0.38

Note: Colours represent the relative value of each component of the index. Darker colours represent higher values.
Source: World Justice Project (2016), "*Open Government Index*".

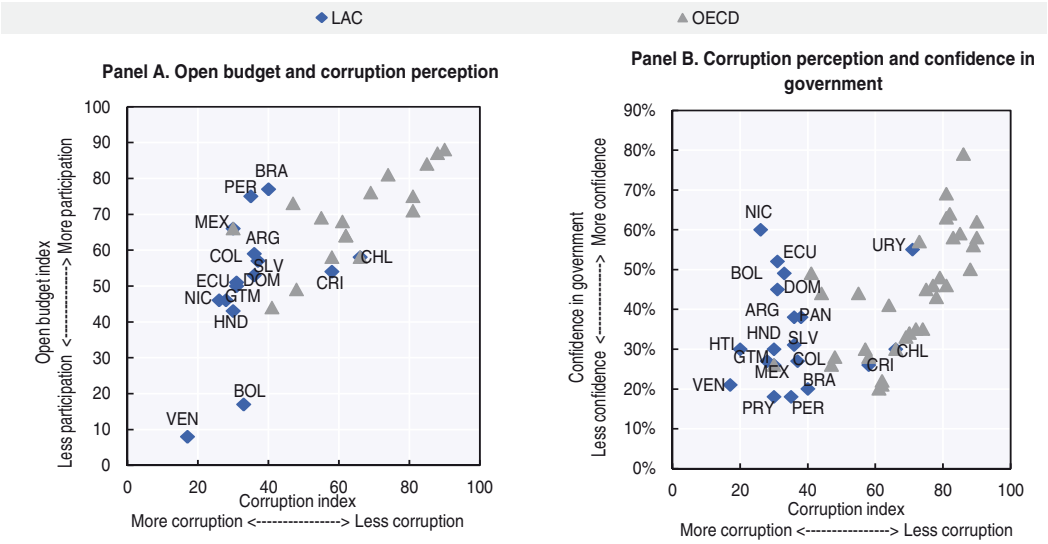
National and sub-national governments in LAC countries have increased their disclosure of information, but challenges remain in how they present data to spur citizens' engagement. Transparency policies are a long-term investment with significant short-term costs borne by the private sector, citizens and the government (executive, legislative, sub-national governments). The costs stem from adopting the rules and investing in implementation of the policies (IDB, 2012). Governments invest fiscal resources towards improving data availability, timeliness and usefulness. They believe

the investment will pay off through increased participation of citizens as voters and as consumers of public goods and services.

Public participation mechanisms are still largely absent from policy-making processes in LAC. For example, survey responses indicate such mechanisms are lacking from the budget process. Where they do exist, citizens have no clear guidelines on how to voice concerns or to understand government expectations for their participation (IBP, 2017). Rethinking these mechanisms to empower and engage citizens is a work in progress. It requires improving how governments communicate with their citizens, but also how citizens engage and participate in the policy process to avoid the over-representation of special interests.

Higher levels of corruption perception erode confidence in government in both LAC and OECD economies (Figure 3.18). In a context of high perception of corruption in the public sector, citizens' expectations of eliciting change are low. This results in apathy and non-participation (Molina, 2013). Transparency and data availability can counter this apathy by reducing levels of perceived corruption. Indeed, cross-country data on budget information availability, participation process and oversight are inversely associated with perceptions of corruption. Governments that disclose more budget information and offer ways for civil society to engage with the budget process are deemed to be less corrupt by citizens and the private sector. Given these associations, improving the budget process (information, participation and oversight) might be a first step towards fostering citizen participation, regaining confidence in government and reinforcing the fiscal pact.

Figure 3.18. **Perception of corruption, open budget information and confidence in government**



Note: The International Budget Partnership (IBP) carries out an open budget survey to establish comparable metrics of budget transparency, participation and oversight. It assesses the amount, level of detail and timeliness of budget information governments are making publicly available to score each country between 0 and 100. Higher scores reflect more budget accountability. Transparency International gauges perceptions of corruption in over two-thirds of the 176 countries and territories in the world. The Corruption Perceptions Index aggregates data from a number of different sources that provide perceptions of business people and country experts on the level of corruption in the public sector. The scale of scores goes from 0 (highly corrupt) to 100 (very clean). Gallup (2017) results are based on the World Poll. They show the percentage of respondents to the question: "In this country, do you have confidence in each of the following, or not? How about national government?"

Source: OECD/CAF/ECLAC based on data from Gallup (2017, *World Poll*, http://www.gallup.com/services/170945/world-poll.aspx; IBP (2017), Open Budget Survey, http://www.internationalbudget.org/opening-budgets/open-budget-initiative/open-budget-survey/; and Transparency International (2017), *Corruption Perception Index*.

StatLink http://dx.doi.org/10.1787/888933651083

Co-ordination problems and selection bias hinder citizen participation mechanisms in LAC. Even when these mechanisms are in place, failure to co-ordinate among interested citizens might result in policy not being affected. For instance, available mechanisms might require citizens to travel to consultations. Because of these costs, citizens might not be able to participate and voice their preferences and concerns over policies that might directly affect them. In a similar vein, when some groups stand to gain more from policy their incentive to co-ordinate is higher. This might enable such groups to capture policy, potentially steering it from results that benefit most of the population.

New forms of participation in LAC are needed to align citizens' incentives and open space for their participation at lower costs (Box 3.8). Open government initiatives need to embed mechanisms to channel citizens' appraisal and feedback to governments at all levels. More importantly, governments should embrace the opportunity to become more responsive and transparent to help close the confidence gap. Mass social media platforms offer a relatively cost-effective way to open spaces for citizens to directly communicate with public institutions and voice their concerns.

Box 3.8. **Participation at the local level: Citizens' councils in LAC**

A number of Latin American countries including Brazil, Colombia, Guatemala, Mexico, Paraguay and Peru have created local citizens' councils to make governance more inclusive and participative. These local spaces bring together representatives of civil society, academics and the private sector to discuss and make decisions about local development issues.

The most notable success of local councils has been allowing marginalised and vulnerable groups to become involved in public decision making that directly concerns them. These include Indigenous peoples, women and even children who created their own council in Colombia, for instance. Furthermore, evaluations of local councils have shown they can lead to direct improvements in service delivery. The first Peruvian Council for the development of Ilo Province, for example, led to important environmental improvements, better supply of basic urban services and increased implementation of sustainable development projects.

Despite their initial success, local councils continue to face important limitations in the LAC region. These include lack of political will from provincial governments and lack of national legislation that creates imbalances between regions. Vague legislation at the federal level also prevents the effective functioning of these local institutions. In some cases, lack of transparency also leads citizens to distrust the council.

Source: ELLA (2013), "Increasing citizen participation in local governance: Latin America's local citizen councils", http://ella.practicalaction.org/wp-content/uploads/files/120716_GOV_CitPar_%20BRIEF2_0.pdf

Despite growing use of social media by governments, communication rarely flows two ways

Public institutions in LAC are increasingly adopting social media platforms as communication tools: 97.6% of local governments within 61 cities of LAC have an official Facebook account, 90.2% have a YouTube channel and 85.4% a Twitter account (Valenti et al., 2015). Social media offer participation and feedback mechanisms that can make policy processes more inclusive. As such, they can rebuild some confidence between governments and citizens. Governments should be aware, however, that "no one size fits all", and careful consideration of the context is required (Mickoleit, 2014).

The OECD Survey on Open Government (OECD, 2015c) finds that social media and online tools are the preferred option to inform the general public about the existence of open government initiatives. In respondent OECD countries, 94% of governments use these platforms, whereas all 12 LAC countries surveyed indicated they inform citizens online and through social media. Despite the popularity of social media as a channel for citizens to voice their concerns, lack of systematic analysis of data means that communication tends to flow one way: from government to society.

Opening communication and feedback channels on open data initiatives, both inside and outside LAC governments, increases the likelihood of citizen engagement (Box 3.9). Donors, governments and NGOs alike are using social accountability tools to inform citizens and communities about their rights, the standards of services they should expect from private contractors and actual performance. All these aim to encourage public participation (World Bank, 2012).

Box 3.9. **Information leads to action**

The Asociación Civil por la Igualdad y la Justicia (Civil Association for Equality and Justice), is a non-profit organisation that monitors public policies. It uses legal tools to fight against inequality, strengthen democracy, protect citizens' rights and address abuses, including corruption in Buenos Aires, Argentina. The association, in partnership with a group of tenant advocates from the same city (Inquilinos Agrupados), used available information to help make housing more accessible.

Both groups gained access to hundreds of complaints against brokers, many of which had gone ignored by authorities. The tenants had complained that brokers were not complying with housing regulations. As a result, they were overcharging tenants on contract renewals or adding unlawful fees. Access to information enabled advocates to depict the magnitude of the abuses and to file against the association representing the city's real estate agencies. The court ruled that brokers charging commissions exceeding the legal limit should be fined.

The data were instrumental both to raise awareness and to form an advocacy strategy that directly led to actions that benefited almost 1 million tenants. In addition to monitoring, advocacy and litigation, these groups continue to focus on disseminating the court ruling. They strive to educate renters about their rights as a way to empower the citizens of Buenos Aires. This is an example of how access to public information can be instrumental in leading to action and change.

Source: Pilo (2017), "In Buenos Aires, right to information helps renters get a foot in the door", www.opensocietyfoundations.org/voices/buenos-aires-right-information-helps-renters-get-foot-door.

The region needs to adopt best practices for open government

According to the results of an open data survey, LAC countries need to adopt best practices to make open government viable, effective, sustainable and suitable in the longer term. These practices, identified by several organisations, depend on each government's specific situation and organisation (ODI, 2015; OECD, 2016g, 2015c, 2014c).

As many as 10 out of the 13 LAC participating countries noted resistance to change or reforms in the public sector as a major constraint to implementing open government initiatives. Governments should foster change in the organisational culture, beginning with management and human resource departments. In this respect, the capacity and skills of civil servants and public employees will greatly determine the success of open government initiatives' design and implementation.

LAC countries viewed lack of funding as an area of concern. As much as 62% of countries find financing a challenge for the co-ordinating institution compared with 43% in OECD member countries. Similarly, all 13 LAC-surveyed countries reported that the institution or ministry responsible for open government projects was the main funding source to implement the initiative. This ratio is also high for OECD member countries at 89%.

Furthermore, 69% of LAC respondents (representing nine countries) receive funds from multilateral organisations to support their open government initiatives. LAC countries need to ensure adequate funding for effective and sustainable long-term implementation of open government. Beyond the absolute amounts needed to implement initiatives, countries need funding sources consistent with the government's goals for open government, and to identify appropriate recipients.

More than half of LAC countries struggle to build effective partnerships with NGOs and the private sector around open government. All told, 54% of LAC respondents reported a lack of, or inadequate, institutional mechanisms to collaborate with NGOs and the private sector as one of three main challenges to consolidating open government. In contrast, 23% of respondents from OECD member countries referred to this as a problem. LAC countries need to strengthen support for open government among external partners to ensure continued demand for open data.

Several LAC countries still generate data manually, especially at lower levels of government. Yet open data require a high degree of information technology involvement for which skilled people are not always available. Therefore, leadership and co-ordination are critical in LAC. Open government will only work well if the government can transition easily to publishing and using data. To that end, all levels of government should promote leadership, co-ordination, human capital and effective organisation as cornerstones to open government, while strengthening monitoring and evaluation for long-term sustainability.

Conclusions and policy recommendations

This chapter argues that states in LAC face a number of barriers to deliver their functions and respond to citizens' evolving demands. Institutions need to be rethought to support states that are more open and transparent, to improve trust; more efficient and effective, through a better administration and improved governance; and more innovative and forward-looking, to support a new connection with citizens who have new demands and face new challenges in a rapidly changing world.

Based on this assessment, the following institutional policy areas are highlighted as priorities for a reform agenda to make the states deliver in the region.

Towards trustworthy states

- **Take decisive action to overcome state weaknesses that limit its functions and delivery of more efficient, effective, innovative and trustworthy public services.** Latin America and the Caribbean's trust in the state has declined during recent years despite a period of sustained and solid economic growth. Corruption and poor public service provision are the main culprits of citizens' lack of confidence in government institutions. In a context of a weaker social contract, a decline in trust further erodes the social fabric that enables democratic governance.
- **Foster the rule of law through independent and effective legal institutions.** More adherence to the rule of law has positive spillovers in fighting against institutional over-reaching and crime. It also hinders both policy capture and corruption.

Independent judiciary systems prosecute officeholders' wrongdoings in the public sector with greater frequency. Moreover, legal autonomy is also associated with greater representativeness within the policy-making process. Finally, it creates higher levels of certainty. This improves the business climate by ensuring adequate contract enforcements and protection of property and civil rights.

- **A strong and cross-cutting integrity system across all levels of government, involving the private sector and society, is crucial to fight corruption**. Most LAC countries have already prioritised anti-corruption policies. Yet enforcing policies and promoting a broader culture of integrity within public and private institutions remains challenging. The OECD *Recommendation of the Council on Public Integrity* sets forward different lines of action in this direction, including for anti-corruption.
- **Promote open governments to improve democratic governance.** Open governments give citizens a participatory role and open up new forms of citizen participation in the public policy process. They enable a culture of transparency, accountability and access to information as a means to fight and prevent corruption. Greater participation, transparency and accountability can open spaces and lower costs for more individuals to participate in the policy-making process. This, in turn, can limit policy capture. The OECD Recommendation of the Council on Open Government puts forward specific policy recommendations in this direction.
- **Regulatory frameworks should promote fair competition and limit harmful practices** that diminish the quality of goods provided to citizens. In particular, public procurement is crucial for delivering citizen services, but it can be captured by private interests. This, in turn, prevents the state from serving the public. The creation of central purchasing bodies (CPBs) as centres of procurement expertise and the development of e-procurement solutions are transforming traditional measures in LAC to combat price rigging. These measures have considerably improved in the past years, such as *Colombia Compra or Chile Compra*, though challenges remain to increase their effectiveness.

Towards a better administration

- **Undertake a comprehensive review of the merit-based civil service recruitment system.** This will yield a double dividend by improving levels of government productivity and increasing the public administration's impartiality. Open, transparent and accountable public institutions that deliver better services are in high demand. Integrity systems as a long-term institutional policy are crucial across all levels of government. Most LAC countries have already set anti-corruption policies as a priority. Yet enforcing policies and promoting a culture of integrity within public institutions remain great challenges.
- **Target skills and training programmes at public servants**. Such programmes would enrich the public sector by making the work environment more competitive and valuable for workers. Investment in skills programmes, especially those pertaining to ICTs, are needed throughout public institutions. These should be geared to improve quality of service delivery and improve productivity of public servants. The need for incorporating innovation practices from inside public institutions also demands development of social and analytical strengths. These should be promoted with specific human resources strategies.
- **Bolster leadership of the Centre of Government (CoG)**. The CoG is critical for horizontal and vertical co-ordination that improves decision-making processes. It also ensures policy coherence throughout different government institutions and levels. Openness and accountability ensure that the needs, preferences and concerns of stakeholders, including underserved populations, are reflected in decision making.

- **Promote regional convergence.** Disparities in administrative capacity between central/federal and regional governments thwart the effectiveness of decentralisation. Given that many regions lag behind, LAC countries need to strengthen administrative capacities through a more qualified bureaucracy and greater fiscal and political powers for sub-national governments. Fostering multi-level governance in the context of decentralisation processes can improve the delivery of services and local decision making. Promoting place-based policies is essential for more accurate development plans and achieving the greatest potential of regions.
- **Promote strategic long-term planning, implementation and performance monitoring.** These tactics are needed to measure spending decisions against the achievement of strategic policy outcomes. More robust information systems could play a significant role in building better decision-making processes by providing useful statistical data at a more micro-level. This is crucial for making evaluation a systematic step in policy making.

Towards a new connection with citizens

- **Integrate digital tools into the public sector**. Digital tools are a core component of modern government and a strategic asset for policy making and improved service delivery. Such tools can also build administrative capacities and improve citizens' perception of the public service. Yet LAC countries struggle to manage and monitor digital strategies. In its quest to adopt digital tools government should continue to redesign good processes and promote inter-governmental co-ordination.
- **Promote public innovation labs as a cost-effective way to manage government risk-taking.** Innovation labs have the ability to assemble multidisciplinary teams and reach out to users and other stakeholders. This provides valuable inputs into designing cost-effective, risk-taking small pilots. Such projects respond to citizens' demands in an efficient, transparent and flexible way. They also encourage the public sector to switch towards designing policies in a more user-centric way.
- **Establish multi-level governance to promote co-operation**. Implementing reforms to build institutions that deliver is not easy. Popular discontent and distrust in government tend to aggravate political polarisation, making it more difficult to enforce meaningful reforms. In this context, effective multi-level governance is vital. Lack of co-operation and co-ordination among actors at different stages of the reform process can distort the quality of policies.

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Chapter 4

Institutions to embrace a future of better jobs and greater well-being in Latin America and the Caribbean

This chapter argues that discussion around rethinking institutions for development in the LAC region should be forward-looking. To feed this discussion, the first part focuses on the potential impact of technological change on the world of work and on economic activity. It also reflects on the institutional challenges to guarantee good quality jobs and economic opportunities in the context of the "fourth industrial revolution". A forward-looking approach to policy making also demands a sustainable fiscal framework. This is the subject of the second part of the chapter, which analyses how to improve taxation to raise more revenues, how to improve spending and how to ensure the long-term sustainability of public finances.

The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

Institutions to embrace a future of better jobs and greater well-being

Institutions must be forward-looking and adapt to technological change and its impact in the nature of work

Promote productive development policies

To create **good quality jobs**

Promote education and skills policies

To favour **employability** and the **match** between **demand** and **supply skills**

Support new labour market institutions

To guarantee **good job** conditions (for example, for the growing **gig economy)**

Efficient and effective public finance management enhances the use of public resources to finance better public services

Taxing better:

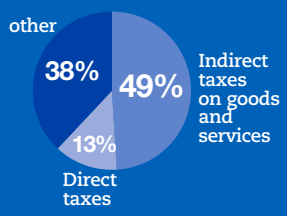
Total **tax revenues** in LAC are low and concentrated on **goods and services...**

... while the **redistributive capacity** of the tax system is low

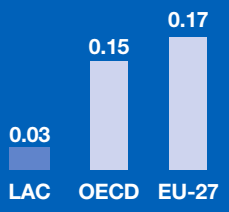
Investing more:

Improving efficiency of **government expenditures** could produce **3% of GDP** to increase investments

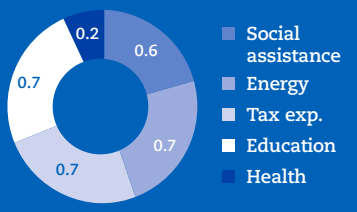
LAC total tax revenues, 2015



Reduction in Gini points



Potential savings of efficient spending



A rapidly changing global context is fuelling an increasing disconnection between citizens and public institutions in Latin America and the Caribbean (LAC), bringing new socio-economic challenges and the need to rethink institutions to embrace emerging opportunities. Various megatrends are shaping an era of uncertainty where citizens perceive new challenges and risks that demand new policy responses, while new opportunities emerge from which they have the ambition to benefit. Climate change, an ageing population and technological progress are three main global trends that could largely transform societies across the globe. Institutions need to be rethought to adapt to these new realities, and to guarantee well-being and socio-economic progress.

This chapter argues that discussion around rethinking institutions for development in the LAC region should be forward-looking. Institutions today must be designed in a way to respond to the evolving aspirations of society, as well as being flexible and adaptive to rapidly changing realities. To feed this discussion, the first part of this chapter focuses on the potential impact of technological change on the world of work and on economic activity. It also reflects on the institutional challenges to guarantee good quality jobs and economic opportunities in the context of the "fourth industrial revolution". Institutions must be rethought to support the expansion of good-quality-job-creating sectors. They should favour employability through more and better education and skills. And they should guarantee good working conditions through standards for all emerging varieties of working arrangements and through stronger social protection systems.

A forward-looking approach to policy making also demands a sustainable fiscal framework. Such a framework must guarantee the capacity of financing more and better public goods and services to respond to citizens' rising and evolving demands. This is the subject of the second part of the chapter, which analyses how to improve taxation to raise more revenues, how to improve spending and how to ensure the long-term sustainability of public finances.

Providing better jobs and socio-economic opportunities in a changing global context

Technological change will transform the nature of work in the LAC region

Technological change has reached an unprecedented pace in recent years, giving way to a new production revolution. In this context, the possibilities of production are continuously expanding, with technologies complementing and amplifying each other's potential (OECD, 2017a). Information and communication technologies (ICTs), artificial intelligence, big data, the expanding power of computing and the Internet of Things (IoT) are some notable examples of this recent trend, which many have called the "fourth industrial revolution" (OECD/CAF/ECLAC, 2016).

This trend is expected to profoundly transform economies, the world of work and the nature of jobs. Rapid innovation and technological progress will lead to deep transformations of economic structures, disrupting some industries that will be challenged as new technologies redefine the terms of competitive success (OECD, 2017a). As a consequence, some sectors may experience a significant decline in their relative share of the total economy and of total employment creation. Others, however, may undergo a steep rise in their value added, in their capacity to create jobs and in their potential for growth. These changes will largely transform economic structures, with large implications for the institutional framework that countries put in place to support sectors with good prospects for future expansion and for job creation.

Technological change in the LAC region will change the nature of jobs as the main tasks performed by humans will be strongly transformed. Technology and machines will have a much deeper presence in production processes, while workers will increasingly perform those tasks more genuinely associated with humans (i.e. non-routine, problem-solving tasks). This will have a direct impact on the kind of skills demanded for jobs and thus require a rethinking of institutions in the field of education and training. In addition, job arrangements and the organisation of work will be deeply transformed. Social and labour protection will face new challenges, including the costs of job destruction associated with more technological, innovation-led economies. This will also require a rethinking of labour institutions to guarantee good working conditions and standards of living, as well as to manage adjustments in employment associated with economic disruption.

The region must adapt its institutional framework to respond to new challenges and embrace emerging opportunities, and to provide citizens with better jobs, prospects of employability and progress and decent standards of living (OECD Ministerial Declaration, 2016). For this, it is critical to focus on productive development policies (to create good quality jobs), education and skills policies (to favour employability), and labour market institutional arrangements (to guarantee good job conditions).

Productive development policies to create good quality jobs

Technological change will transform the nature and structure of LAC economies. New sectors will be created and others destroyed with a significant shift of employment across them. The institutional response of countries to these structural transformations will largely determine their capacity to embrace emerging opportunities. It will also remain critical to align the development model with the Sustainable Development Goals (SDGs), namely with Goal 8 that focuses on promoting sustained, inclusive and sustainable economic growth, full and productive employment, and decent work.

The impact of rapid technological progress on economic structures is particularly visible in the changing role of manufacturing. Manufacturing has always played a central role in driving economic prosperity as an engine of innovation, research, job creation and productivity. But the global manufacturing structure has changed dramatically. Industrial jobs have declined in traditional industrialised countries and increased in newly industrialised countries. In the emerging scenario, industry cannot be viewed as an independent sector of the economy, but rather as the centre of a complex integrated ecosystem. Readiness to play a role in the new ecosystem is a fundamental driver of either countries' success or failure. The role of manufacturing will be critical not only as a source of quality jobs (productivity and high wages), but also as an engine of technological dynamism and an interplay between goods production and digital technologies.

The production revolution is not only transforming economic structures but also business models. In the advanced manufacturing of the 21st century, the digital and physical worlds are converging: advanced hardware is combined with advanced software, sensors and big data analytics. This results in smart products and processes, with greater interaction between consumers, suppliers and manufacturers (ECLAC, 2016). The most significant change in the economy is occurring in business models based on the connectivity of objects or the Internet of Things. In this context, the greatest advances are emerging in health (monitoring applications, medication dispensers and tele-medicine) and in manufacturing (robotisation, advanced manufacturing and the

development of next-generation machine-to-machine (M2M) services), as well as in areas such as energy, transport, natural resources and smart electricity grids.

A shared vision of governments and policy makers is needed to build the preconditions for advanced manufacturing in terms of institutions, policies, infrastructures, advanced skills and technological readiness. Policy makers must understand advanced manufacturing, giving priority to all instruments needed for its development. This vision would help identify the main factors crucial for boosting productivity and development in industrialised countries, which are related to sophistication, technological development and innovation, infrastructure and education, and training (WEF, 2016). These results indicate the relevance of industrial and technological policies, as well as the importance of institutional development to foster growth and productivity. This is particularly important to set the conditions for the "fourth industrial revolution". Transformation is not defined by any particular set of emerging technologies, but rather by the transition to new interconnected systems that are being built on the infrastructure of the digital revolution.

In this context, productive development policies (PDPs) will be critical to embrace the opportunities of technological change and move towards a knowledge-based, innovation-led economy. PDPs, and the corresponding institutions and instruments, are critical tools to influence the rhythm and pattern of growth. They can have a central role in supporting the transition to a new development model (IDB, 2015; Salazar-Xirinachs et al., 2014). The institutional design of PDPs will strongly determine the capacity of countries to embrace change and favour the expansion of new, job-creating sectors. This, in turn, will provide good prospects for growth and productivity gains, as well as the diversification of the productive structure and a more sustained, inclusive and sustainable pattern of growth with more and better jobs.

This productive transformation entails expanding high-value added activities, creating value chains and removing obstacles to competitiveness (ECLAC, 2012). In this respect, the *OECD Productive Transformation framework* provides guidance to promote structural change. Under this framework, and in a context of uncertainty and complexity, more sophisticated policy approaches are needed to favour five main capacities of the institutional system that have been identified as critical to support productive transformation, namely: the capacity to be forward-looking; the capacity to be flexible and react to changing circumstances; the capacity to activate learning dynamics and engender self-discovery processes; the capacity to deal with increasingly complex networks; and the capacity to create resilient linkages and create and retain value (OECD, 2017b).

A strong institutional framework is critical to support PDPs, which have often done harm in the LAC region. In many cases, PDPs in the region have not focused on countries' latent comparative advantages or have been guided by subjective and arbitrary motivations, stemming from a rent-seeking culture and leading to economic inefficiencies. The region must avoid misguided policies, improving their impact as components of a broader development strategy.

The scepticism about PDPs in the region derives from doubts about state capacities, as well as from suspicion that these policies could be used to transfer rents to powerful groups. In this respect, three institutional capabilities appear as critical to support the effective design, implementation and evaluation of PDPs. First, technical capabilities can successfully overcome the technical challenges associated with complex policies. Second, organisational capabilities are needed to foster effective management of policy efforts and to favour policy co-ordination across sectors and with the private sector. Third, political capabilities can guarantee long-term support of strategic priorities and protect the policy process from deviations towards the private interest (IDB, 2015).

PDPs should be inserted into a broader agenda to promote inclusive growth in LAC. An "entrepreneurial" state should take a rigorous, active and forward-looking approach to assess the potential for growth of different sectors and put in place policies to support innovation-led growth. In seeking this, both the public and the private sector play relevant roles. In particular, the role of the state can go well beyond levelling the playing field for private sector initiatives. Rather, it can take certain risks that the private sector is not willing to take, as well as reaping benefits from that risk-taking to favour future investments. In this sense, innovation is not only an outcome of spending on research and development. It is more directly related to the set of institutions that allow new knowledge to diffuse throughout the economy (Mazzucato, 2013).

All in all, the advent of the production revolution represents a critical opportunity in the region to transform economies and exploit new sources of productivity and growth. Extraordinary growth in the past 15 years in LAC has mainly come from labour accumulation, as well as external tailwinds; in fact, LAC has one of the weakest productivity performances of any region in the world (MGI, 2017). But the current scenario challenges traditional sources of growth and opens up new opportunities for drivers of inclusive development. To make the most of this potential, policies must expand high-value added activities, exploiting key value chains, removing obstacles to competitiveness and fostering adoption of digital and automation activities (MGI, 2017). In this sense, policies must provide more and better education and skills for all and strengthening the link with changing labour market demands must be a core strategic priority.

Education and skills to favour employability in a new world of work

Technological progress, which is expected to largely transform the nature of jobs, will lead to a global shift in the demand for skills which is expected to also have an impact in the LAC region.

The net impact of technological change and automation on creating and destroying jobs is difficult to anticipate. It will largely depend on the capacity of countries to adopt institutional responses to the changes on the demand of skills that this will bring about. Jobs will increasingly incorporate technology, and thus humans and machines will have to interact more prominently.

The main tasks performed by workers will significantly change as demand shifts towards skills related to cognitive ability, systems and complex-problem solving. Machines will increasingly be able to replace humans in performing routine and non-routine manual tasks and routine cognitive tasks. Thus, the demand for skills will move towards capacities more specific and exclusive to humans and a rise of the demand for cognitive abilities, systems skills and complex problem-solving skills could be expected in the future (OECD/CAF/ECLAC, 2016).

These emerging challenges could be aggravated in LAC by the large educational gaps that still remain in the region. Although years of schooling have increased, international measurements show large gaps in LAC in terms of formal education in basic competencies of math, reading and science (OECD/CAF/ECLAC, 2014). There are also significant gaps in terms of vocational training and around 50% of formal firms in the region do not find the workforce with the skills they need (OECD/CAF/ECLAC, 2016). Training at the workplace is also poor: while one out of nine workers in the region receives some type of training in a year, the average for the OECD member countries is more than one out of five (IDB, 2015).

The world of education and vocational training is thus confronting one of the most profound changes in its history. To respond to emerging challenges and embrace upcoming opportunities, 21st century jobs demand skills and competencies of a more complex nature (technical, digital, socio-emotional). This implies that curricula, as

well as teaching and learning methods, should be adapted so that they effectively train citizens in skills that are useful to improve their employability prospects.

These transformations also challenge educational and vocational training systems to be up to date, anticipating new requirements and offering lifelong education and training. Anticipation of skills is of particular relevance in such context. This can help address large skills' mismatches in the LAC region and prepare for future skills needs, guiding policy actions in the fields of education, labour and migration (OECD, 2016a). The use of information on skills needs, inferred from labour market information or vacancy surveys, is critical to develop occupational forecasts, to update occupational standards and to design apprenticeships and on-the-job- training programmes, as well to inform curriculum development and set the number of student places at all levels and fields of education. This information can be used more effectively when there is good co-ordination across ministries and strong engagement of stakeholders. In this respect, sector skills councils and independent bodies such as national skills advisory groups are good practices that can largely improve co-ordination (OECD, 2016a).

Governance of the education system is also critical to face a world of increasing complexity and where new challenges will test the capacity to provide the right skills and guarantee coherence and co-ordination among all stakeholders (Box 4.1). Education systems are in fact complex systems, characterised as networks of interdependent actors whose actions affect many other actors, and which evolve, adapt, and re-organise themselves (Snyder, 2013).

Box 4.1. **Governing education in a complex world**

Over the past years many OECD and LAC countries have decentralised the control of their education systems, providing schools and local authorities with greater autonomy over responding to the needs and demands of their communities. As information about school and student accomplishments are now more readily available, parents, but also teachers, students and labour unions, have become more vocal and more involved in education policy on various levels. The greater availability of information, increasingly dynamic relationships in governance arrangements and greater number of stakeholders together call for new approaches to governance (Burns and Köster, 2016).

Understanding education systems as complex means acknowledging that traditional linear governance patterns have limited applicability. Taking the example of decentralisation, devolving power to local authorities will not improve the functioning of the system unless it is accompanied by attention to the connections and interactivity present and by adequate processes supporting the realisation. If the legacies of the system as well as its ambitions for its future are not considered in policies, they are likely to backfire.

The decentralisation of decision-making powers in education to the municipal level may not always have the desired effects of greater local responsiveness. Rather, municipalities lacking adequate capacities and the culture to take responsibility for local education, may fail to implement adequate processes for peer learning and accountability within the municipal hierarchy, resulting in fragmented approaches and shutting the door on co-operation and peer learning. While decentralisation indeed can lead to greater responsiveness to local needs, it needs to be adapted to system history and culture as well as respective processes supporting the transition in place. Although it might be tempting to look for proven recipes for success, policy requires responses adapted to context and considering links between system components and culture of interaction.

Box 4.1. **Governing education in a complex world** *(cont.)*

Five elements of modern governance for complex systems

Governance must be able to integrate the dynamism and complexity of today's education systems at the same time as it steers a clear course towards established goals, all the while financial constraints dictate efficiency. Five elements are crucial to govern complexity in education:

- Focus on effective processes, not on structures. The success of governance structures depends on the underlying processes and right conditions. The number of levels, and the power at each level, is not what makes or breaks a good system. Rather, it is the alignment of policies and practices, the involvement of actors, and the processes underlying governance and reform.
- Be flexible and adaptive to change and uncertainty. Strengthening a system's ability to learn from feedback is crucial for flexibility and adaptiveness as well as for quality assurance and accountability.
- Build capacity, engage in open dialogue and involve stakeholders. While working to include a wide range of perspectives and knowledge, governance in complexity is not rudderless: productive integration of stakeholders only works with a strategic vision and set of processes to harness diverse ideas and input.
- Pursue a whole-of-system approach. Effective governance aligns policies, roles and responsibilities to improve efficiency and reduce potential overlap and conflict across the system and across policies.
- Integrate evidence, knowledge, and the use of data to improve policy making and implementation. A strong knowledge system combines descriptive data, expert practitioner knowledge and research findings – the key is to know what to use, when, why and how.

In the race between education and technology, technology is permanently challenging educational and training systems to keep pace. The structure of demand for competencies is changing fast, which challenges educational and vocational training systems to reform them to improve quality and pertinence. This is partly due to processes of productive transformation, and partly to impacts of the technological revolutions. In the traditional model, specialised institutions outside of enterprises had responsibility for vocational training. With the need to detect skills requirements of enterprises in real time, vocational training must become a public-private partnership with flexible roles and responsibilities. This would give the system the speed and pertinence required by the development process.

The region needs to rethink labour market institutions to guarantee good job conditions

Technological progress will also have an impact on the organisation of work and the nature of working arrangements in the LAC region. This will call for a rethinking of labour market institutions to guarantee decent labour conditions and good quality jobs.

The growing diversification in working arrangements, particularly a rise in non-standard employment (NSE), has been a distinguishing feature of recent years in the world of work (ILO, 2016). This diversification reflects transformations in production from globalisation and technological advances, including digitalisation, that have helped create and disperse production networks across the globe. These transformations, coupled with the rise of artificial intelligence and robotics, the growth of the "platform

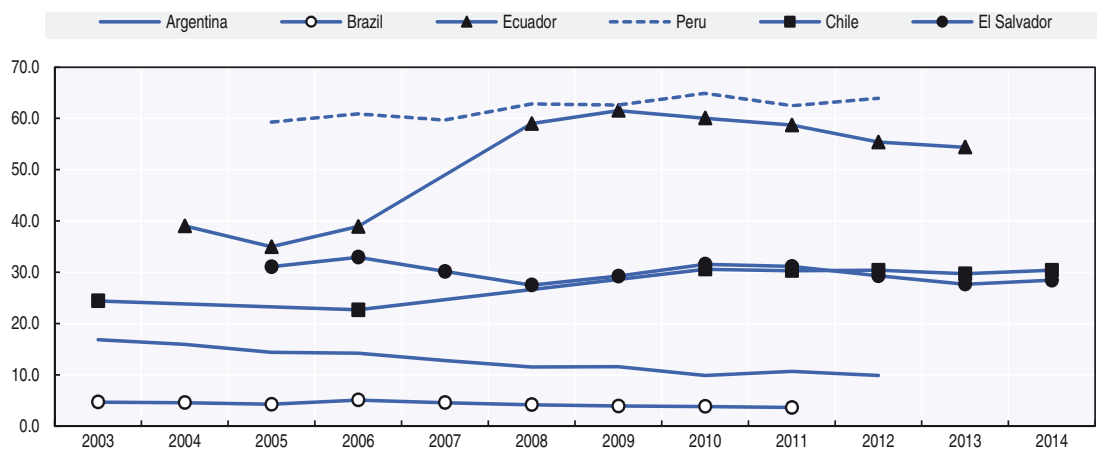
economy" and the trend towards casual labour, have raised questions about the future of work. Social protection systems, including social insurance and tax-financed mechanisms, must find ways to adapt to these changes.

Types of employment have diversified. "Standard employment" has been understood as work that is full time, of indefinite length and part of a subordinate relationship between an employee and an employer. The rise of "non-standard employment" provides opportunities and challenges for the future world of work in general, and social protection in particular. Non-standard forms of employment include temporary employment; part-time work; temporary agency work and other multi-party employment relationships; disguised employment relationships; and dependent self-employment.

This diversification has brought challenges for attaining decent work, given that many labour laws and social security policies depend largely on the standard employment relationship. Even in LAC, where waged employment is more limited and often takes the form of casual work, the regulation of the employment relationship is similar to that in developed countries. Many of the concerns about the effects of NSE on workers, businesses and the labour market are as applicable. While some NSE such as casual employment have been a regular feature of labour markets in many developing countries, other forms, such as temporary agency work, have only appeared in the past few decades. The challenge is therefore to adapt labour and social protection policies to foster an inclusive labour market for the future.

Trends in NSE have not been uniform across the world or LAC, reflecting both different levels of economic development and regulatory policies. Some forms of NSE have grown as a result of changes in the law that have purposely or unwittingly created incentives for their use by enterprises. This can be seen when comparing the differences in the incidence and evolution of temporary employment in six LAC countries between 2003 and 2014 (Figure 4.1). In some countries, such as Argentina and Brazil, the use of temporary employment is limited. In contrast, in Chile and El Salvador around 30% of employees are on temporary contracts, despite differences in the economic structure of the two countries. The incidence of NSE is highest in Ecuador and Peru.

Figure 4.1. **Temporary workers, as a percentage of wage employees (selected Latin American countries, 2003-14)**



Note: Data for Peru are based on written contracts only. Data for Argentina and Brazil are based on Q4 of each year. For Ecuador 2007/08, there is a break in the series.

Source: ILO (2016) based on Argentina: EPH (Q4 of each year); Brazil: PME (IBGE) (Q4); Chile: CASEN; Peru: ENAHO; and El Salvador: EHPM.

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Non-standard forms of employment have a variety of effects on working conditions, including employment security, wages and remuneration, working time, occupational safety and health conditions, access to social security, work-life balance and opportunities for training. Whether these effects are positive or negative largely reflects workers' reasons for entering non-standard employment, and the legal mechanisms in place controlling working conditions in non-standard employment. In general, non-standard employment can bring benefits for workers when engagement reflects both a voluntary choice on the part of the worker and where the contract provides equal treatment compared to "standard" work.

An important concern with respect to NSE is its implications on workers' representation and other fundamental rights at work. Workers in NSE may lack access to freedom of association and collective bargaining rights, either for legal reasons or because of their more tenuous attachment to the workplace. They may also face other violations of their fundamental rights at work, including discrimination. This, in turn, can have implications on working conditions, as collective bargaining is an important regulatory tool.

NSE can also have important implications for working conditions, including on earnings, on occupational safety and health (OSH) and on training. Workers in NSE often earn less than workers in "standard" jobs, even if they have similar backgrounds and characteristics and are doing the same work (ILO, 2016). Labour market studies throughout the world show that a temporary or temporary agency worker can be penalised by up to 30%. There are significant OSH risks owing to a combination of poor induction, training and supervision, communication breakdowns (especially in multi-party employment arrangements) and fractured or disputed legal obligations. Injury rates are higher among workers in NSE. Finally, workers in NSE are less likely to receive on-the-job training, which can have negative repercussions on career development, especially for young workers. This is particularly problematic for LAC, as training rates in the region are low overall.

NSE has important implications for LAC firms as well. NSE may generate short-term financial gains especially if arrangements are exempt from social security contributions and other employee benefits. However, such cost savings are associated with a lack of protection for workers (with negative implications for labour productivity, e.g. in the case of ill health) and are not sustainable if the workforce (standard and non-standard alike) is not well managed. This is particularly true if NSE use is intensive. Indeed, firms that rely heavily on temporary and other forms of NSE risk a gradual erosion of firm-specific skills in the organisation, limiting the firm's ability to respond to changing market demands. As a result, the short-term cost and flexibility gains may be outweighed by longer-term productivity losses. These "intensive-using" firms (in developing and transition countries) tend to be more labour-intensive, invest less in the training of temporary workers and are usually older and less productive (Aleksynska and Berg, 2016).

In this context, there is a need to adapt and strengthen labour market institutions to guarantee good quality jobs in a new world of work. There is also a need to re-assess regulation to ensure decent working conditions, as well as to make efforts – as part of strengthening the social compact – in ensuring compliance with regulations. These measures include: *i) addressing employment misclassification:* recognition of an employment relationship is the precondition for application of labour legislation; *ii) ensuring equal treatment for workers:* legislation can adopt ILO standards that incorporate the principle of equal treatment for part-time workers, fixed-term workers and temporary agency workers; *iii) implementing minimum hours and other safeguards:* these can be useful for addressing some forms of very short hours and on-call arrangements, and improve

income security; *iv) assigning obligations and liabilities in multi-party arrangements:* in such arrangements, workers may find it difficult to clearly identify the respective responsibilities of each party. The ILO's Private Employment Agencies Convention, 1997 (No. 181), requires the determination and allocation of the respective responsibilities of private employment agencies and of user enterprises in relation to labour rights; *v) restricting the use of non-standard employment:* in certain instances, restrictions are needed in the use of NSE to prevent abuses. The EU Directive on Fixed-Term Work requires the adoption of measures to prevent abuse arising from the use of successive fixed-term employment contracts or relationships; and *vi) promoting collective responses and collective agreements:* collective bargaining is another important regulatory tool for addressing potential decent-work deficits for workers in NSE (ILO, 2016).

Improving women's labour market integration

In the LAC region, where labour institutions have been traditionally biased towards men, the production revolution and the transformation of the economy and the world of work open a great opportunity to improve women's participation in labour markets. Historically, conceptions of work have assumed a male breadwinner with a wife and dependants at home – "the industrial man". These views shaped the employment and social security laws that still exist today. They have also shaped how labour markets function, and the position and progress of different groups in the labour market. Moreover, some original laws and standards were designed to limit women's working hours. Female-dominated industries set minimum wages below those of comparable men's wages, in effect legislating their secondary role in the home and the labour market (Vosko, 2010). Social security systems also commonly penalised secondary earners.

The "standard employment relationship" is not a legal concept. However, the consideration of full-time, open-ended and subordinate employment as "standard" employment and the development of labour protections tied to this notion has meant that workers who could not perform work with these characteristics have been unduly penalised. This affected both access to jobs, and also the pay, benefits and conditions of the jobs they were in. In particular, lack of recognition of unpaid reproductive work has perpetuated gender biases in the labour market, with women often relegated to the "margins of paid work" (Vosko, 2010). Because of care responsibilities, women were presumed not to be able to dedicate themselves to full-time work, and these obligations also kept them from doing so (Sirianni and Negrey, 2000).

As a result, when women do participate in the labour market, especially in LAC, they are more likely to be in informal work or not in employment, education or training (NEET); this gives them greater control over their working hours to balance work with domestic and family responsibilities. This is particularly true among young women in the region where 30% aged 15-29 are NEET, relative to 11% of young men (OECD/CAF/ECLAC, 2016). This over-representation in informal work and inactivity also reflects women's greater difficulties in entering and remaining in the formal labour market, which is a consequence of the unequal distribution of unpaid work. On average, women carry out at least two-and-a-half times more unpaid household and care work than men. This inequality affects women's ability to obtain and remain in formal jobs – given the hours and availability that some formal jobs require – as well as the reservation of some employers in hiring women because of other demands on them outside of work.

Women's labour market experience also depends on public policies, which can either reinforce gender stereotyping – and its subsequent ramifications in the labour market – or remedy it. Indeed, differences in labour force participation rates frequently reflect prevailing social welfare policies, tax policies and the provision of public services (Grimshaw, 2011). But policies can be adapted. For example, policies in Sweden in the

1950s and 1960s centred on the notion of the male breadwinner. However, beginning in the 1970s the country began transforming its welfare state on the assumption that all fit adults should be in employment. The social security system changed from one of "derived entitlements" to "individual rights", and paid work was accommodated through the provision of high-quality, public care services, as well as flexible paid leave policies (Bosch, 2004). Moreover, parental leave policies could be shared between mother and father; fathers were given incentives to take parental leave. Other European countries have followed Sweden's example, instituting policies to increase overall labour force participation of women. Key policies included supporting childcare services and paid parental leave policies, and facilitating and promoting good quality, part-time work (Blau and Kahn, 1996).

In a context of rapid technological change, new risks are emerging. The proliferation of NSE may appear more attractive for women, for example, because they facilitate the reconciliation of work and family tasks, but this can also be a source of perpetuation of certain family roles, and these types of jobs generally entail more vulnerable working conditions. Thus, they need to be coupled with a rethinking of labour market institutions. Conversely, some opportunities will arise associated with new technological possibilities that will support work-life balance, as well as the expansion of new sectors that can open opportunities to support the integration of women into the labour market.

Achieving social protection for all

In LAC, there is a need to strengthen and expand social protection systems so that all workers benefit from adequate coverage. This is especially true since technological progress may encourage the proliferation of NSE, as well as profound transformations leading to the destruction of a substantial amount of jobs. In some instances, it may require adapting existing social security systems. Eliminating or lowering thresholds on minimum hours, earnings or duration of employment, for example, can help ensure NSE workers are not excluded from coverage. In other instances, it will require implementing and extending non-contributory social assistance systems so that informally employed workers and those out of the labour market can have coverage.

A combination of contributory and non-contributory forms of social protection can ensure at least a basic level of social security for all. It can also respond to the social protection needs of the majority of the population, including the middle classes, based on equitable and sustainable financing mechanisms.

In addition, this approach allows for the design of national social protection systems that combine different mechanisms that are linked to employment or residence in an equitable and sustainable way, with appropriate financing available through taxes or contributions. As a general rule, combining different types of protection usually gives workers a better level of protection. Four main policies are needed to improve social protection coverage, including responding to the challenges of the future world of work (ILO, 2016).

Ensuring non-discrimination and equal treatment among different contractual arrangements

The social security system may exclude NSE workers either because of short hours or limited contribution period. This policy area is addressed by the ILO Part-Time Work Convention, 1994 (No.175), which states that the minimum number of working hours or earnings need to be lowered so as to avoid the exclusion of an "unduly large percentage of part-time workers". More specifically, social insurance systems can count each hour of work towards social security contributions.

Social insurance coverage for temporary workers can be improved in two ways. First, thresholds set out in the legislation regarding the minimum duration of employment could be lowered. Second, enhanced coverage could ensure greater parity and equality of treatment between workers in different forms of employment. Thus, access to benefits can be improved by allowing greater flexibility with regard to interrupted contribution periods. For example, the period to consider contributions to social insurance could be extended.

Such policies can be complemented by measures to recognise care work (e.g. child rearing) as contribution periods counting towards social security entitlements. As is the case in Chile, this policy can facilitate the access of women to social security benefits and reduce gender inequalities in social insurance systems (Fultz, 2011).

Adapting social insurance schemes to extend coverage to previously excluded categories of workers

In many LAC countries, substantial coverage gaps continue to exist. This is particularly the case for informally employed workers, including casual workers and own-account workers. Social security systems can be made more inclusive by specifically addressing these gaps. Such measures would not only enhance social protection coverage, but also enable workers to move more freely between different sectors and occupations.

Overall coverage rates for some categories of *self-employed workers* remain low in the region. However, many countries elsewhere have begun to include some categories of self-employed workers in social insurance systems. This includes Canada, which provides social insurance cover for self-employed workers in the event of unemployment (OECD, 2015a). Such coverage is especially relevant given the growth of self-employment and of the gig economy.

Some countries have developed innovative mechanisms to cover categories of workers in ways adapted to their specific characteristics and needs. India's construction sector, for example, has a high incidence of sub-contracting and casual work. In response, Worker Welfare Funds cover all those involved in a construction project, including casual and sub-contracted workers. The main contractor contributes 1% of the total value of every construction project (Newitt, Alastair and McLeish, 2014).

Improving the working of social security systems

LAC could enact several measures to improve social security systems. These could simplify administrative procedures for registration and contribution payments, and enhance access to information about individual entitlements. Further, they could help make entitlements portable between different social security schemes and employment statuses. For example, several countries (Argentina, Brazil, Chile) have simplified tax and contribution payments to help certain categories of self-employed (owners of micro-enterprises and their employees) gain access to social security.

Complementing social insurance with non-contributory mechanisms to provide a social protection floor

Mechanisms are needed in LAC to ensure social security coverage for workers in non-standard employment arrangements. These include extension of contributory or non-contributory (tax-financed) social security schemes. Without such mechanisms, workers are likely to have inadequate coverage or no coverage at all. As a result, they will be more exposed to social risks with regard to income security and effective access to health care.

Tax-financed protection plays a key role in filling the gaps and ensuring at least a basic level of coverage, thereby guaranteeing a floor of social protection for everyone. Such non-contributory schemes play an important role, especially for those who are not covered or are insufficiently covered by contributory mechanisms. Tax-financed benefits may also close coverage gaps for NSE workers for child and family benefits (e.g. Argentina), unemployment protection and social assistance (e.g. France, Germany). In the area of health protection, tax financing is essential for national health services and for subsidising health insurance contributions for low-income workers, including many NSE workers who may not be sufficiently covered otherwise.

The combination of contributory and non-contributory elements is key to building a comprehensive social security system with a strong floor of social protection. Different financing sources aid in ensuring the financial, fiscal and economic sustainability of national social security systems, and in achieving universal social protection.

Enhancing the efficiency and effectiveness of public finance to foster inclusive growth

Investing and mobilising resources for sustainable development in an effective and efficient manner is still one of the region's pressing issues. Fiscal indicators show the region lags behind in crucial areas. Per capita government spending among LAC countries was 35% that of OECD economies (USD in PPP 16 876 in 2015), while total tax revenues are 21.7% of gross domestic product (GDP) relative to 34.3% in the OECD. LAC remains the most unequal region in the world with an average Gini coefficient of 0.49 after taxes and transfers, compared with 0.29 in OECD member countries. This highlights the meagre redistributive power of LAC's fiscal system (OECD, 2016b; OECD/CIAT/ECLAC/IDB, 2017).

The state's core functions of raising revenue and allocating public resources and ensuring their sustainability in the long-term are all indispensable to delivering inclusive growth. Yet public support for reform is limited because of the erosion of the fiscal pact and low levels of tax morale (see Chapter 2). In this context, bolstering the state's fiscal capacities requires spending better, improving tax collection, strengthening regional and local governments' capacities, and focusing on public finance's sustainability. In some cases, spending better will not be enough to bridge the existing gaps in infrastructure and social public spending; countries will also need to raise more revenue to invest more. Furthermore, the limited fiscal space due to the upsurge of primary and overall deficits starting in 2011 (Figure 4.2) is exerting some pressure to increase the level of public resources at all levels of government.

Improving the provision of public goods in LAC through decentralisation efforts requires addressing weak institutional fiscal capacities of local and regional governments. Many central governments have transferred the responsibility for public goods and services to regional and local governments to satisfy local needs in a better way. However, these sub-national jurisdictions cannot always mobilise more revenues to cover these additional tasks, resulting in fiscal imbalances. Consequently, they depend on transfers from central governments to make up the difference. Furthermore, a large number of sub-national governments lack institutional capacities to execute transferred funds and deliver adequate public services.

Better spending: Investing for development

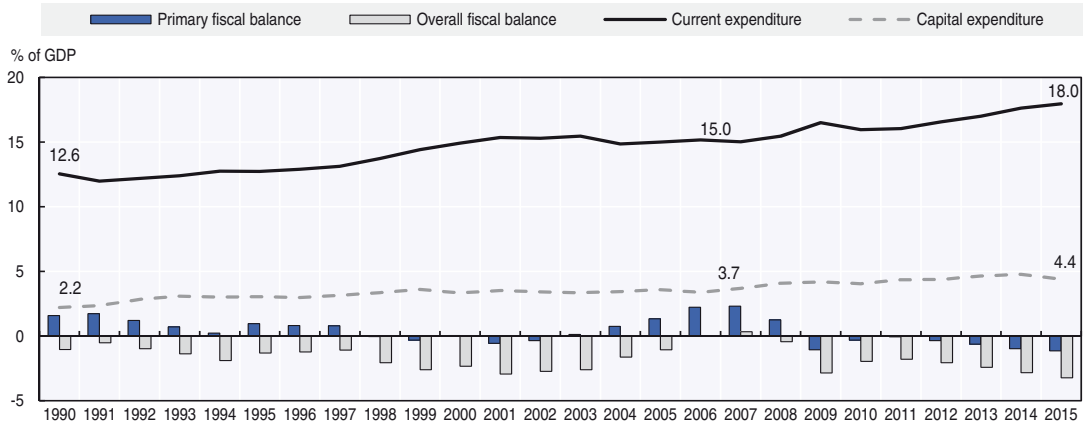
Improving the effectiveness and efficiency of spending in LAC are the first steps towards a renewed fiscal pact, economic growth and development. Governments' spending levels and composition are critical as they directly allocate public funds towards the provision of collective and individual public goods. Since 2007, spurred by the favourable

macroeconomic conditions, LAC increased spending by 4.2 percentage points. Despite this expansion, general government spending in LAC countries was 8.4 percentage points less than in OECD member countries in 2014 (OECD, 2016b). This is a wide gap, given the existing differences in the provision of public goods and services between both regions.

Composition of government expenditures is as important as spending levels. In 2014, and as a share of total government expenditures, LAC economies spent the most on compensation to government employees (an average of 29.1%); OECD member countries spent 23.1% of their budgets on this item. The second largest expenditure for LAC countries was on intermediate consumption goods (14.6%), a percentage slightly higher than in the OECD (14.3%). Finally, LAC countries invested 0.4 percentage points less than OECD economies, 7.3% and 7.7% respectively, in 2014 (OECD, 2016b).

Despite efforts in LAC to rein in expenses of central government on employee wages and the government consumption of goods (current expenditures), these budget items continue to grow more rapidly than investments or capital expenditures. In 2015, current expenditures represented 80% of total central government spending, with capital expenditures taking up the remainder. Since 2007, current expenditures have increased by 2.9 percentage points of GDP, a greater rate of increase than capital expenditures, which increased by 0.7 percentage points. Furthermore, overall increases in their spending have required central governments to incur in debt or seek other financing mechanisms to finance the budget.

Figure 4.2. **Central government expenditures, primary and overall fiscal results in Latin America, 1990-2015**



Note: Non weighted average includes Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, the Dominican Republic, Uruguay and Venezuela.

Source: OECD/CAF/ECLAC based on CEPALSTAT (2017) public finance statistics.

StatLink http://dx.doi.org/10.1787/888933651121

Current expenditure levels and their growth crowd out public investing in several Latin American countries. Government spending on employees' wages and other essential consumption goods are inelastic and harder to adjust in the short term compared to capital expenditures. This makes them less sensitive to fluctuations of the economic cycle. Consequently, available funds are allocated towards financing current expenditures. At the same time, the investment gaps in infrastructure, health, education and other capital goods to improve the provision of public goods and services continue to widen.

Effective public investment at the national and sub-national levels in LAC can be a powerful tool to boost growth and development, reduce territorial disparities and leverage private investment. In contrast, poor or badly managed investment waste

resources, erode public trust and may hamper growth (OECD, 2014a). When compared with the OECD average, investment gaps in LAC countries – particularly at the sub-national level – can be significant. For example, sub-national public investment as a percentage of total public investment in OECD member countries averages almost 60%, rendering sub-national governments important players in the investment arena. However, in most Latin American countries this percentage does not reach 50%. Indeed, in Paraguay, Chile and Costa Rica, it is under 14%. While the amount of investment is certainly important, effective public investment requires substantial co-ordination across levels of government to bridge gaps, as well as governance capacities to design and implement public investment projects. Thus, the impact of public investment depends to a significant degree on *how* governments manage the responsibility across levels of government – an area on which the OECD has issued recommendations (Box 4.2).

Box 4.2. **OECD Recommendation on Effective Public Investment across Levels of Government**

In 2014, the OECD adopted a Recommendation on Effective Public Investment across Levels of Government. This Recommendation outlines a series of 12 principles to help governments assess the strengths and weaknesses of their public investment capacity at national and sub-national levels and to help set priorities for improvement. The principles address cross-cutting challenges in public investment relating to co-ordination, capacity and issues arising from framework conditions. Countries adhering to the Recommendation take steps to ensure that national and sub-national levels of government use resources dedicated to public investment for territorial development effectively, in accordance with the principles set out below:

Pillar 1: Co-ordinate public investment across levels of government and policies

- Invest using an integrated strategy tailored to different places.
- Adopt effective co-ordination instruments across national and sub-national governments.
- Co-ordinate among sub-national governments to invest at the relevant scale.

Pillar 2: Strengthen capacities for public investment and promote policy learning across levels of government

- Assess up-front long-term impacts and risks of public investment.
- Encourage stakeholder involvement throughout the investment cycle.
- Mobilise private actors and financing institutions to diversify sources of funding and strengthen capacities.
- Reinforce the expertise of public officials and institutions throughout the investment cycle.
- Focus on results and promote learning.

Pillar 3: Ensure sound framework conditions for public investment at all levels of government

- Develop a fiscal framework adapted to the investment objectives pursued.
- Require sound, transparent financial management.
- Promote transparency and strategic use of public procurement at all levels of government.
- Strive for quality and consistency in regulatory systems across levels of government.

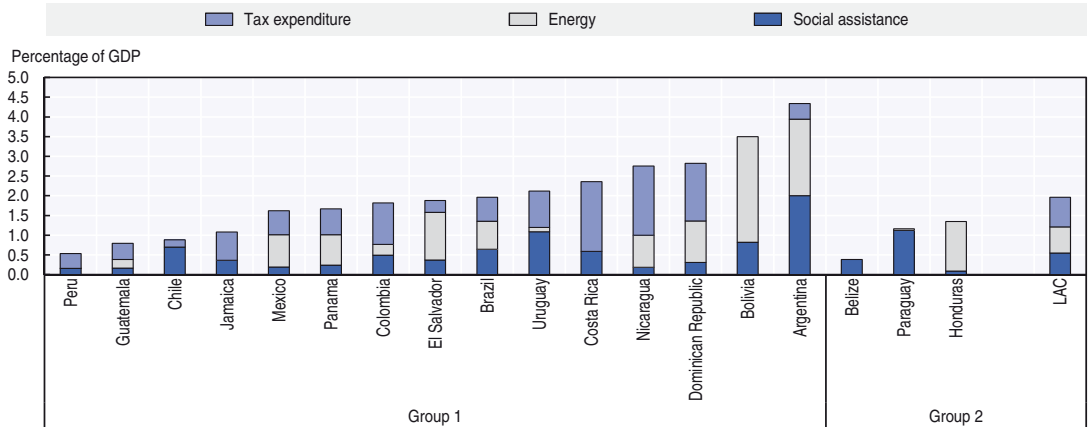
Source: OECD (2014b), Recommendation of the Council on Effective Public Investment across Levels of Government.

Latin American and Caribbean countries require infrastructure investments of 5% of GDP per year for several years to catch up with advanced economies (Serebrisky et al., 2015). Currently, LAC economies invest half of this threshold. The result is a region poorly connected in roads and ports, reduced coverage of basic services such as water and sewerage, and underdeveloped power grids and telecommunication infrastructure. Adequate funding to reduce the infrastructure gap involves spending better, investing more and increasing total investment levels by involving the private sector.

Improving efficiency of government expenditures could produce 3% of GDP in savings to reduce the infrastructure gap in the region. Improving the targeting of energy subsidies, tax expenditures and to a lesser extent social programmes can produce average total savings of 2% of GDP for the region (Figure 4.3, Panel A), while reducing inefficiencies in education and health spending, potentially saves an additional 1% of GDP (Figure 4.3, Panel B) (IDB, 2016). This process entails a detailed review of the budget by sectors to ensure that public servants' wages are consistent with international standards and are in line with achieved outcomes. In addition, it requires a thorough revision of the mechanisms through which subsidies and social programmes provide benefits.

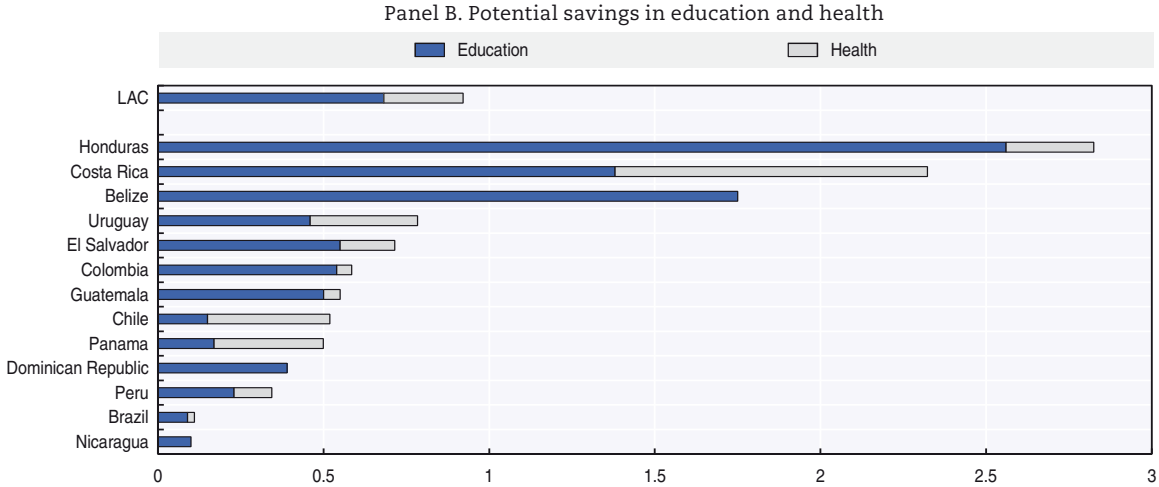
Figure 4.3. **Potential savings through efficient spending in Latin America**

Panel A. Potential savings in targeted expenditure (social programmes, energy and tax expenditure)



Note: For comparison purposes, countries have been split into two groups. Group 1 contains estimates of leakages for countries with data on all three sectors. Group 2 only includes leakage estimates on energy and social assistance.

Panel B. Potential savings in education and health



Note: There are no health filtration estimates for Belize.

Source: IDB (2016), *Saving for Development*, idb/Savings_for_Development.

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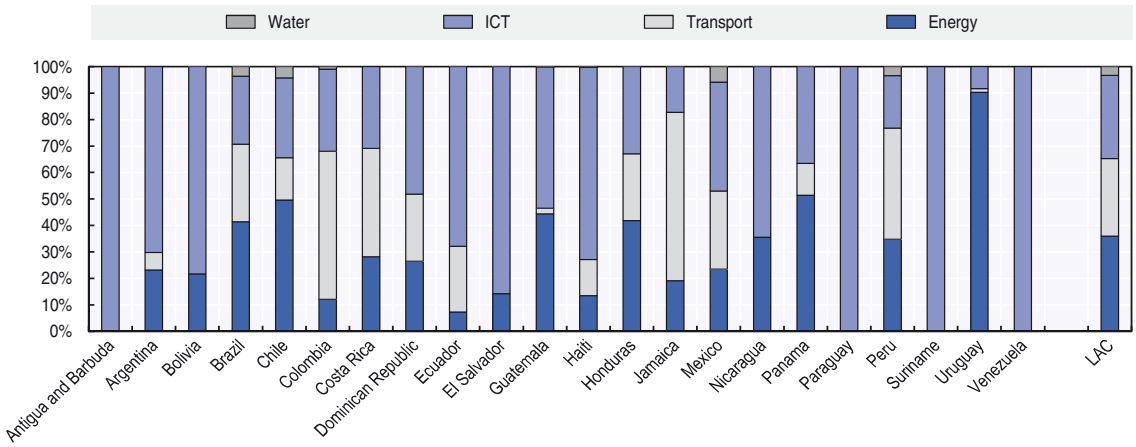
Public-private partnerships (PPPs) can be an effective way to increase total investments in LAC countries, but require greater regulatory clarity and greater institutional capacity. Engaging in PPP processes entails defining clear frameworks and ensuring that government has appropriate capacity to initiate and manage them. As the public sector needs to be a credible partner with appropriate regulations and oversight, enabling the ideal environment for PPPs demands high levels of public governance and co-ordination (Box 4.3). This condition is particularly important as decentralised authorities or local governments which must deal with major private sector actors often manage PPPs (OECD, 2008).

PPPs in LAC countries have focused on ICT, energy and transportation. Despite high heterogeneity across countries in the region, a third of investments in infrastructure come from the private sector. PPPs in ICTs, energy and transport have dominated the total market share, representing more than 90% of PPPs in the region in the last decade (Figure 4.4). In OECD member countries, PPPs have gone beyond these specific sectors and invest in infrastructure, coverage of basic services such as drinking water, and sanitation. In so doing, they address inadequacies in electric networks, energy supply and telecommunications, among others (Sanchez, 2016).

In the region, PPP projects have been traditionally inefficient and have led to increases in their total cost. The performance of concessions is determined by the contract, and by regulatory and institutional design. Flaws in the design of concession contracts have caused excessive costs in Latin America (OECD/ECLAC, 2012). For instance, in Chile, Colombia and Peru, 50 of 61 road contracts were modified at least once between 1993 and 2010, resulting in more than 540 renegotiations. All modified contracts were changed for the first time less than three years after the initial signing of the concession (Bitran, Nieto-Parra and Robledo, 2013).

Figure 4.4. **Public-private partnership investments by sector in Latin America (2006-16)**



Source: OECD/ECLAC/CAF based on World Bank (2017a), *Private Participation in Infrastructure* database, https://ppi.worldbank.org/.

StatLink http://dx.doi.org/10.1787/888933651159

Box 4.3. **Improving the efficiency of public-private partnerships**

Sound regulatory and institutional frameworks are fundamental to increase the effectiveness of public-private partnerships (PPPs) in some countries in the region where weaknesses in prioritisation and planning phases cause inefficiencies in these projects. Empirical analysis in Latin American economies, such as Chile, Colombia and Peru, suggests that state-led renegotiations, which were more common than those

Box 4.3. **Improving the efficiency of public-private partnerships** *(cont.)*

led by firms, were motivated by the opportunistic behaviour of governments. State-led renegotiations that added new stretches of roads and that included additional complementary works during governments' last year in office were costlier than other renegotiations (Bitran, Nieto-Parra and Robledo, 2013). Furthermore, delays and inefficiencies in environmental and land licensing, as well as from consultation with local actors, have affected the timing and certainty of concession contracts in the region. Finally, most of the concession schemes at national level do not apply to regional and municipal governments, affecting the capacity to undertake effective PPPs at local level. *Ex-ante* feasibility studies and the institutional framework supporting value-for-money evaluations could help solve difficulties at the stages highlighted above.

Following a social feasibility analysis, policy makers can use value-for-money evaluations to assess whether a concession model is preferable to direct public sector provision. While most OECD economies do a cost-benefit analysis or use a public-sector comparator, Latin American countries usually limit their analysis to a comparison of tendering results. This creates uncertainty as to whether the private sector can generate value for money. Furthermore, authorities must not heavily discount future payments of concessions or favour concessions over public procurement to meet short- and medium-term fiscal targets. Institutional capacity is therefore necessary to manage and oversee PPP programmes effectively (Reyes-Tagle and Garbacik, 2016). Only nine OECD member countries accounted for concessions as contingent liabilities in government accounts in late 2007 or early 2008 (Araújo and Sutherland, 2010). A change in fiscal accounting can improve concession selection, avoiding reckless investments and the transfer of fiscal commitments to the future. The state controls economic results of the concession through regulations and also receives the work at the end of the contract. Consequently, it could consider concessions as public projects to increase the transparency of public accounts. The OECD 2012 Council Recommendation on PPPs provides guidelines as to when concessions are worth pursuing and addresses their budgetary consequences (OECD, 2012). Reliance on international experiences for improving and making better use of cost-benefit analysis is valuable to the region. The recent French appraisal system and the United Kingdom's project valuation framework are useful examples that emphasise multi-criteria analysis rather than a unique objective (OECD/ITF, 2011).

Some countries in the region have improved the regulatory and institutional framework in the past five years to achieve more effective private participation in infrastructure. Since 2012, for instance, the contract term and resources committed to it in Colombia cannot be increased by more than 20%. The new framework also requires value-for-money analysis to justify executing projects through a PPP instead of through regular public procurement. Further, a new National Infrastructure Agency was created with greater administrative capacity and technical expertise in the design, structuring, tendering and monitoring of contracts. In Honduras, a new independent Fiscal Contingency Unit within the Ministry of Finance has the explicit purpose of approving PPP projects and conducting oversight. All quantifiable firm and contingent commitments by the non-financial public sector in PPP contracts, calculated at present value, may not exceed a limit equivalent to 5% of GDP (Reyes-Tagle and Tejada, 2015). In Peru, recent efforts to increase efficiencies in environmental and land licensing should improve the timing and certainty of concession contracts (OECD, 2016c).

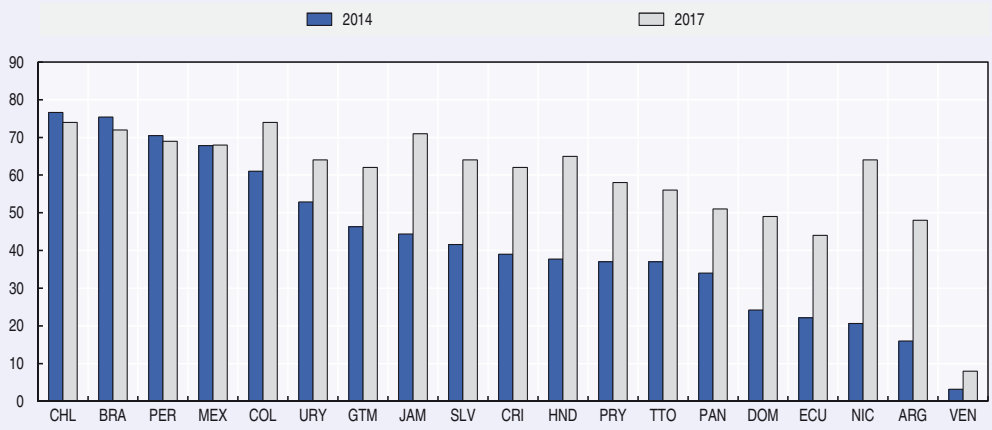
Despite this progress on PPPs, Latin America still faces challenges concerning its readiness for an efficient institutional environment. The Infrascope Index measures the environment of 19 Latin American and Caribbean countries for implementing PPPs

Box 4.3. **Improving the efficiency of public-private partnerships** *(cont.)*

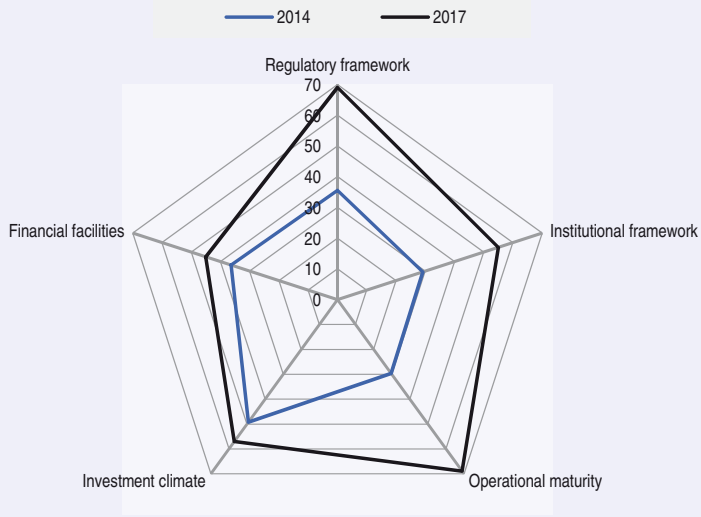
effectively, particularly in infrastructure. The measure takes into account the legal and regulatory framework, the institutional framework, operational maturity, investment climate, financial facilities and sub-national adjustment (EIU, 2014). Since the first Infrascope benchmarking study in 2009, the scores for most countries have increased in each subsequent edition. The average overall score for the region improved by nearly 10 points between 2009 and 2014 (from 32.9 to 42.5). Moreover, the regulatory and institutional framework categories have had the most significant improvement as many countries have updated their PPP and concession laws and set up new PPP agencies or specialised units within existing institutions. However, Latin American and Caribbean countries still face great challenges in this respect (Figure 4.5). In 2014, financial facilities demonstrated the least rate of progress.

Figure 4.5. **Environment for effectively implementing PPPs**

Panel A. Infrascope Index for Latin America (2014-17)



Panel B. Components of the Infrascope Index



Note: The Infrascope Index is measured on a scale from 0 to 100. Countries with a score between 0 and 29.9 are qualified as nascent, 30 to 59.9 as emerging, 60 to 79.9 as developed and 80 to 100 as mature.
Source: EIU (2017), *Economist Intelligence Unit Database for Latin America and the Caribbean* (2017).
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Beyond traditional investment schemes: Social Impact Bonds

Social Impact Bonds (SIBs) are a relatively new and innovative instrument to finance social interventions. Although SIBs have been mostly implemented in developed countries, they are rapidly spreading among middle-income countries.

Traditionally, governments award contracts and grants and link their funding to the completion of a set of activities. The public sector's need for more innovation has led some developed economies to engage in SIBs, which are associated with outcomes-based agreements. Tools like SIBs are implemented as contracts or grants between a funder, an investor and a service provider where payment and financial rewards are contingent upon the achievement of agreed and measurable outcomes (Beeck Center, 2014).

As a financing mechanism for social policies, SIBs could mitigate the public sector's investment risk, increase effectiveness and pay for services now, while requiring public contributions later (Ramsden et al., 2016). SIBs involve three main stakeholders: governments, non-governmental organisations (NGOs) and investors. Governments need to improve social/living conditions and the welfare of people within the constraints of a public budget. NGOs have the field expertise, knowledge and skills to work with the population in need. Investors have private resources and are willing to take risks to receive a return. Each part has different motivations and interests and stands to benefit by working together through the payment-for-results approach.

In the payment-for-results model, the public sector aims to pay only for interventions once the agreed outcomes are achieved. The risk of an unsuccessful service is thus transferred to the investor rather than the delivery organisation (Centre for Public Impact, 2017). This mechanism combines some components of results or performance-based financing and PPPs (Gustaffson-Wright et al., 2015). Usually, SIBs are seen as the next generation of PPPs, as they move away from infrastructure services towards social services touching upon education, health and many more. The idea is to bring together the socially motivated private sector, social organisations and governments to deliver targeted services. SIBs aim to improve outcomes through collaboration between service providers and investors. Because the payment is based on results rather than processes, there is more room for innovation and greater freedom to test new solutions.

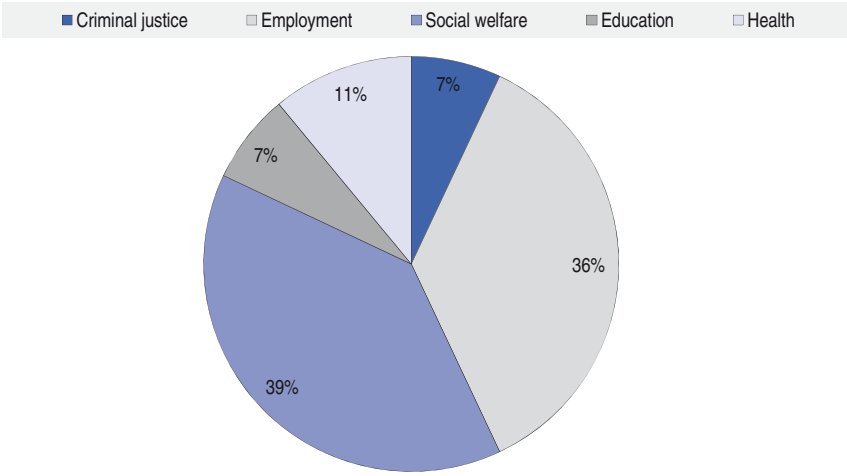
SIBs offer governments a tool to overcome typical public sector barriers. It is a leadership tool that helps address the lack of performance assessment, under-investment in prevention and inability to collaborate effectively with service providers around improving systems (Harvard, 2016). By tackling these issues it can speed up progress in addressing challenging social problems, while making states more efficient in the way they spend public resources.

SIBs are a growing global phenomenon. Initiated in the United Kingdom, all 61 SIBs currently in place are in OECD member countries (32 in the United Kingdom, 10 in the United States and 19 in other countries including Austria, Australia, Belgium, Canada, Finland, Germany, Ireland, Israel, the Netherlands, Portugal, South Africa, South Korea and Switzerland) (Centre for Public Impact, 2017). This tool is currently funding activities in the categories of criminal justice, employment, social welfare, education and health (Figure 4.6).

Increasing expectations and demands in Latin America call for higher result levels and therefore more effective service delivery. In response to these growing needs, SIBs are an interesting tool to shift the way governments finance and deliver public

services. The first SIB in the region, launched in Colombia as a joint-initiative of the Colombian Department for Social Prosperity, IDB Multilateral investment fund, Swiss State Secretariat for Economic affairs (SECO) and private sector foundations engaged in social inclusion projects, targets vulnerable populations – mostly poor, unemployed and victims of violence in three cities (Box 4.4).

Figure 4.6. **Main activities funded by Social Impact Bonds**



Note: Criminal justice includes tackling recidivism. Employment includes reducing NEETs, improving employability and tackling unemployment. Social welfare includes homelessness and child welfare. The education component includes early year education, reducing school dropout and universities. Health includes preventative interventions.

Source: Centre for Public Impact (2017).

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It is too early to draw conclusions on the success of this initiative and on its potential for the region. However, this experiment in Colombia will be an interesting test for institutional capacities in this country and can provide lessons applicable to other Latin American countries. Indeed, Social Impact Bonds not only require political will and the securing of important funds, but also strong co-ordination between different stakeholders and among different levels of government. Most importantly, given the result-oriented nature of the instrument, SIBs require strong monitoring and assessment capacities to measure the impacts (Peña, 2014).

Box 4.4. **Social Impact Bond in Colombia**

In 2017, Colombia launched the first Social Impact Bond (SIB) ever in Latin America. It resulted from an agreement between NGOs, and private and public sector entities with support from international organisations. This new financing mechanism is a first test of the Colombian government to examine the payment-for-results approach.

Among many stakeholders for the SIB, the Colombian Department for Social Prosperity, the Inter-American Development Bank and the Swiss State Secretariat for Economic Affairs, committed to pay a maximum of USD 750 000 to investors based on agreed outcomes and conditions. Socially motivated investors execute the initial budget by investing in a social intervention implemented by one – or more – NGOs.

The project attempts to identify vulnerable populations through several database systems, and make them more employable. Service providers are selected in the

Box 4.4. **Social Impact Bond in Colombia** *(cont.)*

market. NGOs with expertise in a particular area handle services related to such areas as registration and counselling; pre-training and post-training assessment; specific skills training and socio-emotional skills; psychosocial support; job intermediation; job placement and accompaniment. Following the payment-for-results approach, services providers have autonomy to carry out the intervention and focus on intended results, which are mainly about the number of people employed and length of time they retain the job.

The amount of the government's payment is based on a differentiated unit price. This price gathers the costs of the intervention and a percentage of return for investors. The total amount paid will depend mainly on the number of employed individuals; the price will vary depending on the length of time that the person had been retained in the job (from three to six months). For the maximum amount, an external evaluation should demonstrate that participants were employed and lasted in the job for at least six months.

The autonomy of the service providers, as well as the risk tolerance that characterises private investors, allows and even incentivises innovation in the field of the intervention. Indeed, as the payment-for-results approach does not make payment conditional on certain activities or methods, NGOs can decide for themselves how to obtain better results.

Raising tax revenue for development and inclusive growth

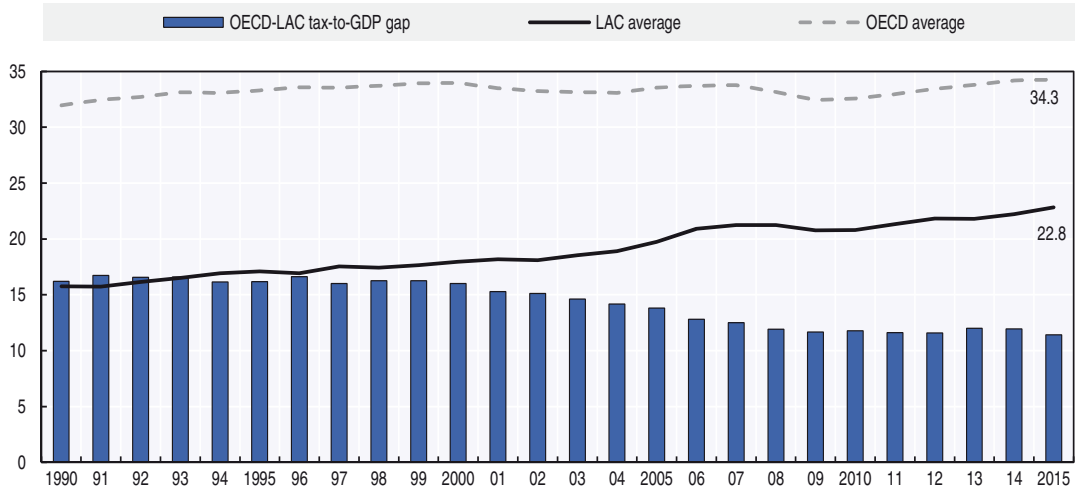
Tax systems in Latin America and the Caribbean yield insufficient levels of tax revenues to fund development goals. Strengthening the state's ability to sustain public finance stability and fund development efforts entails a thorough process of tax reform. Tax policy reform should focus on progressivity, achieve a simpler and broader tax base, improve environmental outcomes through pricing mechanisms and improve taxing capacities of local and regional governments.

Improving revenues through efficient and progressive taxes is crucial to ensure sustainable economic development. This guarantees sufficient financing to cover government functions and, more importantly, to replace and enable capital formation within countries and improve equality. Tax revenues have increased by 7.1 percentage points during the last two and a half decades, rising constantly with the exception of a minor decline experienced in 2008 and 2009 (Figure 4.7, Panel A).

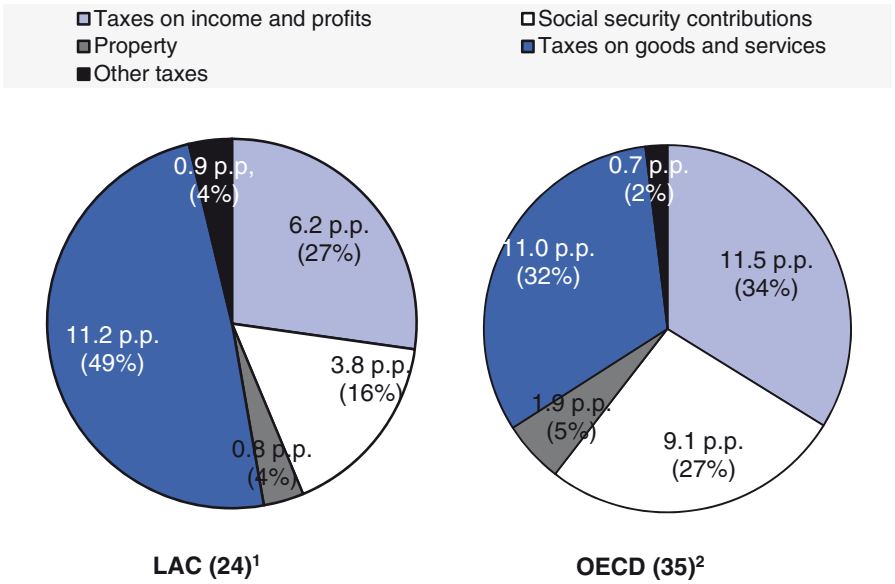
Despite these improvements, total tax revenues in Latin America and the Caribbean remain 11.5 percentage points of GDP lower than in OECD member countries. Moreover, tax revenues continue heavily skewed towards indirect taxes on goods and services (49% of total tax revenues). Direct taxes for their part continue to be weak, given the low in-take of personal income tax and property taxes (13% of total tax revenues). For its part, the corporate income tax (CIT) represents 16% of total tax revenues. However, the pervasiveness of special provisions and differentiated tax treatments to economic sectors distort efficient allocation of investments. As a result, direct taxation depends mainly on social security contributions, which are normally earmarked to finance current and future benefits of ageing populations.

Figure 4.7. **Tax revenue in LAC and OECD: levels and composition**

Panel A. Tax-to-GDP ratios, 1990-2015



Panel B. Total tax revenue composition as percentage of GDP and total tax revenues (2015)



Note: Other taxes includes un-allocable tax revenues on income, profits and capital gains and other taxes that cannot be classified according to the OECD Interpretative Guide available in OECD (2016b), *Revenue Statistics 2016*.
1. Represents a group of 24 Latin American and Caribbean countries. Chile and Mexico are also part of the OECD (35) group.
2. Represents the unweighted average for OECD member countries.
Source: OECD/CIAT/ECLAC/IDB (2017), *Revenue Statistics in Latin America and the Caribbean 1990-2015*.
StatLink http://dx.doi.org/10.1787/888933651216

The value added tax (VAT) is the pillar of most tax systems in Latin American and Caribbean countries. Since 1990, VAT revenue has increased by 3.7 percentage points of GDP, outgrowing any other tax. It yielded an average of 6.0% of GDP in 2015. These levels were below VAT-to-GDP revenues in OECD member countries (6.8%), a difference of 0.8 percentage points. Notwithstanding, the importance of the VAT in LAC becomes more apparent in the context of how much it represents of total tax collection. Indeed,

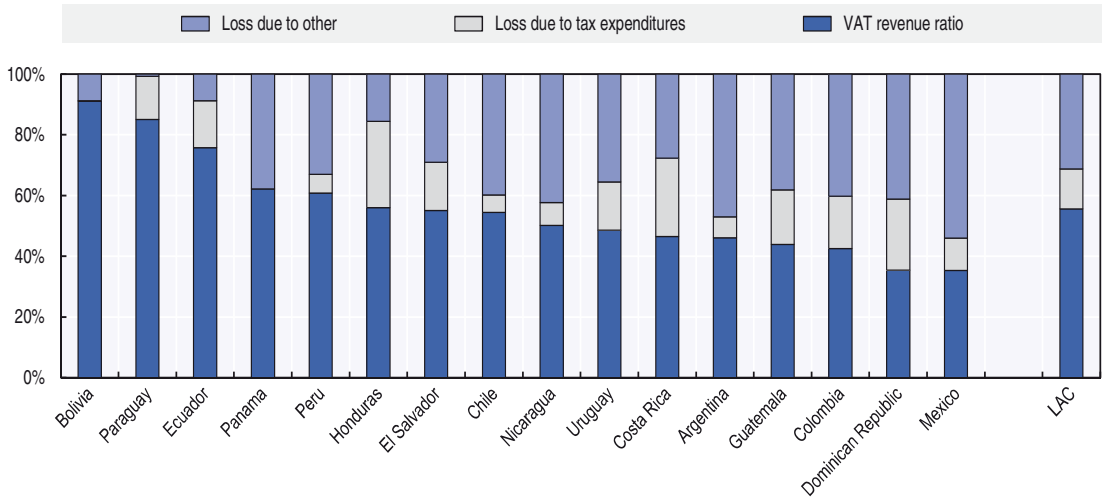
the VAT represents 26.3% of total tax revenue in LAC, 6.5 percentage points higher than in OECD member countries (19.8%).

The VAT would benefit from greater simplification and better control in the region. An analysis of the VAT revenue ratio (VRR), a measure of actual revenue relative to potential revenue and of the ratio of tax expenditures to the potential VAT revenue suggests that in 2015 for every 100 currency units of potential VAT revenue, 56 units were collected by the tax administration; 13 were forgone revenue owing to exemptions, reduced rates or other benefits dictated by tax policy; and 31 were lost owing to other factors that cannot be explained by the previous two. These might include measurement errors, fraud, evasion, elusion or aggressive tax planning (Figure 4.8).

This analysis suggests there is space to improve the VAT's revenue collection through the rationalisation of fiscal benefits. A proper year-by-year evaluation of the intended and actual benefits and the recipients of these benefits would help ensure that revenues are not forgone without a justifiable cause. On the other hand, actions to strengthen the tax administration to curb evasion and to achieve higher levels of compliance are the best strategies to help the VAT reach its total potential. The use of ICTs to simplify the VAT's filing process, electronic invoicing (Box 4.5) and the use of big data for data cross-referencing are all tools that can help exert a better control of the tax.

Figure 4.8. **Decomposition of the VAT's potential revenue**

As a percentage of potential VAT revenue



Note: The figure decomposes the potential revenue of the VAT into three categories: i) VAT revenue ratio (VRR) is the proportion of the potential VAT actually collected by the tax administration; ii) tax expenditures is the proportion of the potential VAT that is not collected owing to reduced rates, exemptions, zero rates and other fiscal benefits or reliefs; and iii) other is the rest of the potential revenue VAT base that cannot be explained through tax expenditures, that is, it groups measurement errors, evasion, elusion, fraud or aggressive tax planning to avoid paying the tax. The potential VAT revenue is calculated by levying the generalised VAT rate on final consumption expenditure (the sum of private consumption and general government final consumption expenditure).

Source: OECD/CAF/ECLAC based on data from OECD/ECLAC/CIAT/IDB (2017), *Revenue Statistics in Latin America and the Caribbean*; World Bank (2017b), *World Development Indicators database*; National Ministries of Finance and National Tax Administrations.

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Box 4.5. **Beyond control and compliance: The externalities of electronic invoicing**

Electronic billing is gaining ground in Latin American countries as a means to modernise the tax administration and tackle evasion. Argentina, Brazil, Chile, Colombia, Ecuador, Guatemala, Mexico, Peru and Uruguay have all introduced e-invoicing schemes, while countries including Costa Rica, El Salvador, Nicaragua and Panama are all developing frameworks to enforce these mechanisms. The electronic invoice (e-bill or e-invoice) is a digital file that contains information pertaining to the sale of goods and services. The merchant transmits this e-invoice directly to the tax authority once the transaction has transpired. This enables the tax administration to exert better fiscal control in real time and at a lower administrative cost.

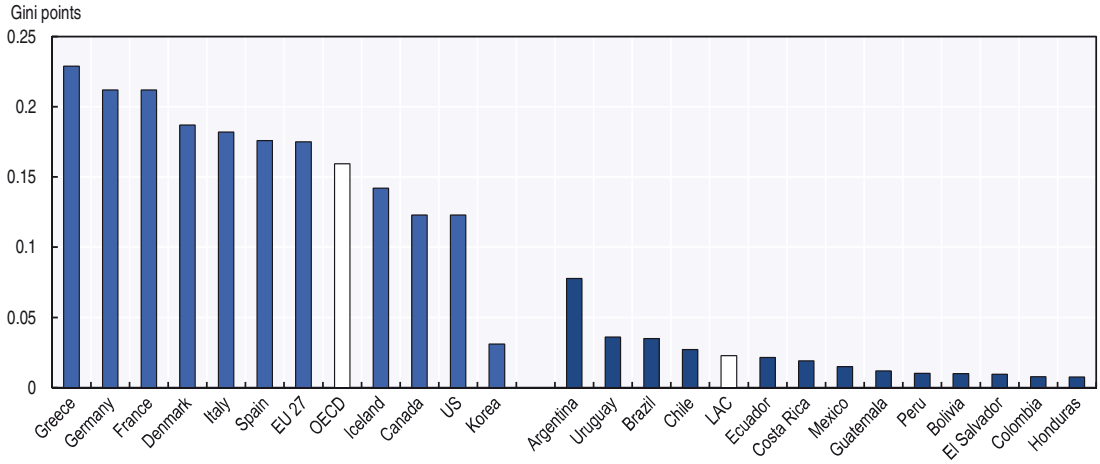
Electronic invoicing encourages job and firm formality, reduces compliance costs, increases tax collection and creates positive externalities. First, the e-bill increases the perception of auditing among informal firms that conduct business with formal firms. In so doing, it encourages informal firms to formalise as it becomes a requirement of their clients/suppliers to conduct business within an integrated system. For instance, in Brazil e-invoicing helped reduce informal employment from 55% to 40% in the last decade (MGI and IDV, 2014). Second, an e-billing system reduces human errors, eases access to taxing files, improves the tax administration's response times and simplifies VAT filing and reporting. The net effect is an increase in tax revenues. In Brazil, the first country in LAC to implement such an e-billing scheme, tax evasion dropped from 32% to 25% (Munoz, MacDowell and Goes, 2017), and profits reported by firms increased by 22% over four years (Naritomi, 2015). Enhanced fiscal control from these measures increased revenues. In Uruguay, the application of the electronic bill raised VAT revenues by 5.3% (Barreix and Zambrano, forthcoming). In Mexico, e-billing increased the amounts of VAT declared to the authorities by 2.2%, 3.2% and 7.1% in 2011, 2012 and 2013, respectively (Fuentes Castro, 2016).

The returns to investments on e-invoicing schemes outweigh the costs to both the public and private sectors. From a public perspective, enforcing an e-billing programme requires a strong and modern tax administration, with solid departments in charge of collection, auditing and ICTs and well-developed taxpayer registries. Following this initial investment, modernisation produces many benefits: increasing tax collection through reduction of evasion, improving efficiency of the tax administration and fostering voluntary tax compliance. From the private perspective, this process requires merchants to invest in training and specialised software and equipment; in exchange, merchants gain from reducing the costs of filing for VAT payments and curbing unfair competition from informal firms.

Current taxation systems in LAC have a small redistributive capacity because of the limited participation of direct taxes. In OECD economies, taxes and transfers contribute to the reduction of the Gini coefficient by up to approximately 15 percentage points. In most Latin American economies, however, that reduction is below 3 percentage points (Figure 4.9). The state's capacity to ensure reasonable redistribution is key to strengthening the fiscal pact, and the social contract between governments and their citizens. Countries with lower income inequality are associated with greater capacity to raise taxes (Cárdenas and Tuzemen, 2010).

Figure 4.9. **Impact of taxes and transfers on income distribution in Latin America and selected OECD economies**

2012 for OECD economies and circa 2011 for Latin America



Note: The redistributive capacity is the difference between the Gini coefficient of the market income and the Gini coefficient after taxes and transfers.

Source: Data for Latin American economies is obtained from Lustig (2016). For OECD economies, the data is from the *OECD Income Distribution Database (IDD)*.

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Improving the personal income tax (PIT) system can enhance revenues and have a positive impact on income redistribution in the region. Collection of personal income tax in Latin America is approximately 2.1% of GDP, which is relatively low compared with the OECD average of 8.4% (Figure 4.7, Panel B). The PIT's revenue-raising capacity is constrained owing to an over-emphasis on progressivity. On average, only individuals in the richest 10% of the population are liable for the tax. A myriad of exemptions, deductions and standard tax allowances diminish the tax base. As a result, on average, only 38% of the taxable base is subject to the tax in the tenth decile. These factors limit the revenue raised by the tax, all of which paradoxically erodes the tax's redistributive power. Improving the revenue collected by the PIT requires revising the tax allowances granted by the tax and updating the tax schedule (Barreix, Benítez and Pecho, 2017).

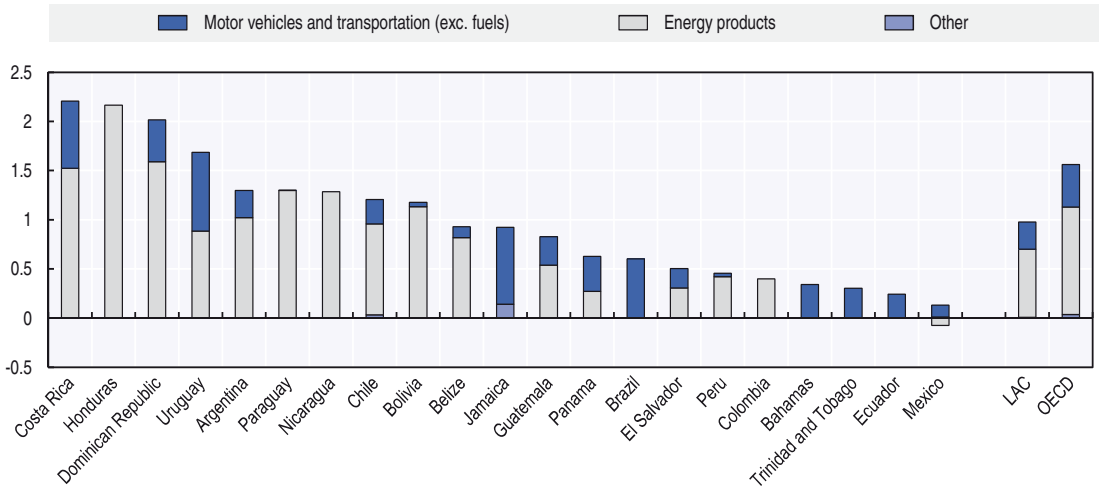
LAC countries can improve both tax revenues and the efficiency of the corporate income tax (CIT) by rationalising incentives and eliminating distortions to the allocation of investments. CIT revenues were favoured by the increases in prices of commodities during the last decade. Since 2003 and throughout the super commodity cycle, CIT revenues went from 2.3% to 3.7% of GDP. Tax reforms were successful in expanding the tax base by including passive foreign income, which also contributed to a small increase in revenue from the CIT. Notwithstanding, fiscal incentives to attract foreign investments in special economic sectors, especially in Central America, are granted at an average fiscal cost of approximately 0.9% of GDP (IDB, 2013a). The largest incentives are given to free trade zones, local development and tourism. Many of these provisions have not been appropriately assessed to measure their effectiveness.

Taxing externalities can increase available fiscal resources and contribute to improving environmental outcomes in the LAC region. Taxation is an important asset within the policy toolset to drive resource efficiency, reduce waste and move towards a sustainable economy (OECD, 2015b). In LAC, externalities imposed on the environment are rarely corrected through taxes. Some environmentally related taxes do exist, such as excises on gasolines and diesels, and taxes on permits for motor vehicles. However, these are levied to increase revenue rather than to improve upon environmental

outcomes (Lorenzo, 2016). In LAC countries, revenue from environmentally related taxes tallied 0.98% of GDP in 2014, most of which is collected through levies on fuels (0.69% of GDP). The other large component is derived from revenues raised on motor vehicles and transportation (0.28% of GDP).

Figure 4.10. **Environmentally related tax revenues (2014)**

As percentage of GDP



Source: OECD (2017c), *Environmental Taxation* database; OECD/ECLAC/CIAT/IDB (2017), http://www.oecd.org/env/tools-evaluation/environmentaltaxation.htm; OECD/CIAT/ECLAC/IDB (2017), *Revenue Statistics in Latin America and the Caribbean 2017*, http://dx.doi.org/10.1787/rev_lat_car-2017-en-fr.

StatLink http://dx.doi.org/10.1787/888933651273

Finally, strengthening the tax administration's capacities is a critical part of a broader tax reform strategy that aims at increasing revenues, improving efficiency and reducing inequality. Strengthening the international tax rules through the implementation of the recommendations of the OECD/G20 Base Erosion and Profit Shifting (BEPS) project helps create a more even playing field, which increases overall socio-economic development in the region. Furthermore, moving towards Automatic Exchange of Information for Tax Purposes should help fight tax evasion and give countries greater scope to tax both domestic and foreign-source income earned by tax-resident businesses and households. Twelve Latin American and Caribbean countries – Argentina, Brazil, Chile, Colombia, Costa Rica, Haiti, Jamaica, Mexico, Panama, Paraguay, Peru and Uruguay – are among the 94 countries that have joined the inclusive framework on BEPS.

Governments are decentralising to connect more closely with citizens

Governments in the LAC region are pursuing fiscal and political decentralisation to connect more closely with citizens. The processes of decision making and budgetary powers have been widely acknowledged as important tools to stimulate more efficient provision of public goods and improve preference-matching, thus enhancing democratic participation and accountability (Brosio and Jimenez, 2012). The premise is that decentralisation could also allow for more targeted delivery of public services based on the demands and necessities of the local population that these local institutions directly represent.

Strong and connected federal, regional and local levels of public institutions are necessary to capitalise on the full potential of multi-level governance (Chapter 3). In practice, both fiscal and political decentralisation in most Latin American countries faces

significant challenges. On the one hand, several responsibilities have been transferred to regional and local governments during the last decade and a half, despite the existence of an inadequate revenue base to finance these additional responsibilities. Instead, sub-national governments have relied highly on transfers from central governments that often undermine their incentives to raise more tax revenues and improve on the delivery of services.

Despite these moves, LAC countries tend to be, on average, more fiscally centralised than OECD member countries: sub-national government expenditure is three times lower in the LAC region than the OECD average. Sub-national expenditure represents 6.5% of GDP and 20.9% of public expenditure, compared with 16.6% and 40.2% respectively in OECD countries – and 9% and 23.9% worldwide (OECD/UCLG, 2016). Sub-national investment in many LAC countries is also highly centralised and below the OECD average. For example, in Paraguay, Chile and Costa Rica, sub-national governments are responsible for less than 14% of public investments compared with an average of almost 60% in the OECD.

Further, despite significant increases in total fiscal revenue at the sub-national levels due to transfers, taxing powers remain extremely low in most Latin American countries. By failing to take advantage of their taxing potential, sub-national authorities undermine their abilities to provide more targeted and effective service delivery to the population that they directly serve. This can affect the generation of own-source revenue by local authorities. This, in turn, limits their ability to pursue development policies, programmes and investments that are locally generated and thus potentially more reflective of their needs and those of their citizens.

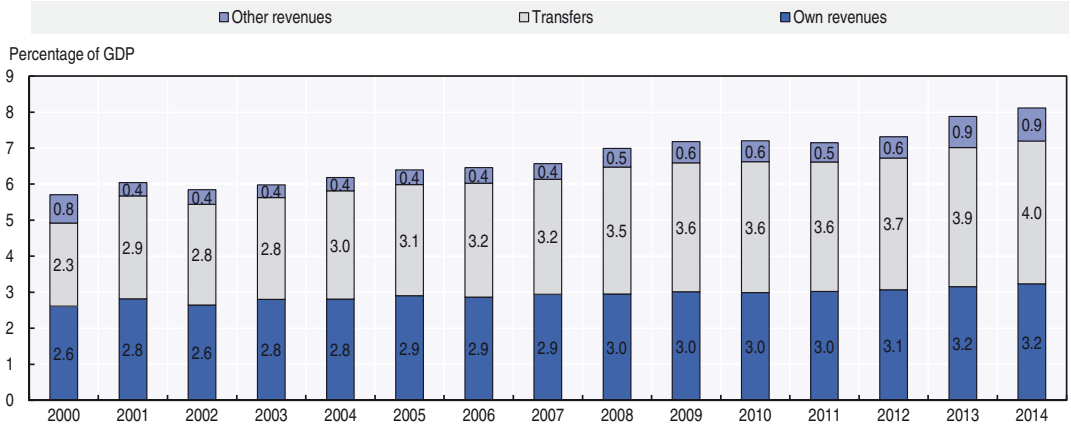
While there are important differences across countries, total fiscal revenue of sub-national governments in Latin America has significantly increased during the last 15 years. On average, total fiscal revenue increased from 5.7% of GDP to 8.1% (Figure 4.11). There are multiple ways in which sub-national governments may increase their revenues: i) generation of own resources; ii) inter-governmental transfers; and iii) through debt iv) a combination of the three alternatives.

Despite these options, the increase in total fiscal revenues can be attributed to greater dependence on transfers from central governments (with the exception of Costa Rica, Chile, Brazil and Uruguay). On average, total transfers increased from 2.3% of GDP to 3.2% of GDP. In countries such as Argentina and Mexico, central governments contribute more than 8% of GDP to transfers directed to their sub-national governments. The central governments of Colombia and Ecuador contribute 5.0% and 3.6% respectively, while the central government of Brazil contributes 3.7% of GDP. At the other end of the spectrum, countries such as Peru and Uruguay only contribute 2.6% and 1.1% of GDP, respectively (OECD/CIAT/ECLAC/IDB, 2017).

The decentralisation of tax powers has been relatively weak in most countries of the region. Most sub-national governments contribute very little to the total revenue of Latin American countries (Figures 4.11 and 4.12). On average, sub-national authorities collect 2-5% of their country's total tax revenues. While this lower performance seems to apply to most Latin American countries, the exception of Brazil is worth noting. The sub-national governments of Brazil – which include both states and municipalities – collect more than 30% of total revenue. Therefore, in LAC there is a significant degree

of centralisation of tax powers at these levels of government (OECD/ECLAC/CIAT/IDB, 2017).

Figure 4.11. **Evolution of the total revenue structure in sub-national governments, Latin America average, 2000-14**

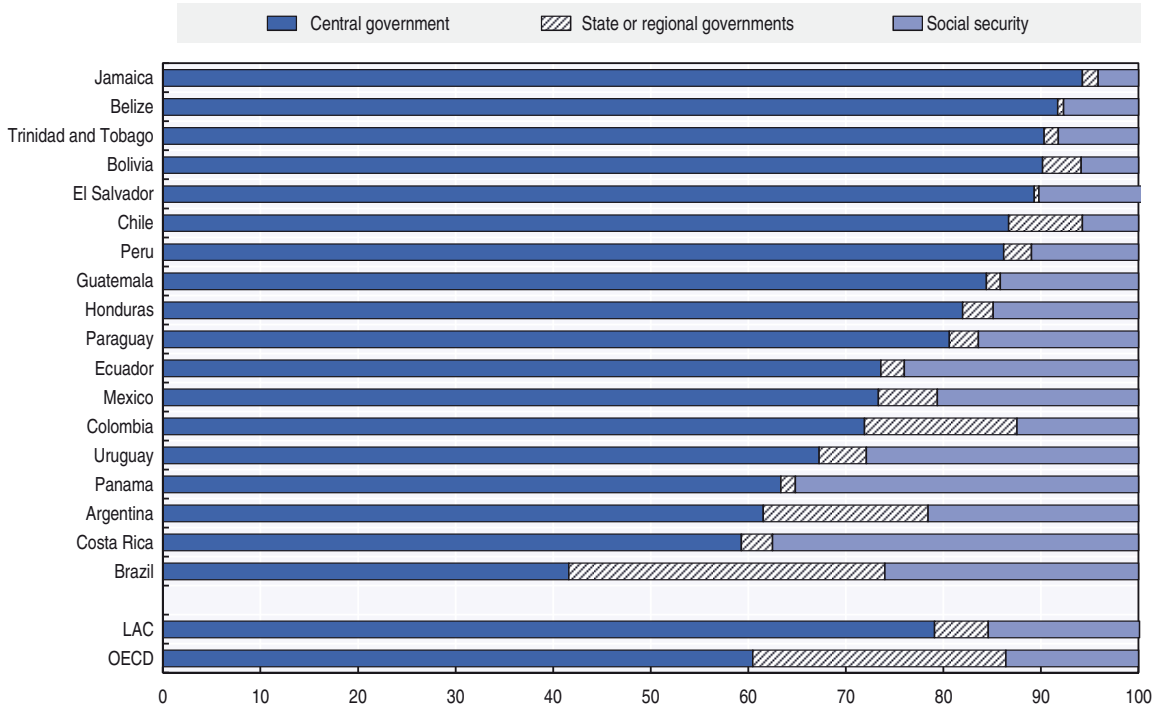


Note: The concept of sub-national governments will refer to the provinces in the case of Argentina; prefectures and municipalities in Bolivia; states and municipalities in Brazil; municipalities in Chile; departments and municipalities in Colombia; local governments (cantons) in Costa Rica; provincial councils and municipalities in Ecuador; states and municipalities in Mexico.

Source: OECD/CIAT/ECLAC/IDB (2017).

StatLink http://dx.doi.org/10.1787/888933651292

Figure 4.12. **Tax revenue by level of government, Latin America and OECD, 2014**



Source: OECD/CIAT/ECLAC/IDB (2017).

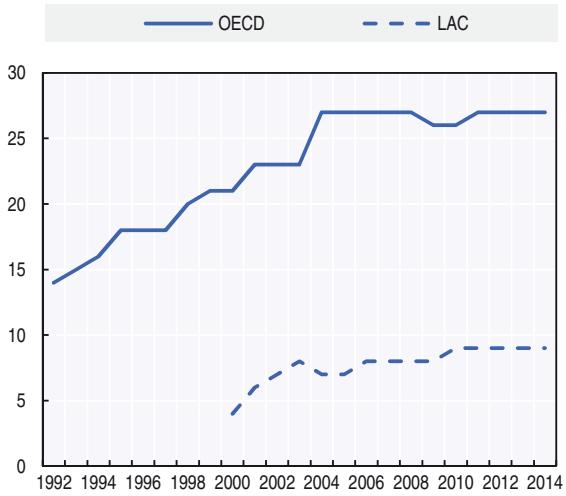
StatLink http://dx.doi.org/10.1787/888933651311

Fiscal rules can strengthen macroeconomic management

Macroeconomic management has improved considerably in the region in the last two decades, based on sounder monetary and fiscal frameworks. Since the early 2000s, a particular case for fiscal rules has spread (Figure 4.13). Nine countries in the region are implementing a fiscal rule (albeit different types): Brazil, Chile, Colombia, Costa Rica, Ecuador, Jamaica, Mexico, Panama and Peru (IMF, 2017).

Fiscal rules can contribute to long-term sustainability of public finances, while ensuring adequate funding for investments. They improve management processes and yield stable and predictable fiscal horizons in which actions can be planned with a degree of trust and certainty. These rules have usually followed three main objectives: ensuring debt sustainability; strengthening stability; and improving the expenditure composition (investment).

Figure 4.13. **Number of countries using fiscal rules in Latin America and OECD**



Fiscal rule / Country	Expenditure rule	Revenue rule	Budget balance rule	Debt rule
Argentina	2000-08		2000-08	
Brazil	2000-14			2000-14
Chile			2001-14	
Colombia	2000-14		2011-14	
Costa Rica			2001-14	
Ecuador	2010-14		2003-09	2003-09
Jamaica			2010-14	2010-14
Mexico	2013-14		2006-14	
Panama			2002-03, 2009-14	2002-03, 2009-14
Peru	2000-14		2000-14	

Source: Alberola et al. (2016), "Fiscal policy and the cycle in Latin America", *BIS Working Paper No. 543*, http://www.bis.org/publ/work543.pdf.
StatLink http://dx.doi.org/10.1787/888933651330

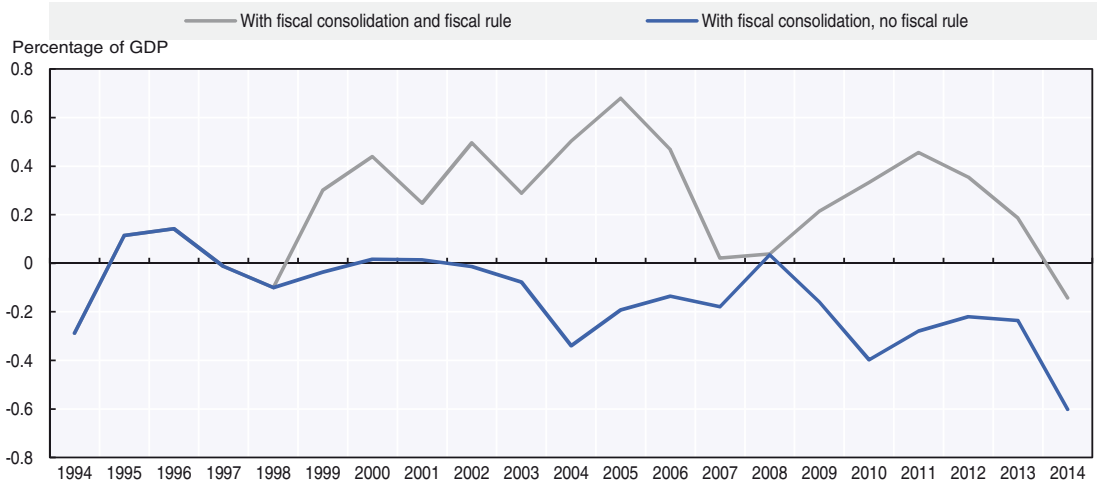
The economies from the region that have applied these rules have largely preferred those that entail budget balance. In most cases, they have complemented them with a second rule, normally an expenditure or a debt rule (Figure 4.13). A particular case is Ecuador, which has used three different fiscal rules in the last 20 years; currently, it is using only the expenditure rule. Along with Ecuador, Chile uses a single rule, in its case for budget balance. Most cases have clear mechanisms to deal with non-compliance with the rule. For example, if Chile, Colombia or Peru fail to follow the budget balance rule, they must present a proposal to the legislative power with corrective measures (OECD/IDB, 2014). If the expenditure rule is not followed in Brazil or Colombia, it is up to the authorities to undertake measures.

Fiscal policy in Latin America has been traditionally pro-cyclical; fiscal rules play a role to reverse this characteristic. Countries in the region, as in other emerging areas, tended to spend too much in good times and were forced to save during economic downfalls. These policies exacerbate the economic cycle. Latin American dependence on external financing and the recurrence of sudden stops may have made the region more prone to this behaviour. Nevertheless, things may be changing since the 2009 financial crisis. Fiscal policy has become less pro-cyclical as the relevance of financial restrictions has

diminished; economies with fiscal rules have shown a more countercyclical behaviour (Alberola et al., 2016).

Countries under a fiscal rule are less pro-cyclical than those without such a rule (Figure 4.14). The former even display episodes of countercyclical fiscal policy, a result traditionally reserved for developed economies. Nevertheless, despite sounder fiscal frameworks, fiscal balances are weaker now than before the financial crisis, raising doubts of resilience in case the slowdown becomes long term or deepens. In response to the crisis, some countries in the region approved fiscal stimulus, but expenditure packages, mostly current spending, are not flexible in the recovery (see Celasun et al., 2015; and Powell, 2015). In other words, few economies have applied an exit strategy from the stimulus and the region is far from the levels of fiscal space seen before the crisis.

Figure 4.14. **Fiscal stance in selected economies in Latin America**



Source: Alberola et al. (2016), "Fiscal policy and the cycle in Latin America", BIS Working Paper No. 543, http://www.bis.org/publ/work543.pdf.

StatLink http://dx.doi.org/10.1787/888933651349

Fiscal rules also aim to improve expenditure composition. A well-documented bias in budgeting results in a volatile and low public investment, notably in infrastructure in most emerging regions. Latin America is no exception, exhibiting investment rates (both public and private) far below the rates observed in emerging Asia or those needed to close the gaps with more developed regions.

In this respect, exit strategies should not only reconstruct fiscal space, but also develop fiscal frameworks more favourable to public infrastructure (see Carranza, Daude and Melguizo, 2014, for an analysis for Latin America). Peru had the good practice of combining a deficit ceiling for the non-financial sector and a cap in the growth rate of current expenditures. This allows for a significant increase in public investment.

Conclusions

In a rapidly changing global context, citizens perceive the rise of new challenges and demand institutions that are ready to respond to them. At the same time, they embrace opportunities brought about by ongoing global transformations. Institutions must be rethought to respond to these demands and support a stronger connection with citizens. To that end, they must be transformed by being flexible, innovative and proactive.

A particular trend that directly affects citizens' lives and well-being is related to technological change, which is having an impact on economies and on growth prospects,

as well as on the nature of jobs. The institutional response must favour the creation of more good quality jobs, fostering the employability of citizens by providing better education and skills, and guaranteeing good working conditions. Institutions need to address the challenge of promoting economic growth and the expansion of sectors with the capacity to create jobs.

In this respect, productive development policies (PDPs) must play a critical role, and be supported by greater technical, organisational and political capabilities to be successful. This must be coupled with ambitious education and skills policies to foster employability in a context of changing demands for skills and a changing set of tasks performed by humans.

Quality of education must be strengthened alongside pertinence to improve the connection with labour market demands, which need to be more effectively anticipated. Also, the institutional framework must be redesigned to stand ready to provide training all through the working life, and train in skills that will be in higher demand.

Finally, technological progress has led to the proliferation of new forms of labour arrangements, with negative consequences in terms of social protection and overall working conditions. Labour market institutions need to be rethought to guarantee good quality working conditions. Strategies include ensuring the non-discrimination and equal treatment among different contractual arrangements, adapting social insurance schemes to extend coverage to previously excluded categories of workers, improving the overall working of social security systems, or complementing social insurance with non-contributory mechanisms, among others.

A forward-looking approach to policy making also demands a sustainable fiscal framework. It must be able to guarantee the capacity of financing more and better public goods and services to respond to rising and evolving citizens' demands. To this end, countries will have to ensure proper funding through effective and efficient spending, better taxation and proper rules to ensure long-term sustainability.

There are several steps to this process. First, subsidies, government programmes and tax expenditures should be continually appraised to guarantee they reach their intended goals and recipients. Public-private partnerships and Social Impact Bonds offer interesting ways to improve spending and maximise public outcomes. Second, taxation should focus on eliminating unnecessary distortions, while pursuing a more progressive tax system that diminishes inequality and improves environmental outcomes. Decentralisation efforts should be wary of undermining sub-national governments' capacity. Finally, fiscal rules yield stable and predictable fiscal horizons, allowing actions to be planned with a degree of trust and certainty. This helps ensure fiscal space to generate the kind of economic and productive investments the region needs and to prepare future generations with the kinds of skills future markets will demand.

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Country notes

ARGENTINA

Recent trends in citizens' perceptions

The quality of the national government in Argentina remains above the Latin America and Caribbean (LAC) average, although it deteriorated over the last decade. The Quality of the Government Index, ranging from 0 to 1 and measured by proxies of corruption, law and order, and bureaucracy quality, decreased from 0.56 to around 0.47 between 2005 and 2015. This decrease is also reflected in the share of citizens expressing confidence in the national government, which fell from 52% to 42% of the population between 2006 and 2016. Nonetheless, across these two indicators, Argentina still ranks above the average for the LAC region.

The share of citizens that perceive corruption as being widespread in the country climbed from 76-78% between 2006-16. However, Argentineans seem more confident in the country's judicial system than ten years ago. Almost 31% expressed confidence in the country's judicial system and courts in 2016 compared to 27% in 2006.

Beyond material conditions, individual well-being encompasses several subjective factors that affect citizens' quality of life (OECD, 2015). Citizen satisfaction with public services has seen an upward trend in Argentina, although still low. Only 56% of the population are satisfied or very satisfied with public education or health. The share of citizens that expressed satisfaction with public education increased by almost 10 percentage points between 2010 and 2015.

Upward trends in both citizen satisfaction with public services and social mobility suggest that Argentina's socio-economic progress in recent years has been increasing citizens' effective well-being. Positive socio-economic changes in Argentina are reflected in a growing middle class (daily per capita income of USD 10-50 PPP) accompanied by a shrinking share of the population with less than USD 4 a day. The size of the middle class in Argentina increased by almost 13 percentage points, between 2005 and 2014, reaching 49%. This share of the population that classified as middle income coincides with the share of people who subjectively consider themselves to be part of this socio-economic level.

Recent policies to strengthen the state-society link

Argentina is designing its third Open Government National Action Plan for 2017-19 and has consolidated government data in a unique portal with public access. This is aligned with the Right of Access to Public Information Law (No. 27.275), approved in 2016. This law aims to guarantee citizen access to public information, while promoting citizen participation and public management transparency. The government's efforts also include the creation of Justicia 2020, a space for citizen participation and a platform for access to information on the judicial sector's public policies.

In matters of digital government, the country recently launched its plan "País Digital". The plan aims to: *i)* implement digital projects that promote modernisation of national services; *ii)* integrate management systems between the country's different jurisdictions; and *iii)* articulate digital management and services initiatives with the private sector, the academic field, civil society and the community.

Among its efforts to tackle corruption, Argentina has strengthened its integrity policy through the Presidential Decrees 201/17 and 202/17. These intend to prevent conflicts of interest regarding judicial and extrajudicial proceedings and public procurement accordingly. Furthermore, the government of Argentina established an anticorruption office within the Ministry of Justice and Human Rights. The office aims to prevent and investigate corruption, while providing support for transparency policies. Most recently in 2017, the government of Argentina signed the OECD Recommendation on Public Integrity.

Key indicators: Argentina

I. STATE CAPACITIES

	Argentina		LAC		OECD	
Fiscal	**2005**	**2015**	**2005**	**2015**	**2005**	**2015**
Total tax revenue as % of GDP (1)	24.5	32.1	19.8	22.8	33.6	34.3
	2012		**2012**		**2012**	
Difference in income inequality pre and post-tax and government transfers (2)	0.07		0.03		0.18	

	Argentina		LAC (17)*		OECD	
Legal	**2005**	**2015**	**2005**	**2015**	**2005**	**2015**
Rule of law (3)	-0.58	-0.80	-0.4	-0.37	1.25	1.31
	2006	**2016**	**2006**	**2016**	**2006**	**2016**
Judicial independence (4)	6.0	6.0	6.12	6.18	-	-

	Argentina		LAC		OECD	
Administrative (%) (5)	**2009**	**2016**	**2009**	**2016**	**2009**	**2016**
Employment in public sector as % of total employment	15.9	17.2	11.3	12.5	21.4	24.6
Share of public sector employment filled by women	53.4	53.7	48.1	50.0	58.4	58.5

II. PERCEPTIONS AND CHARACTERISTICS OF SOCIETY

	Argentina				LAC (17)			
Citizens' socio-economic status (%)	**Less than USD 4 PPP**	**Vulne-rable**	**Middle Class**	**Affluent**	**Less than USD 4 PPP**	**Vulne-rable**	**Middle Class**	**Affluent**
Share of population by level of income, 2014 (6)	13	36	49	2	23	39	35	3
Share of population by level of income, 2005	26	36	36	2	38	36	24	2

	Low	**Middle Low**	**Middle**	**Middle High**	**High**	**Low**	**Middle Low**	**Middle**	**Middle High**	**High**
Self-perception of social class, 2015 (7)	12.6	35.4	49.1	2.9	0.1	23.1	30.5	40.4	4.3	1.7
Self-perception of social class, 2011	10.2	31.5	54.3	3.7	0.3	24.6	31.0	38.9	4.3	1.3

	Argentina		LAC		OECD	
Citizens' level of trust (%) (8)	**2006**	**2016**	**2006**	**2016**	**2006**	**2016**
Share of population that perceives corruption as being widespread in the country	76.0	78.0	73.0	79.0	60.0	65.0
Share of population that expresses confidence in the country's judicial system and courts	27.0	31.0	33.0	34.0	50.0	49.0
Share of population that expresses confidence in the national government	52.0	42.0	39.0	29.0	43.0	37.0

	Argentina		LAC	
Satisfaction with public services (%) (7)	**2010**	**2015**	**2010**	**2015**
Share of people that expresses being "satisfied" or "very satisfied" with public education	46.8	56.0	54.3	53.8
Share of people that expresses being "satisfied" or "very satisfied" with public hospitals	52.7	55.4	48.0	40.7
Share of people that perceive citizen security as being "good" or "very good"	10.4	7.4	16.1	16.0
Share of people that expresses being satisfied with the city (overall) (8)	80.0	77.0	78.0	72.0

	Argentina		LAC	
Tax morale indicators (7)	**2005**	**2015**	**2005**	**2015**
Tax morale weighted index	8.12	8.90	7.70	7.94
Share of population that declares tax evasion as never justifiable (%)	47.1	66.4	39.2	48.1

III. TOOLS FOR BRIDGING THE GAP STATE-CITIZENS-MARKET

	Argentina		LAC (17)		OECD	
Efficient	**2004**	**2012-2015**	**2004**	**2012-2015**	**2004**	**2012-2015**
Civil service merit (9)	-	-	33	45	-	-
	2013		**2013**		**2013**	
Economy-wide Product Market Regulation (10)	3.11		2.40		1.47	
Trustworthy (11)	**2016**		**2016**		**2016**	
Anti-corruption policy (11a)	5.0		5.12		6.91	
Impartial public administration (11b)	3.43		3.68		5.15	
Open and innovative	**2016**		**2016**		**2016**	
OUR (Open, Useful, Reusable Government Data) index (12)	0.47		0.44		0.56	

	Argentina		LAC (17)		OECD	
Governance indicators (13)	**2005**	**2015**	**2005**	**2015**	**2005**	**2015**
Voice and accountability	0.24	0.33	0.12	0.18	1.22	1.12
Political stability and absence of violence/terrorism	-0.01	-0.07	-0.32	-0.09	0.71	0.64
Government effectiveness	-0.09	-0.09	-0.23	-0.17	1.35	1.3
Regulatory quality	-0.57	-0.96	-0.11	-0.05	1.28	1.28

	Argentina		LAC (17)		OECD	
Quality of government (11)	**2005**	**2015**	**2005**	**2015**	**2005**	**2015**
Indicator of quality of government	0.56	0.47	0.45	0.44	0.79	0.78

Footnotes and sources can be found in the technical note at the end of the country notes.

BRAZIL

Recent trends in citizens' perceptions

The quality of the Brazilian government, measured by the Quality of Government Index which ranges from 0 to 1 and includes proxies for corruption, law and order, and bureaucracy quality, decreased from 0.41 to around 0.39 between 2005 and 2015. This places the country below both the Latin America and Caribbean (LAC) average (0.44) and the OECD average (0.78) by 2015. Similarly, other governance indicators regarding voice and accountability, political stability, government effectiveness and regulatory quality have also deteriorated over the last decade in the country.

Citizens' level of trust in Brazil's judicial system has increased between 2006-16. However, the level of confidence in the national government has decreased by more than 8 percentage points, and only 26% of the population expressed confidence in the national government in 2015. This places the country below the LAC average (29%) and the OECD average (37%). Brazilians' satisfaction with public services decreased significantly between 2010 and 2015. During the same period, citizens' perception of security also worsened: almost 21% of Brazilians classified citizen security as being either "good" or "very good" in 2010, while only 6.4% did so in 2015. Moreover, less than one-quarter of the population expressed being very satisfied or satisfied with public education or public hospitals in 2015.

This situation contrasts with a rising middle class, which increased by 16 percentage points between 2005 and 2015. Approximately 40% of the population classified as middle class according to their income level (individuals with a daily per capita income of USD 10-50 PPP) in 2015. Beyond material conditions, individual well-being encompasses several subjective factors that affect citizens' quality of life (OECD, 2015). Subjective perceptions of well-being show that only about 33% of Brazilians considered themselves part of the middle class in 2015. All this reflects the important challenges in Brazil's government capacity to transform economic progress into better provision of public services and opportunities for all.

Recent policies to strengthen the state-society link

Brazil has made advancements over the last decade to engage civil society, promote transparency and integrity, and fight corruption. The country, in the midst of its third Open Government Action Plan, has made available both open government and open data websites. As a result of regulatory frameworks on public access to information (Law 12527 of 2011), Brazil has an integrated system for citizens' petitions, complaints and requests. Moreover, the Executive Branch recently introduced an open data policy (Decree 8.777 of 2016). It aims to develop a culture of public transparency, open data, better public services, scientific research on public governance and integrated e-government services in the country. To that end, public institutions must make it easy for the general public to access their information and create specialised units to ensure compliance with this civil right.

Remarkably, the Law of Conflict of Interests (12.813 of 2013) covers public servants both while they work in public administration and after leaving it. The Law of Organized Crime (12.850 of 2013) regulates individual co-operation with justice. The Law of Money Laundering (12.683 of 2012) makes more tough criminal procedures on money laundering. And finally, Law SOE (13.303 of 2016) determines that anti-corruption rules apply equally to all SOEs and its subsidiaries.

The General Comptroller of Brazil includes a Transparency Portal, an innovative programme to disseminate information on federal public resources, including the budget. It aims to allow citizens to monitor the use of public money. Brazil has also established an Anticorruption Law (12.846 of 2013). It provides a framework of corporate and individual liability for acts of corruption against Brazilian and foreign public officials or government bodies. Nonetheless, recent political scandals reaffirm the need for additional anti-corruption policies.

Key indicators: Brazil

I. STATE CAPACITIES

	Brazil		LAC		OECD	
Fiscal	**2005**	**2015**	**2005**	**2015**	**2005**	**2015**
Total tax revenue as % of GDP (1)	32.8	32.0	19.8	22.8	33.6	34.3
	2012		**2012**		**2012**	
Difference in income inequality pre and post-tax and government transfers (2)	0.06		0.03		0.18	

	Brazil		LAC (17)*		OECD	
Legal	**2005**	**2015**	**2005**	**2015**	**2005**	**2015**
Rule of law (3)	-0.49	-0.19	-0.40	-0.37	1.25	1.31
	2006	**2016**	**2006**	**2016**	**2006**	**2016**
Judicial independence (4)	6.0	7.0	6.12	6.18	-	-

	Brazil		LAC		OECD	
Administrative (%) (5)	**2009**	**2016**	**2009**	**2016**	**2009**	**2016**
Employment in public sector as % of total employment	12.0	12.3	11.3	12.5	21.4	24.6
Share of public sector employment filled by women	57.4	56.9	48.1	50.0	58.4	58.5

II. PERCEPTIONS AND CHARACTERISTICS OF SOCIETY

	Brazil				LAC (17)			
Citizens' socio-economic status (%)	**Less than USD 4 PPP**	**Vulne-rable**	**Middle Class**	**Affluent**	**Less than USD 4 PPP**	**Vulne-rable**	**Middle Class**	**Affluent**
Share of population by level of income, 2015 (6)	20	36	40	4	24	39	34	3
Share of population by level of income, 2005	38	36	24	2	38	36	24	2

	Low	Middle Low	Middle	Middle High	High	Low	Middle Low	Middle	Middle High	High
Self-perception of social class, 2015 (7)	29.8	34.7	32.9	2.0	0.6	23.1	30.5	40.4	4.3	1.7
Self-perception of social class, 2011	32.1	32.1	32.2	2.8	0.8	24.6	31.0	38.9	4.3	1.3

	Brazil		LAC		OECD	
Citizens' level of trust (%) (8)	**2006**	**2016**	**2006**	**2016**	**2006**	**2016**
Share of population that perceives corruption as being widespread in the country	72.0	78.0	73.0	79.0	60.0	65.0
Share of population that expresses confidence in the country's judicial system and courts	37.0	42.0	33.0	34.0	50.0	49.0
Share of population that expresses confidence in the national government	34.0	26.0	39.0	29.0	43.0	37.0

	Brazil		LAC	
Satisfaction with public services (%) (7)	**2010**	**2015**	**2010**	**2015**
Share of people that expresses being "satisfied" or "very satisfied" with public education	35.4	24.1	54.3	53.8
Share of people that expresses being "satisfied" or "very satisfied" with public hospitals	27.9	14.2	48.0	40.7
Share of people that perceive citizen security as being "good" or "very good"	20.8	6.4	16.1	16.0
Share of people that expresses being satisfied with the city (overall) (8)	78.0	68.0	78.0	72.0

	Brazil		LAC	
Tax morale indicators (7)	**2005**	**2015**	**2005**	**2015**
Tax morale weighted index	7.8	7.9	7.7	7.9
Share of population that declares tax evasion as never justifiable (%)	40.1	53.6	39.2	48.1

III. TOOLS FOR BRIDGING THE GAP STATE-CITIZENS-MARKET

	Brazil		LAC (17)		OECD	
Efficient	**2004**	**2012-2015**	**2004**	**2012-2015**	**2004**	**2012-2015**
Civil service merit (9)	93	93	33	45	-	-
	2013		**2013**		**2013**	
Economy-wide Product Market Regulation (10)	2.5		2.4		1.47	
Trustworthy (11)	**2016**		**2016**		**2016**	
Anti-corruption policy (11a)	7		5.12		6.91	
Impartial public administration (11b)	4.0		3.7		5.1	
Open and innovative	**2016**		**2016**		**2016**	
OUR (Open, Useful, Reusable Government Data) index (12)	0.5		0.4		0.6	

	Brazil		LAC (17)		OECD	
Governance indicators (13)	**2005**	**2015**	**2005**	**2015**	**2005**	**2015**
Voice and accountability	0.45	0.38	0.12	0.18	1.22	1.12
Political stability and absence of violence/terrorism	-0.23	-0.38	-0.32	-0.09	0.71	0.64
Government effectiveness	-0.10	-0.19	-0.23	-0.17	1.35	1.30
Regulatory quality	0.03	-0.21	-0.11	-0.05	1.28	1.28

	Brazil		LAC (17)		OECD	
Quality of government (11)	**2005**	**2015**	**2005**	**2015**	**2005**	**2015**
Indicator of quality of government	0.41	0.39	0.45	0.44	0.79	0.78

Footnotes and sources can be found in the technical note at the end of the country notes.

CHILE

Recent trends in citizens' perceptions

The quality of government in Chile is high. According to the Quality of Government Index, which ranges from 0 to 1 and includes measures of corruption, law and order, and bureaucracy quality, Chile scores 0.75 out of 1. This is well above the LAC average (0.44) and similar to the OECD average (0.78). This score renders Chile as the country with the highest government quality in the region. In spite of this, and in line with the regional trend, there is a growing lack of trust in the national government; in 2016, only 20% of the population expressed confidence in this institution. Decreasing trust is largely associated with the perception of unequal opportunities across the population. According to the Anti-Corruption Policy index (from 0 to 10), Chile scores 9.0, above the LAC and OECD average of 5.12 and 6.91 respectively. However, 82% of Chileans perceived corruption as being widespread in 2016.

Individual well-being encompasses several subjective factors that affect citizens' quality of life (OECD, 2015). Notably, Chileans are increasingly less satisfied with public services in the country. In 2015, only 14% of the population was satisfied or very satisfied with public hospitals, and 21% with public education. Furthermore, citizens seem to be growing more concerned about their security: over 2010-15, the share of people that perceived citizen security as being good or very good fell from 19% to 11%.

The country has made important progress in terms of the material conditions of well-being (i.e. income) and social mobility in recent years. The size of the middle class (daily per capita income of USD 10-50 PPP) increased from 34% to 52% between 2006-15. Yet the subjective assessment of social class shows that while 39% of the population considered themselves part of the middle class in 2015, over 55% identified themselves as either low or middle-low class. This, together with a growing dissatisfaction with public services, suggests a disconnect between economic progress and non-monetary measures of well-being. With one of the largest middle class groups in LAC, Chile faces a major challenge to mend this disconnect and improve services for a growing and demanding middle class.

Recent policies to strengthen the state-society link

Chile has put in place several policies to strengthen transparency, open government and anti-corruption. To complement its Transparency Law, Chile introduced the Law on Lobbying (No 20 730 of 2014). This legislates disclosure of information about meetings between authorities and officials with private sector individuals or entities, and on their travel and the gifts they receive.

In 2015, the government launched an ambitious Agenda on Integrity and Transparency. This followed recommendations of the Final Report of the Presidential Advisory Council against Conflicts of Interest, Traffic of Influences and Corruption, from the same year. The agenda focuses on building trust between the government and citizens through both legislative and administrative measures. These include the Law for Strengthening and Transparency of Democracy (No 20 900 of 2016), the New Law of Political Parties (Law No 20 915 of 2016), the Law for Sanctions of Loss of Position (No 20 870 of 2015), the Law of Probity in the Public Function (No 20 880 of 2016), the Law on Constitutional Autonomy of the Electoral Service (Law No 20 860 of 2015), the Law on Obligatory Civic Education (Law No 20 911 of 2016), the Law for Strengthening of Senior Public Management (Law No 20 955 of 2016), and a new law that creates the new Commission of the Financial Market (Law No 21 000 of 2017).

So far, Chile has implemented three National Action Plans in the context of the Open Government Partnership. The current plan was launched in 2016. The country has promoted, together with Peru, the creation of the LAC Public Integrity Network with the support of the OECD and the Inter-American Development Bank. This network aims at supporting other countries in the region to exchange ideas, experiences and lessons learned. Together, the partners aim to find solutions to common challenges in the implementation of public integrity policies. Lastly, in terms of digital government, Chile has made progress in applying information and communication technologies to simplify the services and information offered by the state. ChileAtiende is one tool used by the government to bridge the state-citizen gap.

Key indicators: Chile

I. STATE CAPACITIES

	Chile		LAC		OECD	
Fiscal	**2005**	**2015**	**2005**	**2015**	**2005**	**2015**
Total tax revenue as % of GDP (1)	20.7	20.6	19.8	22.8	33.6	34.3
	2012		**2012**		**2012**	
Difference in income inequality pre and post-tax and government transfers (2)	0.04		0.03		0.18	

	Chile		LAC (17)*		OECD	
Legal	**2005**	**2015**	**2005**	**2015**	**2005**	**2015**
Rule of law (3)	1.27	1.33	-0.4	-0.37	1.25	1.31
	2006	**2016**	**2006**	**2016**	**2006**	**2016**
Judicial independence (4)	9	9	6.12	6.18	-	-

	Chile		LAC		OECD	
Administrative (%) (5)	**2009**	**2016**	**2009**	**2016**	**2009**	**2016**
Employment in public sector as % of total employment	10.0	10.8	11.3	12.5	21.4	24.6
Share of public sector employment filled by women	52.8	54.9	48.1	50.0	58.4	58.5

II. PERCEPTIONS AND CHARACTERISTICS OF SOCIETY

Citizens' socio-economic status (%)	Chile				LAC (17)			
	Less than USD 4 PPP	Vulne-rable	Middle Class	Affluent	Less than USD 4 PPP	Vulne-rable	Middle Class	Affluent
Share of population by level of income, 2015 (6)	8	35	52	5	24	39	34	3
Share of population by level of income, 2006	19	44	34	3	34	38	26	2

	Low	Middle Low	Middle	Middle High	High	Low	Middle Low	Middle	Middle High	High
Self-perception of social class, 2015 (7)	15.2	44.6	38.6	0.6	1.0	23.1	30.5	40.4	4.3	1.7
Self-perception of social class, 2011	18.3	43.6	35.1	2.3	0.8	24.6	31.0	38.9	4.3	1.3

	Chile		LAC		OECD	
Citizens' level of trust (%) (8)	**2006**	**2016**	**2006**	**2016**	**2006**	**2016**
Share of population that perceives corruption as being widespread in the country	53.0	82.0	73.0	79.0	60.0	65.0
Share of population that expresses confidence in the country's judicial system and courts	27.0	15.0	33.0	34.0	50.0	49.0
Share of population that expresses confidence in the national government	58.0	20.0	39.0	29.0	43.0	37.0

	Chile		LAC	
Satisfaction with public services (%) (7)	**2010**	**2015**	**2010**	**2015**
Share of people that expresses being "satisfied" or "very satisfied" with public education	29.2	20.8	54.3	53.8
Share of people that expresses being "satisfied" or "very satisfied" with public hospitals	28.5	14.2	48.0	40.7
Share of people that perceive citizen security as being "good" or "very good"	19.3	11.0	16.1	16.0
Share of people that expresses being satisfied with the city (overall) (8)	79.0	81.0	78.0	72.0

	Chile		LAC	
Tax morale indicators (7)	**2005**	**2015**	**2005**	**2015**
Tax morale weighted index	8.71	8.25	7.70	7.94
Share of population that declares tax evasion as never justifiable (%)	53.8	43.8	39.2	48.1

III. TOOLS FOR BRIDGING THE GAP STATE-CITIZENS-MARKET

	Chile		LAC (17)		OECD	
Efficient	**2004**	**2012-2015**	**2004**	**2012-2015**	**2004**	**2012-2015**
Civil service merit (9)	60	67	33	45	-	-
	2013		**2013**		**2013**	
Economy-wide Product Market Regulation (10)	1.51		2.4		1.47	
Trustworthy (11)	**2016**		**2016**		**2016**	
Anti-corruption policy (11a)	9.0		5.12		6.91	
Impartial public administration (11b)	5.59		3.68		5.15	
Open and innovative	**2016**		**2016**		**2016**	
OUR (Open, Useful, Reusable Government Data) index (12)	0.54		0.44		0.56	

	Chile		LAC (17)		OECD	
Governance indicators (13)	**2005**	**2015**	**2005**	**2015**	**2005**	**2015**
Voice and accountability	1.24	0.99	0.12	0.18	1.22	1.12
Political stability and absence of violence/terrorism	0.85	0.40	-0.32	-0.09	0.71	0.64
Government effectiveness	1.22	1.08	-0.23	-0.17	1.35	1.3
Regulatory quality	1.41	1.35	-0.11	-0.05	1.28	1.28

	Chile		LAC (17)		OECD	
Quality of government (11)	**2005**	**2015**	**2005**	**2015**	**2005**	**2015**
Indicator of quality of government	0.78	0.75	0.45	0.44	0.79	0.78

Footnotes and sources can be found in the technical note at the end of the country notes.

COLOMBIA

Recent trends in citizens' perceptions

The quality of government, as shown by the Quality of Government Index ranging from 0 to 1 and including measures of corruption, law and order, and bureaucracy quality, increased from 0.38 to 0.42 over 2005-15. Colombia has also had progress regarding its efforts to increase government data accessibility and availability, and to foster data re-use to deliver value, according to the OUR (Open, Useful, Reusable government data) index in 2015. With a score of 0.76 out of 1, Colombia ranks above both the LAC and OECD averages (0.44 and 0.56, respectively). Furthermore, the country has made some progress regarding its governance indicators.

Citizens' trust in government has decreased since 2006, in a similar trend to the regional LAC average. Approximately 86% of Colombians perceived corruption as being widespread in the country in 2016. This represents an increase of 13 percentage points with respect to 2006, placing Colombia above the regional average of 79%. Likewise, the share of the population that expressed confidence in the national government fell from 48 to 26% over the same period. Additionally, only 25% of Colombians expressed trust in the country's courts in 2016.

This decrease in citizens' trust in government parallels a growing dissatisfaction with the country's services. Beyond material conditions, individual well-being encompasses several subjective factors that affect citizens' quality of life (OECD, 2015). Only 51% of citizens was satisfied or very satisfied with the public education system in 2015, while only 28% was satisfied or very satisfied with the services in public hospitals. Perceptions of citizen security have also deteriorated: the share of people that perceived citizen security as being good or very good decreased from 23% to 16.6% between 2010 and 2015. These changes in citizens' institutional perception and their overall satisfaction with public services may be linked to the higher visibility of corruption cases following efforts to fight this conduct in the country. They could also be linked to the expansion of a middle class (daily per capita income of USD 10-50 PPP) – from 18% to 31% between 2005 and 2015 – with stricter and more demanding views about corruption and public institutions.

Recent policies to strengthen the state-society link

During the past decade, Colombia has worked on a "whole-of-government" agenda aimed at strengthening integrity and transparency. As such, it established an Open Government National Plan and a Transparency and Access to Public Information Law (1712-2014). The latter aims to outline the principles and procedures that guarantee citizens' right of access to information in the possession of any public authority. Furthermore, the fight against corruption has had significant milestones in recent years.

Colombia has amended the legislative framework to fight corruption and strengthen rule of law by enacting a set of regulations on this matter. The government established the National Civil Commission for Fighting Corruption in 2011, which promotes civil society participation to fight corruption. It also created the Transparency and Anti-Corruption Observatory, an interactive tool aimed at promoting transparency and combating corruption within the government. More recently, the government strived to improve regulation of corporate liability for foreign bribery and other acts of corruption (Law 1778 of 2016).

The government has also made new efforts to fight abuses that brought out losses and diversion of public resources (Decree 92 of 2017), as well as efforts to regulate conformity of candidates to be part of the National Citizens Commission to Fight Corruption (Decree 958 of 2016). The latter is expected to improve trust of civil society in fighting corruption. Additionally, Colombia is a member of the Organization of American States (OAS) Convention against corruption. It has also signed and ratified the UN Anticorruption Convention and adopted the OECD Anti-Bribery Convention.

The government has taken measures to improve state capacity. Among them is *Compra Eficiente*, an entity that centralises procurement processes of ministries and public institutions in a single executive agency. By aggregating technical, legal and logistical capacities that serve the multiple entities, the agency could reduce administrative costs and increase efficiency.

Key indicators: Colombia

I. STATE CAPACITIES

	Colombia		LAC		OECD	
Fiscal	**2005**	**2015**	**2005**	**2015**	**2005**	**2015**
Total tax revenue as % of GDP (1)	18.1	20.8	19.8	22.8	33.6	34.3
	2012		**2012**		**2012**	
Difference in income inequality pre and post-tax and government transfers (2)	0.01		0.03		0.18	

	Colombia		LAC (17)*		OECD	
Legal	**2005**	**2015**	**2005**	**2015**	**2005**	**2015**
Rule of law (3)	-0.66	-0.31	-0.4	-0.37	1.25	1.31
	2006	**2016**	**2006**	**2016**	**2006**	**2016**
Judicial independence (4)	6.0	7.0	6.12	6.18	-	-

	Colombia		LAC		OECD	
Administrative (%) (5)	**2009**	**2016**	**2009**	**2016**	**2009**	**2016**
Employment in public sector as % of total employment	4.6	3.9	11.3	12.5	21.4	24.6
Share of public sector employment filled by women	39.8	47.4	48.1	50.0	58.4	58.5

II. PERCEPTIONS AND CHARACTERISTICS OF SOCIETY

Citizens' socio-economic status (%)	Colombia				LAC (17)			
	Less than USD 4 PPP	Vulne-rable	Middle Class	Affluent	Less than USD 4 PPP	Vulne-rable	Middle Class	Affluent
Share of population by level of income, 2015 (6)	28	39	31	2	24	39	34	3
Share of population by level of income, 2005	45	35	18	2	38	36	24	2

	Low	Middle Low	Middle	Middle High	High	Low	Middle Low	Middle	Middle High	High
Self-perception of social class, 2015 (7)	27.8	27.2	36.9	6.4	1.7	23.1	30.5	40.4	4.3	1.7
Self-perception of social class, 2011	27.4	28.1	38.2	5.4	0.8	24.6	31.0	38.9	4.3	1.3

	Colombia		LAC		OECD	
Citizens' level of trust (%) (8)	**2006**	**2016**	**2006**	**2016**	**2006**	**2016**
Share of population that perceives corruption as being widespread in the country	73.0	86.0	73.0	79.0	60.0	65.0
Share of population that expresses confidence in the country's judicial system and courts	38.0	25.0	33.0	34.0	50.0	49.0
Share of population that expresses confidence in the national government	48.0	26.0	39.0	29.0	43.0	37.0

	Colombia		LAC	
Satisfaction with public services (%) (7)	**2010**	**2015**	**2010**	**2015**
Share of people that expresses being "satisfied" or "very satisfied" with public education	55.9	51.1	54.3	53.8
Share of people that expresses being "satisfied" or "very satisfied" with public hospitals	36.3	28.2	48.0	40.7
Share of people that perceive citizen security as being "good" or "very good"	23.3	16.6	16.1	16.0
Share of people that expresses being satisfied with the city (overall) (8)	81.0	77.0	78.0	72.0

	Colombia		LAC	
Tax morale indicators (7)	**2005**	**2015**	**2005**	**2015**
Tax morale weighted index	7.31	7.89	7.70	7.94
Share of population that declares tax evasion as never justifiable (%)	29.2	41.7	39.2	48.1

III. TOOLS FOR BRIDGING THE GAP STATE-CITIZENS-MARKET

	Colombia		LAC (17)		OECD	
Efficient	**2004**	**2012-2015**	**2004**	**2012-2015**	**2004**	**2012-2015**
Civil service merit (9)	53.0	67.0	33	45	-	-
	2013		**2013**		**2013**	
Economy-wide Product Market Regulation (10)	1.77		2.4		1.47	
Trustworthy (11)	**2016**		**2016**		**2016**	
Anti-corruption policy (11a)	5.0		5.12		6.91	
Impartial public administration (11b)	3.73		3.68		5.15	
Open and innovative	**2016**		**2016**		**2016**	
OUR (Open, Useful, Reusable Government Data) index (12)	0.76		0.44		0.56	

	Colombia		LAC (17)		OECD	
Governance indicators (13)	**2005**	**2015**	**2005**	**2015**	**2005**	**2015**
Voice and accountability	-0.30	-0.07	0.12	0.18	1.22	1.12
Political stability and absence of violence/terrorism	-2.03	-1.06	-0.32	-0.09	0.71	0.64
Government effectiveness	-0.16	-0.03	-0.23	-0.17	1.35	1.3
Regulatory quality	0.06	0.45	-0.11	-0.05	1.28	1.28

	Colombia		LAC (17)		OECD	
Quality of government (11)	**2005**	**2015**	**2005**	**2015**	**2005**	**2015**
Indicator of quality of government	0.38	0.42	0.45	0.44	0.79	0.78

Footnotes and sources can be found in the technical note at the end of the country notes.

COSTA RICA

Recent trends in citizens' perceptions

The quality of the government of Costa Rica is quite high. With a score of 0.50 out of 1 across the Quality of Government index, which includes measures of corruption, law and order, and bureaucracy quality, Costa Rica's performance is above the regional average of 0.44. Yet perception of corruption in Costa Rica has remained relatively constant at 76% throughout the last decade. This number is close to the average of 79% for Latin America and the Caribbean, but remains above the 65% average observed among OECD member countries. Notably, confidence in the government fell from 38% to 28% between 2006 and 2016, settling below both the LAC average (29%) and the OECD average (37%). The share of people that expressed confidence in the country's judicial system and courts decreased from 47% to 41% during the same period; nonetheless, this share remains 7 percentage points above the average for the region (34%).

Individual well-being encompasses several subjective factors that affect citizens' quality of life (OECD, 2015). Satisfaction with public education and public hospitals decreased by approximately 2 and 10 percentage points between 2005 and 2015, respectively. However, satisfaction with these services remained relatively high by 2015. With respect to public education, 71% of the population was satisfied or very satisfied compared to the regional average of 54%. Similarly, 45% was satisfied or very satisfied with public hospitals compared to the regional average of 41%. Moreover, an increasing share of citizens perceive security as being good or very good, with the share rising from 15% to 21% between 2010 and 2015. Across all of these indicators, Costa Rica ranks well above the regional averages; this places Costa Rica as one of the countries with the highest citizen satisfaction in terms of public services provision.

Costa Rica's middle class (daily per capita income of USD 10-50 PPP) remained relatively stagnant with a slight increase of 3 percentage points, up to 48%. This, together with a decreasing trend in the satisfaction with public services, reflects a need to improve state capacity to transform economic progress into better services and social well-being.

Recent policies to strengthen the state-society link

The government of Costa Rica established a Law against Corruption and Illicit Enrichment in the Public Function (Law 8422) in 2004 to promote regulatory reforms to prevent, detect and punish corruption. Furthermore, the 2014-18 National Development Plan emphasises strengthening transparency, as well as access to information and active participation of citizens. Costa Rica is designing the third Open Government National Action Plan, with a special focus on the Sustainable Development Goals. The country has websites for both Open Data and Open Government, where citizens can access several services online, and a unique portal that centralises public procurements. Moreover, it is the first country in the region to develop an Open Justice policy and a policy of active citizen participation within the executive branch of government.

Representatives from all branches of government signed an Open State Agreement to advance the national agenda for transparency, citizen participation and fight against corruption. With this agreement in hand, Costa Rica will move forward on policies towards an Open State, as well as the articulation of Open Government initiatives. The agreement's construction catered to the Open Government philosophy, and thus included participation from members of the executive, legislative and judiciary branches, local governments, national civil society organisations and private sector, as well as four representatives of foreign countries. These workshops and bilateral meetings had the guidance of the OECD, as well as the British Embassy's financial support. Recently, the Executive Branch published a set of two executive decrees. One aims to improve access to information in a more systematic process, while the other establishes data that institutions have to publish and the open format they must use.

Additionally, Costa Rica has adopted the United Nations (UN) and Organization of American States (OAS) Conventions against Corruption, as well as the Convention on Combating Bribery of Foreign Public Officials of the OECD.

Key indicators: Costa Rica

I. STATE CAPACITIES

	Costa Rica		LAC		OECD	
Fiscal	**2005**	**2015**	**2005**	**2015**	**2005**	**2015**
Total tax revenue as % of GDP (1)	19.6	23.1	19.8	22.8	33.6	34.3
	2012		**2012**		**2012**	
Difference in income inequality pre and post-tax and government transfers (2)	0.02		0.03		0.18	

	Costa Rica		LAC (17)*		OECD	
Legal	**2005**	**2015**	**2005**	**2015**	**2005**	**2015**
Rule of law (3)	0.51	0.48	-0.4	-0.37	1.25	1.31
	2006	**2016**	**2006**	**2016**	**2006**	**2016**
Judicial independence (4)	9.0	9.0	6.12	6.18	-	-

	Costa Rica		LAC		OECD	
Administrative (%) (5)	**2009**	**2016**	**2009**	**2016**	**2009**	**2016**
Employment in public sector as % of total employment	15.2	14.8	11.3	12.5	21.4	24.6
Share of public sector employment filled by women	49.0	48.5	48.1	50.0	58.4	58.5

II. PERCEPTIONS AND CHARACTERISTICS OF SOCIETY

	Costa Rica				LAC (17)			
Citizens' socio-economic status (%)	**Less than USD 4 PPP**	**Vulne-rable**	**Middle Class**	**Affluent**	**Less than USD 4 PPP**	**Vulne-rable**	**Middle Class**	**Affluent**
Share of population by level of income, 2015 (6)	11	36	48	5	24	39	34	3
Share of population by level of income, 2010	13	39	45	4	28	40	30	2

	Low	Middle Low	Middle	Middle High	High	Low	Middle Low	Middle	Middle High	High
Self-perception of social class, 2015 (7)	13.5	31.5	46.8	6.6	1.5	23.1	30.5	40.4	4.3	1.7
Self-perception of social class, 2011	13.8	34.3	44.8	5.4	1.7	24.6	31.0	38.9	4.3	1.3

	Costa Rica		LAC		OECD	
Citizens' level of trust (%) (8)	**2006**	**2016**	**2006**	**2016**	**2006**	**2016**
Share of population that perceives corruption as being widespread in the country	75.0	76.0	73.0	79.0	60.0	65.0
Share of population that expresses confidence in the country's judicial system and courts	47.0	41.0	33.0	34.0	50.0	49.0
Share of population that expresses confidence in the national government	38.0	28.0	39.0	29.0	43.0	37.0

	Costa Rica		LAC	
Satisfaction with public services (%) (7)	**2010**	**2015**	**2010**	**2015**
Share of people that expresses being "satisfied" or "very satisfied" with public education	72.7	70.9	54.3	53.8
Share of people that expresses being "satisfied" or "very satisfied" with public hospitals	56.1	45.3	48.0	40.7
Share of people that perceive citizen security as being "good" or "very good"	15.1	20.8	16.1	16.0
Share of people that expresses being satisfied with the city (overall) (8)	84.0	78.0	78.0	72.0

	Costa Rica		LAC	
Tax morale indicators (7)	**2005**	**2015**	**2005**	**2015**
Tax morale weighted index	8.07	8.03	7.70	7.94
Share of population that declares tax evasion as never justifiable (%)	54.6	54.8	39.2	48.1

III. TOOLS FOR BRIDGING THE GAP STATE-CITIZENS-MARKET

	Costa Rica		LAC (17)		OECD	
Efficient	**2004**	**2012-2015**	**2004**	**2012-2015**	**2004**	**2012-2015**
Civil service merit (9)	67	73	33	45	-	-
	2013		**2013**		**2013**	
Economy-wide Product Market Regulation (10)	2.37		2.40		1.47	
Trustworthy (11)	**2016**		**2016**		**2016**	
Anti-corruption policy (11a)	8		5.12		6.91	
Impartial public administration (11b)	4.35		3.68		5.15	
Open and innovative	**2016**		**2016**		**2016**	
OUR (Open, Useful, Reusable Government Data) index (12)	0.46		0.44		0.56	

	Costa Rica		LAC (17)		OECD	
Governance indicators (13)	**2005**	**2015**	**2005**	**2015**	**2005**	**2015**
Voice and accountability	0.81	1.14	0.12	0.18	1.22	1.12
Political stability and absence of violence/terrorism	0.70	0.58	-0.32	-0.09	0.71	0.64
Government effectiveness	0.15	0.38	-0.23	-0.17	1.35	1.3
Regulatory quality	0.58	0.49	-0.11	-0.05	1.28	1.28

	Costa Rica		LAC (17)		OECD	
Quality of government (11)	**2005**	**2015**	**2005**	**2015**	**2005**	**2015**
Indicator of quality of government	0.51	0.50	0.45	0.44	0.79	0.78

Footnotes and sources can be found in the technical note at the end of the country notes.

DOMINICAN REPUBLIC

Recent trends in citizens' perceptions

The quality of government has remained fairly stable in the Dominican Republic (DR) during the past decade, as showed by the Quality of Government Index, measured by proxies of corruption, law and order, and bureaucracy quality. The country scored 0.32 in this index in 2015, slightly above 2005 (0.31), and well below the average of the LAC region (0.44) and the OECD average (0.78). Yet the majority of the population (55%) expressed trust towards the national government in 2016, greatly surpassing the regional average of 29% and the OECD average of 37%.

Individual well-being encompasses several subjective factors that affect citizens' quality of life (OECD, 2015). Satisfaction with public education and health is high in the Dominican Republic. The share of the population that expressed being satisfied or very satisfied with public education increased by approximately 25 percentage points between 2010 and 2015, reaching a level of 82%. During the same period, the proportion of the population satisfied or very satisfied with public hospitals remained constant. Perception of citizen security also improved. The share of the population that perceived citizen security as being good or very good has increased by over 9 percentage points since 2005, up to a level of 17% in 2015.

Improvements in citizen satisfaction are consistent with positive trends in terms of social mobility. The size of the middle class increased from 19% to 29% over 2005-15 (daily per capita income of USD 10-50 PPP). In spite of this progress, the government still has room for improvement. Progress in the country's redistributive capacity and in the quality of federal services may well be limited by the government's low fiscal capacity. With a tax revenue of 14% of GDP, the Dominican Republic is below the regional average (23%). Further, it is also one of the countries in the region with the lowest share of fiscal revenues. The country has much room to improve institutional measures, particularly in terms of corruption and impartiality of public administration.

Recent policies to strengthen the state-society link

Access to public information in the Dominican Republic is enforced by Law 200 of 2004. This law establishes that every person has the right to request and receive complete, truthful, adequate and timely information from any organ of the state. This includes tax information from the non-financial public sector to the general public, particularly as a way to monitor and evaluate fiscal activities. Among its resources, the country has websites for both open government and open data. A Citizen Portal serves as the national gateway and one-stop access to all online services, information, transaction and interaction with the state. Here citizens can find topics related to health, education, transparency, purchases and taxes.

The Participatory Anti-Corruption Initiative (IPAC) was developed between 2010-12. This initiative consulted citizens over 18 months, providing space for dialogue and permanent feedback between government and civil society. IPAC was the basis of the first Action Plan of the Dominican Republic within the Alliance for Open Government. Moreover, the government created the General Direction of Ethics and Governmental Integrity in 2012. In addition to overseeing matters of ethics, transparency, open government, the fight against corruption, conflict of interest, it works to provide free access to information within government entities.

The Dominican Republic is implementing its third Open Government Action Plan for 2016-18. This plan aims at promoting publication of municipal open data and municipal public procurement processes. As part of promoting a transparency culture, it will also implement a municipal transparency management model, develop websites to monitor presidential commitments and to publish a citizens' budget, as well as create portals for citizens' participation and consumer complaints. It will also launch a tool to monitor and evaluate the transparency portals of state institutions, and a virtual school for transparency. Finally, it will develop a mobile tool for reporting faults in the water systems.

Key indicators: Dominican Republic

I. STATE CAPACITIES

	Dominican Republic		LAC		OECD	
Fiscal	**2005**	**2015**	**2005**	**2015**	**2005**	**2015**
Total tax revenue as % of GDP (1)	11.9	13.7	19.8	22.8	33.6	34.3
	2012		**2012**		**2012**	
Difference in income inequality pre and post-tax and government transfers (2)	-		0.03		0.18	

	Dominican Republic		LAC (17)*		OECD	
Legal	**2005**	**2015**	**2005**	**2015**	**2005**	**2015**
Rule of law (3)	-0.68	-0.46	-0.4	-0.37	1.25	1.31
	2006	**2016**	**2006**	**2016**	**2006**	**2016**
Judicial independence (4)	6.0	6.0	6.12	6.18	-	-

	Dominican Republic		LAC		OECD	
Administrative (%) (5)	**2009**	**2016**	**2009**	**2016**	**2009**	**2016**
Employment in public sector as % of total employment	12.5	13.8	11.3	12.5	21.4	24.6
Share of public sector employment filled by women	48.7	49.8	48.1	50.0	58.4	58.5

II. PERCEPTIONS AND CHARACTERISTICS OF SOCIETY

	Dominican Republic				LAC (17)			
Citizens' socio-economic status (%)	**Less than USD 4 PPP**	**Vulne-rable**	**Middle Class**	**Affluent**	**Less than USD 4 PPP**	**Vulne-rable**	**Middle Class**	**Affluent**
Share of population by level of income, 2015 (6)	25	45	29	1	24	39	34	3
Share of population by level of income, 2005	40	40	19	1	38	36	24	2

	Low	Middle Low	Middle	Middle High	High	Low	Middle Low	Middle	Middle High	High
Self-perception of social class, 2015 (7)	25.2	26.0	38.0	5.5	5.2	23.1	30.5	40.4	4.3	1.7
Self-perception of social class, 2011	26.8	34.1	31.0	5.6	2.4	24.6	31.0	38.9	4.3	1.3

	Dominican Republic		LAC		OECD	
Citizens' level of trust (%) (8)	**2006**	**2016**	**2006**	**2016**	**2006**	**2016**
Share of population that perceives corruption as being widespread in the country	62.0	65.0	73.0	79.0	60.0	65.0
Share of population that expresses confidence in the country's judicial system and courts	41.0	30.0	33.0	34.0	50.0	49.0
Share of population that expresses confidence in the national government	64.0	55.0	39.0	29.0	43.0	37.0

	Dominican Republic		LAC	
Satisfaction with public services (%) (7)	**2010**	**2015**	**2010**	**2015**
Share of people that expresses being "satisfied" or "very satisfied" with public education	57.1	81.9	54.3	53.8
Share of people that expresses being "satisfied" or "very satisfied" with public hospitals	49.0	51.6	48.0	40.7
Share of people that perceive citizen security as being "good" or "very good"	7.3	16.9	16.1	16.0
Share of people that expresses being satisfied with the city (overall) (8)	77.0	70.0	78.0	72.0

	Dominican Republic		LAC	
Tax morale indicators (7)	**2005**	**2015**	**2005**	**2015**
Tax morale weighted index	6.96	7.88	7.70	7.94
Share of population that declares tax evasion as never justifiable (%)	32.7	59.1	39.2	48.1

III. TOOLS FOR BRIDGING THE GAP STATE-CITIZENS-MARKET

	Dominican Republic		LAC (17)		OECD	
Efficient	**2004**	**2012-2015**	**2004**	**2012-2015**	**2004**	**2012-2015**
Civil service merit (9)	7.0	27.0	33	45	-	-
	2013		**2013**		**2013**	
Economy-wide Product Market Regulation (10)	2.26		2.4		1.47	
Trustworthy (11)	**2016**		**2016**		**2016**	
Anti-corruption policy (11a)	2.0		5.12		6.91	
Impartial public administration (11b)	2.73		3.68		5.15	
Open and innovative	**2016**		**2016**		**2016**	
OUR (Open, Useful, Reusable Government Data) index (12)	0.43		0.44		0.56	

	Dominican Republic		LAC (17)		OECD	
Governance indicators (13)	**2005**	**2015**	**2005**	**2015**	**2005**	**2015**
Voice and accountability	-0.09	0.13	0.12	0.18	1.22	1.12
Political stability and absence of violence/terrorism	-0.23	0.17	-0.32	-0.09	0.71	0.64
Government effectiveness	-0.55	-0.34	-0.23	-0.17	1.35	1.3
Regulatory quality	-0.38	-0.04	-0.11	-0.05	1.28	1.28

	Dominican Republic		LAC (17)		OECD	
Quality of government (11)	**2005**	**2015**	**2005**	**2015**	**2005**	**2015**
Indicator of quality of government	0.31	0.32	0.45	0.44	0.79	0.78

Footnotes and sources can be found in the technical note at the end of the country notes.

EL SALVADOR

Recent trends in citizens' perceptions

The quality of the national government of El Salvador has deteriorated over the past decade. The Quality of Government Index, ranging from 0 to 1, decreased from 0.46 to 0.39 over 2005-15. The country is below the LAC average (0.44), and the OECD average (0.78). Regarding other governance indicators, such as government effectiveness (-0.24), regulatory quality (0.20), political stability (-0.05) and voice and accountability (0.13), El Salvador has made little progress over the last decade. It remains below the LAC averages for most of these indicators (-0.17, -0.05, -0.09 and 0.18, respectively) and below the OECD averages in all of them (1.3, 1.28, 0.64 and 1.12, respectively).

The trust of citizens in public institutions diminished over the last decade. Currently, 25% of people in the country express confidence in the national government compared to 37% in 2006. Over the same period, confidence in the judicial system and courts has remained stagnant at 24%. This is below the LAC averages (29% and 34%, respectively) and the OECD averages (37% and 49%, respectively).

Citizens' well-being involves a broad set of subjective factors that affect people's quality of life (OECD, 2015). El Salvador has had an important setback during the last five years in terms of citizens' satisfaction with public services. Between 2010 and 2015, the share of the population that expressed being very satisfied or satisfied with public education fell from 76% to 61%. Similarly, while 71% of people expressed being very satisfied or satisfied with public hospitals in 2010, only 45% thought in the same way in 2015. Yet the level of satisfaction in El Salvador with public education and hospitals is well positioned compared with the LAC averages (54% and 41%, respectively).

On the other hand, El Salvador has made significant progress in terms of the material conditions of well-being (i.e. income) and social mobility over the last decade. Notably, around 14% of the population have been lifted out of poverty, and the middle class increased from 19% to 21% between 2005 and 2015.

Recent policies to strengthen the state-society link

The Law on Access to Public Information establishes the right of access to public information in El Salvador. It states that everyone has the right to request and receive information generated, administered or held by public institutions in a timely and truthful manner. The incumbent government has successfully created the Secretariat for Citizen Participation, Transparency and Anti-Corruption of the Presidency. This new entity has launched several initiatives regarding open and electronic government, and anti-corruption and transparency policy. Furthermore, the government added the use of information and communication technologies to help produce technical information in plain language. This move is expected to make interaction between public institutions and citizens more friendly and intuitive.

Through the Alliance for Open Government, the country committed to promote greater openness within the public administration. This alliance will improve access to public services with an emphasis on health and access to public information. It also aims to enhance public integrity, as well as management of public resources. Through this plan, the government seeks to provide citizens with tools for participation, to foster more transparency in public management and to broaden access to information.

More than 60 public institutions typically take part in the annual Transparency Week, where the government presents results of compliance of public officials with the letter and spirit of the law. Additionally, it highlights anti-corruption initiatives such as laws to promote government ethics and access to public information, as well as creation of the Institute for Access to Information and Mechanisms of Accountability.

Key indicators: El Salvador

I. STATE CAPACITIES

	El Salvador		LAC		OECD	
Fiscal	**2005**	**2015**	**2005**	**2015**	**2005**	**2015**
Total tax revenue as % of GDP (1)	13.9	17.3	19.8	22.8	33.6	34.3
	2012		**2012**		**2012**	
Difference in income inequality pre and post-tax and government transfers (2)	0.01		0.03		0.18	

	El Salvador		LAC (17)*		OECD	
Legal	**2005**	**2015**	**2005**	**2015**	**2005**	**2015**
Rule of law (3)	-0.47	-0.59	-0.4	-0.37	1.25	1.31
	2006	**2016**	**2006**	**2016**	**2006**	**2016**
Judicial independence (4)	6.00	6.00	6.12	6.18	-	-

	El Salvador		LAC		OECD	
Administrative (%) (5)	**2009**	**2016**	**2009**	**2016**	**2009**	**2016**
Employment in public sector as % of total employment	8.0	13.2	11.3	12.5	21.4	24.6
Share of public sector employment filled by women	45.8	41.7	48.1	50.0	58.4	58.5

II. PERCEPTIONS AND CHARACTERISTICS OF SOCIETY

	El Salvador				LAC (17)			
Citizens' socio-economic status (%)	**Less than USD 4 PPP**	**Vulne-rable**	**Middle Class**	**Affluent**	**Less than USD 4 PPP**	**Vulne-rable**	**Middle Class**	**Affluent**
Share of population by level of income, 2015 (6)	28	50	21	1	24	39	34	3
Share of population by level of income, 2005	42	38	19	1	38	36	24	2

	Low	**Middle Low**	**Middle**	**Middle High**	**High**	**Low**	**Middle Low**	**Middle**	**Middle High**	**High**
Self-perception of social class, 2015 (7)	43.0	31.0	21.2	3.6	1.3	23.1	30.5	40.4	4.3	1.7
Self-perception of social class, 2011	37.8	36.1	18.7	4.9	2.5	24.6	31.0	38.9	4.3	1.3

	El Salvador		LAC		OECD	
Citizens' level of trust (%) (8)	**2006**	**2016**	**2006**	**2016**	**2006**	**2016**
Share of population that perceives corruption as being widespread in the country	64.0	70.0	73.0	79.0	60.0	65.0
Share of population that expresses confidence in the country's judicial system and courts	24.0	24.0	33.0	34.0	50.0	49.0
Share of population that expresses confidence in the national government	37.0	25.0	39.0	29.0	43.0	37.0

	El Salvador		LAC	
Satisfaction with public services (%) (7)	**2010**	**2015**	**2010**	**2015**
Share of people that expresses being "satisfied" or "very satisfied" with public education	76.3	60.5	54.3	53.8
Share of people that expresses being "satisfied" or "very satisfied" with public hospitals	71.3	44.9	48.0	40.7
Share of people that perceive citizen security as being "good" or "very good"	14.8	14.0	16.1	16.0
Share of people that expresses being satisfied with the city (overall) (8)	84.0	76.0	78.0	72.0

	El Salvador		LAC	
Tax morale indicators (7)	**2005**	**2015**	**2005**	**2015**
Tax morale weighted index	8.56	8.16	7.70	7.94
Share of population that declares tax evasion as never justifiable (%)	63.0	56.9	39.2	48.1

III. TOOLS FOR BRIDGING THE GAP STATE-CITIZENS-MARKET

	El Salvador		LAC (17)		OECD	
Efficient	**2004**	**2012-2015**	**2004**	**2012-2015**	**2004**	**2012-2015**
Civil service merit (9)	13.0	33.0	33	45	-	-
	2013		**2013**		**2013**	
Economy-wide Product Market Regulation (10)	2.0		2.40		1.47	
Trustworthy (11)	**2016**		**2016**		**2016**	
Anti-corruption policy (11a)	5.0		5.12		6.91	
Impartial public administration (11b)	3.23		3.68		5.15	
Open and innovative	**2016**		**2016**		**2016**	
OUR (Open, Useful, Reusable Government Data) index (12)	-		0.44		0.56	

	El Salvador		LAC (17)		OECD	
Governance indicators (13)	**2005**	**2015**	**2005**	**2015**	**2005**	**2015**
Voice and accountability	-0.01	0.13	0.12	0.18	1.22	1.12
Political stability and absence of violence/terrorism	-0.03	-0.05	-0.32	-0.09	0.71	0.64
Government effectiveness	-0.32	-0.24	-0.23	-0.17	1.35	1.3
Regulatory quality	-0.05	0.20	-0.11	-0.05	1.28	1.28

	El Salvador		LAC (17)		OECD	
Quality of government (11)	**2005**	**2015**	**2005**	**2015**	**2005**	**2015**
Indicator of quality of government	0.46	0.39	0.45	0.44	0.79	0.78

Footnotes and sources can be found in the technical note at the end of the country notes.

MEXICO

Recent trends in citizens' perceptions

Governance in Mexico continues to improve, according to various indicators. On a scale from -2.5 to 2.5, government effectiveness rose from 0.08 to 0.21 between 2005-15, and regulatory quality increased from 0.28 to 0.4 in the same period. The country is above Latin America and Caribbean (LAC) averages in both indicators (-0.17 and -0.05 respectively), yet below the OECD averages (1.3 and 1.28 respectively). However, in terms of voice and accountability (-0.13) and political stability (-0.87), Mexico is below the LAC averages (0.18 and -0.09, respectively) and the OECD averages (1.12 and 0.64, respectively).

Confidence in public institutions has diminished over the last decade. Notably, 28% of the population expressed confidence in the national government and 32% expressed confidence in the judicial system and courts by 2015. As a result, Mexico ranks below the LAC averages (29% and 34%, respectively) and the OECD averages (37% and 49%). Also, perception of corruption has been rising, increasing 8 percentage points between 2006 (75%) and 2016 (83%). This ranks Mexico above the LAC average (79%) and the OECD average (65%).

Numerous subjective factors affect citizens' quality of life and therefore individual well-being (OECD, 2015). Mexico progressed in terms of citizens' satisfaction with public services between 2010 and 2015. In 2015, 58% of people expressed being very satisfied or satisfied with public education and 46% expressed being very satisfied or satisfied with public hospitals. In this aspect, Mexico is above the LAC averages (54% and 41%, respectively). Over the last decade, one-fourth of the population has remained in the middle class (individuals with a daily per capita income of USD 10-50 PPP). This suggests that Mexico has remained rather stagnant in terms of the material conditions of well-being (i.e. income) and social mobility.

Recent policies to strengthen the state-society link

Mexico has several initiatives to encourage citizen participation in planning and management of public affairs. The government has a National Open Data Policy and is developing a National Digital Platform. The platform will gather information from at least eight public systems to strengthen the fight against corruption.

The Law of Transparency and Access to Information was introduced to help consolidate public institutions through Open Government mechanisms. It primarily aims to improve public management, promote dissemination of information through open and accessible data, strengthen accountability and encourage effective participation of civil society. Similarly, the Law of Administrative Responsibilities aims to establish strict rules surrounding the responsibilities, obligations and sanctions for public servants.

The on-line platform Gob.mx promotes innovation, drives efficiency and transforms processes within the government. It aims to provide citizens with an integrated, accessible and modern government. The National System of Transparency, Access to Public Information and Protection of Personal Data co-ordinates and directs policies that guarantee such rights. Furthermore, the citizen observatory of the participatory budget, introduced in 2015, aims to monitor and evaluate the management of public budgets and resources. The Open Government Guide aims to reduce the gap between government agencies and citizens by making it easier for citizens to participate. It gathers best practices for all government entities to engage the public, and incorporates the principles of transparency, accountability and innovation. The Ministry of Public Administration works with the Ministry of Interior to monitor and evaluate compliance of the guidelines on citizen participation.

Mexico is also implementing the National Anti-Corruption System across its different areas of government. This system helps prevent, detect and punish acts of corruption.

Key indicators: Mexico

I. STATE CAPACITIES

	Mexico		LAC		OECD	
Fiscal	**2005**	**2015**	**2005**	**2015**	**2005**	**2015**
Total tax revenue as % of GDP (1)	12.6	17.4	19.8	22.8	33.6	34.3
	2012		**2012**		**2012**	
Difference in income inequality pre and post-tax and government transfers (2)	0.02		0.03		0.18	

	Mexico		LAC (17)*		OECD	
Legal	**2005**	**2015**	**2005**	**2015**	**2005**	**2015**
Rule of law (3)	-0.41	-0.47	-0.40	-0.37	1.25	1.31
	2006	**2016**	**2006**	**2016**	**2006**	**2016**
Judicial independence (4)	6.00	5.00	6.12	6.18	-	-

	Mexico		LAC		OECD	
Administrative (%) (5)	**2009**	**2016**	**2009**	**2016**	**2009**	**2016**
Employment in public sector as % of total employment	11.8	10.0	11.3	12.5	21.4	24.6
Share of public sector employment filled by women	46.5	49.3	48.1	50.0	58.4	58.5

II. PERCEPTIONS AND CHARACTERISTICS OF SOCIETY

	Mexico				LAC (17)			
Citizens' socio-economic status (%)	**Less than USD 4 PPP**	**Vulne-rable**	**Middle Class**	**Affluent**	**Less than USD 4 PPP**	**Vulne-rable**	**Middle Class**	**Affluent**
Share of population by level of income, 2014 (6)	28	46	25	2	23	39	35	3
Share of population by level of income, 2005	30	42	26	2	38	36	24	2

	Low	**Middle Low**	**Middle**	**Middle High**	**High**	**Low**	**Middle Low**	**Middle**	**Middle High**	**High**
Self-perception of social class, 2015 (7)	26.1	31.6	38.5	2.7	1.1	23.1	30.5	40.4	4.3	1.7
Self-perception of social class, 2011	27.2	31.8	37.6	2.7	0.8	24.6	31.0	38.9	4.3	1.3

	Mexico		LAC		OECD	
Citizens' level of trust (%) (8)	**2006**	**2016**	**2006**	**2016**	**2006**	**2016**
Share of population that perceives corruption as being widespread in the country	75.0	83.0	73.0	79.0	60.0	65.0
Share of population that expresses confidence in the country's judicial system and courts	35.0	32.0	33.0	34.0	50.0	49.0
Share of population that expresses confidence in the national government	43.0	28.0	39.0	29.0	43.0	37.0

	Mexico		LAC	
Satisfaction with public services (%) (7)	**2010**	**2015**	**2010**	**2015**
Share of people that expresses being "satisfied" or "very satisfied" with public education	60.0	57.6	54.3	53.8
Share of people that expresses being "satisfied" or "very satisfied" with public hospitals	48.4	46.0	48.0	40.7
Share of people that perceive citizen security as being "good" or "very good"	10.7	11.5	16.1	16.0
Share of people that expresses being satisfied with the city (overall) (8)	75.0	72.0	78.0	72.0

	Mexico		LAC	
Tax morale indicators (7)	**2005**	**2015**	**2005**	**2015**
Tax morale weighted index	7.52	7.31	7.70	7.94
Share of population that declares tax evasion as never justifiable (%)	39.7	36.0	39.2	48.1

III. TOOLS FOR BRIDGING THE GAP STATE-CITIZENS-MARKET

	Mexico		LAC (17)		OECD	
Efficient	**2004**	**2012-2015**	**2004**	**2012-2015**	**2004**	**2012-2015**
Civil service merit (9)	47.0	40.0	33	45	-	-
	2013		**2013**		**2013**	
Economy-wide Product Market Regulation (10)	1.91		2.40		1.47	
Trustworthy (11)	**2016**		**2016**		**2016**	
Anti-corruption policy (11a)	4.0		5.12		6.91	
Impartial public administration (11b)	2.71		3.68		5.15	
Open and innovative	**2016**		**2016**		**2016**	
OUR (Open, Useful, Reusable Government Data) index (12)	0.66		0.44		0.56	

	Mexico		LAC (17)		OECD	
Governance indicators (13)	**2005**	**2015**	**2005**	**2015**	**2005**	**2015**
Voice and accountability	0.19	-0.13	0.12	0.18	1.22	1.12
Political stability and absence of violence/terrorism	-0.44	-0.87	-0.32	-0.09	0.71	0.64
Government effectiveness	0.08	0.21	-0.23	-0.17	1.35	1.3
Regulatory quality	0.28	0.40	-0.11	-0.05	1.28	1.28

	Mexico		LAC (17)		OECD	
Quality of government (11)	**2005**	**2015**	**2005**	**2015**	**2005**	**2015**
Indicator of quality of government	0.53	0.38	0.45	0.44	0.79	0.78

Footnotes and sources can be found in the technical note at the end of the country notes.

PANAMA

Recent trends in citizens' perceptions

Governance in Panama has improved over the last decade, according to various World Governance Indicators. Notably, on a scale from -2.5 to 2.5, the country has made progress in terms of government effectiveness (from 0.06 to 0.30 in 2005-15), regulatory quality (from 0.19 to 0.37 in 2005-15), political stability (from -0.18 to 0.41 in 2005-15) and voice and accountability (from 0.44 to 0.50 in 2005-15). Regarding these indicators, Panama is above the Latin America and Caribbean (LAC) averages (-0.17, -0.05, -0.09 and 0.18, respectively).

Panama shows mixed though generally positive results in terms of trust in public bodies. Notably, 33% of citizens expressed confidence in the national government in 2016, less than in 2006 (36%); this remains slightly above the LAC average (29%), yet below the OECD average (37%). Conversely, the share of the population in expressing confidence in the judicial system and courts, rose from 37% to 45% in 2006-16; this is significantly above the LAC average (34%) and almost in line with the OECD average (49%). Also, between 2006-16, the share of people perceiving corruption as widespread dropped from 85% to 77%. Such level of perception of corruption in Panama is in line with the LAC average (79%), but above the OECD average (65%).

Several subjective factors affect citizens' quality of life and therefore individual well-being (OECD, 2015). In terms of citizens' satisfaction with public services, Panama has shown a slight deterioration between 2010 and 2015. The share of the population that expressed being satisfied or very satisfied with public education slightly declined from 59% to 57% between 2005-15; this share fell from 53% to 46% regarding public hospitals between 2005-15. However, Panama remains slightly above the LAC averages for these two indicators (54% and 41%, respectively).

Panama has made progress in terms of the material conditions of well-being (i.e. income) and social mobility. The country has been successfully consolidating a wider middle class; 45% of Panamanians in 2015 earned a daily per capita income of USD 10-50 PPP – 11 percentages points more than in 2008 (34%).

Recent policies to strengthen the state-society link

The government has made several legislative attempts to reform Panama's procurement laws to make the administration more transparent and competitive. There are rules for transparency in public management, making information open and available to the public. Thanks to this initiative, public entities must periodically update these public sources and public servants can be sanctioned for non-compliance. Additionally, Panama launched the Single Treasury Account (CUT) in 2015 unifying 5 818 bank accounts held by public entities in local banks. In this way, the state can better manage the liquidity of public funds, increase the effectiveness of the treasury system, streamline payment processing and promote savings to the public treasury.

The National Authority for Transparency and Access to Information was created in 2013 to consolidate and promote specific measures to prevent and combat corruption and a new law was introduced in 2012 to regulate electronic procedures with the state (Law 83 of 2012). In a complementary move, the National Authority for Government Innovation ensures optimal use of information and communication technologies for modernisation of public management. In this regard, two initiatives stand out. *Panama Tramita* (Panama Processes) seeks the integration of the great variety of procedures that different government entities offer to citizens. For its part, *Panama Online* seeks to renew the way in which the citizens deal with the state so that all procedures can be done in an agile and transparent manner. The Government Open Data (DAG) initiative in Panama has made the information generated by public institutions available to citizens, with some exceptions. These data are available without restriction of access and are free to use, re-use and redistribute.

The Regional Anticorruption Academy for Central America and the Caribbean was created five years ago and has been consolidating a stronger presence over recent years in Panama.

Key indicators: Panama

I. STATE CAPACITIES

	Panama		LAC		OECD	
Fiscal	**2005**	**2015**	**2005**	**2015**	**2005**	**2015**
Total tax revenue as % of GDP (1)	14.4	16.2	19.8	22.8	33.6	34.3
	2012		**2012**		**2012**	
Difference in income inequality pre and post-tax and government transfers (2)	-		0.03		0.18	

	Panama		LAC (17)*		OECD	
Legal	**2005**	**2015**	**2005**	**2015**	**2005**	**2015**
Rule of law (3)	-0.1	-0.1	-0.4	-0.37	1.25	1.31
	2006	**2016**	**2006**	**2016**	**2006**	**2016**
Judicial independence (4)	5.00	5.00	6.12	6.18	-	-

	Panama		LAC		OECD	
Administrative (%) (5)	**2009**	**2016**	**2009**	**2016**	**2009**	**2016**
Employment in public sector as % of total employment	14.9	24.6	11.3	12.5	21.4	24.6
Share of public sector employment filled by women	51.2	52.3	48.1	50.0	58.4	58.5

II. PERCEPTIONS AND CHARACTERISTICS OF SOCIETY

	Panama				LAC (17)			
Citizens' socio-economic status (%)	**Less than USD 4 PPP**	**Vulne-rable**	**Middle Class**	**Affluent**	**Less than USD 4 PPP**	**Vulne-rable**	**Middle Class**	**Affluent**
Share of population by level of income, 2015 (6)	17	33	45	5	24	39	34	3
Share of population by level of income, 2008	26	37	34	3	31	39	28	2

	Low	Middle Low	Middle	Middle High	High	Low	Middle Low	Middle	Middle High	High
Self-perception of social class, 2015 (7)	15.2	29.7	47.0	5.2	2.9	23.1	30.5	40.4	4.3	1.7
Self-perception of social class, 2011	12.0	20.7	53.3	10.1	3.8	24.6	31.0	38.9	4.3	1.3

	Panama		LAC		OECD	
Citizens' level of trust (%) (8)	**2006**	**2016**	**2006**	**2016**	**2006**	**2016**
Share of population that perceives corruption as being widespread in the country	85.0	77.0	73.0	79.0	60.0	65.0
Share of population that expresses confidence in the country's judicial system and courts	37.0	45.0	33.0	34.0	50.0	49.0
Share of population that expresses confidence in the national government	36.0	33.0	39.0	29.0	43.0	37.0

	Panama		LAC	
Satisfaction with public services (%) (7)	**2010**	**2015**	**2010**	**2015**
Share of people that expresses being "satisfied" or "very satisfied" with public education	58.7	56.6	54.3	53.8
Share of people that expresses being "satisfied" or "very satisfied" with public hospitals	53.2	45.7	48.0	40.7
Share of people that perceive citizen security as being "good" or "very good"	18.7	13.7	16.1	16.0
Share of people that expresses being satisfied with the city (overall) (8)	83.0	80.0	78.0	72.0

	Panama		LAC	
Tax morale indicators (7)	**2005**	**2015**	**2005**	**2015**
Tax morale weighted index	7.76	7.51	7.70	7.94
Share of population that declares tax evasion as never justifiable (%)	37.0	50.0	39.2	48.1

III. TOOLS FOR BRIDGING THE GAP STATE-CITIZENS-MARKET

	Panama		LAC (17)		OECD	
Efficient	**2004**	**2012-2015**	**2004**	**2012-2015**	**2004**	**2012-2015**
Civil service merit (9)	0.0	20.0	33	45	-	-
	2013		**2013**		**2013**	
Economy-wide Product Market Regulation (10)	2.23		2.40		1.47	
Trustworthy (11)	**2016**		**2016**		**2016**	
Anti-corruption policy (11a)	3.0		5.12		6.91	
Impartial public administration (11b)	-		3.68		5.15	
Open and innovative	**2016**		**2016**		**2016**	
OUR (Open, Useful, Reusable Government Data) index (12)	-		0.44		0.56	

	Panama		LAC (17)		OECD	
Governance indicators (13)	**2005**	**2015**	**2005**	**2015**	**2005**	**2015**
Voice and accountability	0.44	0.50	0.12	0.18	1.22	1.12
Political stability and absence of violence/terrorism	-0.18	0.41	-0.32	-0.09	0.71	0.64
Government effectiveness	0.06	0.30	-0.23	-0.17	1.35	1.3
Regulatory quality	0.19	0.37	-0.11	-0.05	1.28	1.28

	Panama		LAC (17)		OECD	
Quality of government (11)	**2005**	**2015**	**2005**	**2015**	**2005**	**2015**
Indicator of quality of government	0.44	0.44	0.45	0.44	0.79	0.78

Footnotes and sources can be found in the technical note at the end of the country notes.

PARAGUAY

Recent trends in citizens' perceptions

Paraguay has made progress in terms of governance over the last decade. In particular, the country has advanced regarding its quality of government, measured by proxies of corruption, law and order, and bureaucracy quality, which increased from 0.25 to 0.31 over 2005-15 (in the Quality of Government Index which ranges from 0 to 1). Yet the country remains below the Latin American and Caribbean (LAC) average (0.44) and the OECD average (0.78). Similarly, Paraguay has advanced in terms of regulatory quality, political stability and voice and accountability over the last decade, but remains below the LAC and the OECD averages.

The country has remained stagnant in terms of building public trust over the last decade. Confidence of citizens in the national government fell from 31% to 28% over 2006-16. However, the country is in line with the LAC average (29%) and below the OECD average (37%). Similarly, confidence in the judicial system and courts has deteriorated slightly over the last decade. Notably, 75% of the population expressed that corruption was widespread in 2006. In 2016, figures show only a one percentage point decrease.

Individual well-being encompasses several subjective factors that affect citizens' quality of life (OECD, 2015). Satisfaction with public services, for example, has deteriorated in Paraguay over the last decade. In particular, the percentage of the population being satisfied or very satisfied with public education fell from 53% to 44% over 2010-15, well below the LAC average of 54% in 2015. Likewise, the share of the population satisfied or very satisfied with public hospitals fell from 49% to 33% over 2010-15, below the LAC average of 41% in 2015. Paraguay has made quite good progress in terms of the material conditions of well-being (i.e. income) and social mobility, with the middle class (daily per capita income of USD 10-50 PPP) increasing from 22% to 38% in 2005-15.

Recent policies to strengthen the state-society link

Paraguay has several initiatives to strengthen the connection between public institutions and citizens. Under the Third National Action Plan, the incumbent government has made available an online platform of Open Government and another platform for Open Data containing more than 200 data sets from 115 institutions.

The National Development Plan (NDP) 2030 establishes a key transversal objective of making public management more efficient and transparent. Thus the country established a legal framework to guarantee both citizens' free access to public information and government transparency, and the effective exercise of the right to access public information. As of August 2017, 127 government institutions and 35 local governments had adhered themselves to the Access to Information Portal. Furthermore, a recent decree (10044 of 2012) and a new law (5282 of 2014) promote free access to public information and government transparency. They mandate that all Executive Branch agencies must have anti-corruption and access to information offices.

Another priority objective of the NDP 2030 is to reduce corruption in the country through two main actions. First, it seeks to improve transparency and state control mechanisms. Second, it aims to increase participation of beneficiaries and users in monitoring programmes at different levels of government. The creation of the National Anti-Corruption Secretariat and its expansion and strengthening since 2012 has enabled citizens to submit anonymous corruption complaints to an online portal. This, in turn, permits tracking of each complaint submitted. As of 2017, citizens had submitted hundreds of complaints, resulting in 828 investigations, 233 penal cases and 164 administrative audits.

In 2013, the government created the National Secretariat of Information and Communication Technologies. It also introduced a legal framework for the usage of information and communication technologies in the public sector. At the local level, Departmental and Municipal Development Councils have been established in most of the national territory. They aim to involve civil society in decision-making processes and hold elected officials accountable for their practices.

Key indicators: Paraguay

I. STATE CAPACITIES

	Paraguay		LAC		OECD	
Fiscal	**2005**	**2015**	**2005**	**2015**	**2005**	**2015**
Total tax revenue as % of GDP (1)	13.8	17.9	19.8	22.8	33.6	34.3
	2012		**2012**		**2012**	
Difference in income inequality pre and post-tax and government transfers (2)	-		0.03		0.18	

	Paraguay		LAC (17)*		OECD	
Legal	**2005**	**2015**	**2005**	**2015**	**2005**	**2015**
Rule of law (3)	-1.0	-0.7	-0.4	-0.37	1.25	1.31
	2006	**2016**	**2006**	**2016**	**2006**	**2016**
Judicial independence (4)	5.00	5.00	6.12	6.18	-	-

	Paraguay		LAC		OECD	
Administrative (%) (5)	**2009**	**2016**	**2009**	**2016**	**2009**	**2016**
Employment in public sector as % of total employment	8.8	10.1	11.3	12.5	21.4	24.6
Share of public sector employment filled by women	46.7	50.5	48.1	50.0	58.4	58.5

II. PERCEPTIONS AND CHARACTERISTICS OF SOCIETY

	Paraguay				LAC (17)			
Citizens' socio-economic status (%)	**Less than USD 4 PPP**	**Vulne-rable**	**Middle Class**	**Affluent**	**Less than USD 4 PPP**	**Vulne-rable**	**Middle Class**	**Affluent**
Share of population by level of income, 2015 (6)	20	39	38	3	24	39	34	3
Share of population by level of income, 2005	37	40	22	1	38	36	24	2

	Low	**Middle Low**	**Middle**	**Middle High**	**High**	**Low**	**Middle Low**	**Middle**	**Middle High**	**High**
Self-perception of social class, 2015 (7)	15.4	31.6	47.0	5.3	0.8	23.1	30.5	40.4	4.3	1.7
Self-perception of social class, 2011	19.6	30.7	44.3	4.5	0.9	24.6	31.0	38.9	4.3	1.3

	Paraguay		LAC		OECD	
Citizens' level of trust (%) (8)	**2006**	**2016**	**2006**	**2016**	**2006**	**2016**
Share of population that perceives corruption as being widespread in the country	75.0	74.0	73.0	79.0	60.0	65.0
Share of population that expresses confidence in the country's judicial system and courts	31.0	28.0	33.0	34.0	50.0	49.0
Share of population that expresses confidence in the national government	31.0	28.0	39.0	29.0	43.0	37.0

	Paraguay		LAC	
Satisfaction with public services (%) (7)	**2010**	**2015**	**2010**	**2015**
Share of people that expresses being "satisfied" or "very satisfied" with public education	53.1	43.7	54.3	53.8
Share of people that expresses being "satisfied" or "very satisfied" with public hospitals	48.6	33.2	48.0	40.7
Share of people that perceive citizen security as being "good" or "very good"	17.4	5.2	16.1	16.0
Share of people that expresses being satisfied with the city (overall) (8)	86.0	90.0	78.0	72.0

	Paraguay		LAC	
Tax morale indicators (7)	**2005**	**2015**	**2005**	**2015**
Tax morale weighted index	8.07	7.56	7.70	7.94
Share of population that declares tax evasion as never justifiable (%)	43.8	35.2	39.2	48.1

III. TOOLS FOR BRIDGING THE GAP STATE-CITIZENS-MARKET

	Paraguay		LAC (17)		OECD	
Efficient	**2004**	**2012-2015**	**2004**	**2012-2015**	**2004**	**2012-2015**
Civil service merit (9)	13.0	40.0	33	45	-	-
	2013		**2013**		**2013**	
Economy-wide Product Market Regulation (10)	2.45		2.40		1.47	
Trustworthy (11)	**2016**		**2016**		**2016**	
Anti-corruption policy (11a)	5.0		5.12		6.91	
Impartial public administration (11b)	-		3.68		5.15	
Open and innovative	**2016**		**2016**		**2016**	
OUR (Open, Useful, Reusable Government Data) index (12)	0.62		0.44		0.56	

	Paraguay		LAC (17)		OECD	
Governance indicators (13)	**2005**	**2015**	**2005**	**2015**	**2005**	**2015**
Voice and accountability	-0.41	-0.12	0.12	0.18	1.22	1.12
Political stability and absence of violence/terrorism	-0.64	-0.02	-0.32	-0.09	0.71	0.64
Government effectiveness	-0.79	-0.95	-0.23	-0.17	1.35	1.3
Regulatory quality	-0.82	-0.27	-0.11	-0.05	1.28	1.28

	Paraguay		LAC (17)		OECD	
Quality of government (11)	**2005**	**2015**	**2005**	**2015**	**2005**	**2015**
Indicator of quality of government	0.25	0.31	0.45	0.44	0.79	0.78

Footnotes and sources can be found in the technical note at the end of the country notes.

PERU

Recent trends in citizens' perceptions

Peru has made positive progress concerning governance over the last decade. Particularly, the country improved in terms of various governance indicators, namely government effectiveness, regulatory quality, political stability and voice and accountability. Peru has also improved relative to citizens' trust in public institutions. Notably, 28% of people in Peru expressed confidence in the national government in 2016, an improvement from 2006 (17%), but still below the LAC average (29%) and the OECD average (37%). Similarly, confidence in the country's judicial systems and courts improved by 7 percentage points, increasing from 14% to 21% over 2006-16, but still remains well below the LAC average in 2016 (34%). Over the same period, fewer people expressed the belief that corruption is widespread in the country. The share decreased from 89% to 83%, but still lies above the LAC average of 79%.

Individual well-being encompasses several subjective factors that affect citizens' quality of life (OECD, 2015). With this in mind, 32% of the population expressed being satisfied or very satisfied with public hospitals in 2015 (an increase of almost 7 percentage points from 2005). Similarly, 36% of population expressed being satisfied or very satisfied with public education in 2015, which is 3 percentage points above results in 2005. Nonetheless, these indicators are well below the LAC average, suggesting that great challenges remain regarding the delivery of public services in the country.

Peru has made great progress in terms of the material conditions of well-being (i.e. income) and social mobility over the last decade. The country has been consolidating a wider middle class (daily per capita income of USD 10-50 PPP) that accounted for 37% of the population in 2015, up from a level of 18% in 2005.

Recent policies to strengthen the state-society link

Peru is pursuing an agenda to connect citizens with public institutions and promote more inclusive development. This agenda focuses on citizen safety, the fight against corruption, better delivery of water and sanitation, and a citizen-oriented government service reform. Among other initiatives, the Information Analysis Unit created the Anti-Corruption Observatory of Peru. The government also approved creation of the Public Prosecutor's office specialised in crimes of corruption. Additionally, a high-level team was created to facilitate, co-ordinate and prioritise government actions towards achievement of better services and care to citizens.

All government entities have to carry out the Citizen Care Quality Assessment. This new framework also establishes a team that will continually focus on identifying and simplifying obsolete procedures in each sector, as well as reducing administrative burdens. To improve and simplify service delivery, the government wants to further expand the Centres of Better Attention to the Citizen.

The country has promoted, together with Chile, the creation of the LAC Public Integrity Network with the support of the OECD and the Inter-American Development Bank. This network aims at supporting other countries in the region to exchange ideas, experiences and lessons learned. Together, the partners wish to find solutions to common challenges in the implementation of public integrity policies.

The government of Peru recently launched gob.pe, a user friendly version of its Portal of Services to Citizens and Companies that aims to group all state-run procedures to both citizens and firms in one place. Furthermore, the government of Peru has been making the open data portal more accessible and operational. It has also enhanced the Digital Government Secretariat, which proposes national policies and strategies in the field of e-Government. Finally, Peru is developing data and studies nationwide to produce evidence-based policies, which are expected to improve effectiveness and efficiency in public organisations.

Key indicators: Peru

I. STATE CAPACITIES

	Peru		LAC		OECD	
Fiscal	**2005**	**2015**	**2005**	**2015**	**2005**	**2015**
Total tax revenue as % of GDP (1)	16.5	17.1	19.8	22.8	33.6	34.3
	2012		**2012**		**2012**	
Difference in income inequality pre and post-tax and government transfers (2)	0.01		0.03		0.18	

	Peru		LAC (17)*		OECD	
Legal	**2005**	**2015**	**2005**	**2015**	**2005**	**2015**
Rule of law (3)	-0.7	-0.5	-0.4	-0.37	1.25	1.31
	2006	**2016**	**2006**	**2016**	**2006**	**2016**
Judicial independence (4)	6.00	6.00	6.12	6.18	-	-

	Peru		LAC		OECD	
Administrative (%) (5)	**2009**	**2016**	**2009**	**2016**	**2009**	**2016**
Employment in public sector as % of total employment	8.7	8.4	11.3	12.5	21.4	24.6
Share of public sector employment filled by women	43.3	47.9	48.1	50.0	58.4	58.5

II. PERCEPTIONS AND CHARACTERISTICS OF SOCIETY

	Peru				LAC (17)			
Citizens' socio-economic status (%)	**Less than USD 4 PPP**	**Vulne-rable**	**Middle Class**	**Affluent**	**Less than USD 4 PPP**	**Vulne-rable**	**Middle Class**	**Affluent**
Share of population by level of income, 2015 (6)	19	42	37	2	24	39	34	3
Share of population by level of income, 2005	46	35	18	1	38	36	24	2

	Low	Middle Low	Middle	Middle High	High	Low	Middle Low	Middle	Middle High	High
Self-perception of social class, 2015 (7)	22.9	28.7	39.5	6.6	2.3	23.1	30.5	40.4	4.3	1.7
Self-perception of social class, 2011	21.9	31.9	42.2	3.6	0.5	24.6	31.0	38.9	4.3	1.3

	Peru		LAC		OECD	
Citizens' level of trust (%) (8)	**2006**	**2016**	**2006**	**2016**	**2006**	**2016**
Share of population that perceives corruption as being widespread in the country	89.0	83.0	73.0	79.0	60.0	65.0
Share of population that expresses confidence in the country's judicial system and courts	14.0	21.0	33.0	34.0	50.0	49.0
Share of population that expresses confidence in the national government	17.0	28.0	39.0	29.0	43.0	37.0

	Peru		LAC	
Satisfaction with public services (%) (7)	**2010**	**2015**	**2010**	**2015**
Share of people that expresses being "satisfied" or "very satisfied" with public education	33.1	36.4	54.3	53.8
Share of people that expresses being "satisfied" or "very satisfied" with public hospitals	25.3	32.0	48.0	40.7
Share of people that perceive citizen security as being "good" or "very good"	5.6	8.9	16.1	16.0
Share of people that expresses being satisfied with the city (overall) (8)	77.0	69.0	78.0	72.0

	Peru		LAC	
Tax morale indicators (7)	**2005**	**2015**	**2005**	**2015**
Tax morale weighted index	7.37	7.85	7.70	7.94
Share of population that declares tax evasion as never justifiable (%)	27.7	31.7	39.2	48.1

III. TOOLS FOR BRIDGING THE GAP STATE-CITIZENS-MARKET

	Peru		LAC (17)		OECD	
Efficient	**2004**	**2012-2015**	**2004**	**2012-2015**	**2004**	**2012-2015**
Civil service merit (9)	20.0	53.0	33	45	-	-
	2013		**2013**		**2013**	
Economy-wide Product Market Regulation (10)	1.66		2.40		1.47	
Trustworthy (11)	**2016**		**2016**		**2016**	
Anti-corruption policy (11a)	6.0		5.12		6.91	
Impartial public administration (11b)	3.93		3.68		5.15	
Open and innovative	**2016**		**2016**		**2016**	
OUR (Open, Useful, Reusable Government Data) index (12)	0.49		0.44		0.56	

	Peru		LAC (17)		OECD	
Governance indicators (13)	**2005**	**2015**	**2005**	**2015**	**2005**	**2015**
Voice and accountability	-0.02	0.16	0.12	0.18	1.22	1.12
Political stability and absence of violence/terrorism	-0.98	-0.51	-0.32	-0.09	0.71	0.64
Government effectiveness	-0.60	-0.28	-0.23	-0.17	1.35	1.3
Regulatory quality	0.08	0.49	-0.11	-0.05	1.28	1.28

	Peru		LAC (17)		OECD	
Quality of government (11)	**2005**	**2015**	**2005**	**2015**	**2005**	**2015**
Indicator of quality of government	0.47	0.44	0.45	0.44	0.79	0.78

Footnotes and sources can be found in the technical note at the end of the country notes.

URUGUAY

Recent trends in citizens' perceptions

Uruguay has made some advancement in terms of governance over the last decade. Particularly, the quality of government, measured by the Quality of Government Index, which ranges from 0 to 1 and includes proxies of corruption, law and order, and bureaucracy quality, increased from 0.47 to 0.56 between 2005 and 2015. Uruguay is above the Latin America and Caribbean (LAC) average (0.44), yet below the OECD average (0.78).

Uruguay ranks among the countries with the highest level of citizens' trust in the national government (42%), well above the LAC average (29%) and the OECD average (37%). Similarly, regarding confidence in the country's judicial system and courts, Uruguay (41%) is slightly above the LAC average (34%), yet below the OECD average (49%). Still, Uruguayans' confidence in the national government, judicial system and courts has decreased over the last decade. Similarly, citizens' perception of corruption seems to be rising, shifting from 32% to 54% over 2006-16. Nevertheless, the share of population that perceives corruption as widespread in the country is lower than both the LAC average (79%) and the OECD average (65%).

Beyond material conditions, individual well-being encompasses several subjective factors that affect citizens' quality of life (OECD, 2015). In terms of satisfaction with public services, Uruguay has a mixed performance over the last decade. The share of people that express being very satisfied or satisfied with public education decreased from 60% to 52% over 2005-15. This places the country slightly below the LAC average (54%). Nonetheless, people expressing being very satisfied or satisfied with public hospitals increased slightly over the same period from 66% to 67%. This is significantly above the LAC average (41%). On the other hand, Uruguay has made substantial progress in terms of material conditions of well-being (i.e. income) and social mobility over the last decade. Notably, the middle class (daily per capita income of USD 10-50 PPP) jumped from 37% to 61% of the population in the period 2005-15.

Recent policies to strengthen the state-society link

Uruguay has taken successful steps to promote citizen participation, which include laws, regulatory frameworks and innovative tools. Within the framework of the Sustainable Development Goals, and with respect to transparency, governance and access to information, Uruguay is committed to three main goals: reducing corruption and bribery in all its forms; creating accountable and effective institutions at all levels; and ensuring public access to information and protection of fundamental freedoms, in accordance with national laws and international agreements.

There have been several legal reforms to favour government transparency. In 2008, the government established regulations to strengthen transparency and facilitate public access to information. As a result of this framework, public entities must publish information in an open data format to help interested people gain broad and easy access. In addition, the government created the Unit for Access to Public Information in 2009. Finally, the government created the Public Transparency and Ethics Board to oversee the fight against corruption. It advises the criminal justice system in seeking retribution against high-level civil servants for crimes against the public administration and treasury.

Uruguay has defined a National Open Government Action Plan to promote electronic government initiatives through two bodies: the Electronic Government Agency and the Information and Knowledge Society. These bodies aim to promote an efficient and citizen-centred state and a new form of citizenship through the introduction, appropriation and good use of information and communication technologies.

Furthermore, Uruguay has implemented strong anti-corruption laws, introducing strict rules on conduct of civil servants, affidavits, advertising of contracts and the applicable criminal law.

Key indicators: Uruguay

I. STATE CAPACITIES

	Uruguay		LAC		OECD	
Fiscal	**2005**	**2015**	**2005**	**2015**	**2005**	**2015**
Total tax revenue as % of GDP (1)	23.9	27.0	19.8	22.8	33.6	34.3
	2012		**2012**		**2012**	
Difference in income inequality pre and post-tax and government transfers (2)	0.07		0.03		0.18	

	Uruguay		LAC (17)*		OECD	
Legal	**2005**	**2015**	**2005**	**2015**	**2005**	**2015**
Rule of law (3)	0.43	0.68	-0.4	-0.37	1.25	1.31
	2006	**2016**	**2006**	**2016**	**2006**	**2016**
Judicial independence (4)	10.00	10.00	6.12	6.18	-	-

	Uruguay		LAC		OECD	
Administrative (%) (5)	**2009**	**2016**	**2009**	**2016**	**2009**	**2016**
Employment in public sector as % of total employment	14.3	15.0	11.3	12.5	21.4	24.6
Share of public sector employment filled by women	48.7	52.1	48.1	50.0	58.4	58.5

II. PERCEPTIONS AND CHARACTERISTICS OF SOCIETY

Citizens' socio-economic status (%)	Uruguay				LAC (17)			
	Less than USD 4 PPP	**Vulne-rable**	**Middle Class**	**Affluent**	**Less than USD 4 PPP**	**Vulne-rable**	**Middle Class**	**Affluent**
Share of population by level of income, 2015 (6)	7	27	61	5	24	39	34	3
Share of population by level of income, 2005	22	39	37	2	38	36	24	2

	Low	**Middle Low**	**Middle**	**Middle High**	**High**	**Low**	**Middle Low**	**Middle**	**Middle High**	**High**
Self-perception of social class, 2015 (7)	13.6	32.5	50.0	3.3	0.6	23.1	30.5	40.4	4.3	1.7
Self-perception of social class, 2011	14.2	32.5	49.2	3.5	0.5	24.6	31.0	38.9	4.3	1.3

	Uruguay		LAC		OECD	
Citizens' level of trust (%) (8)	**2006**	**2016**	**2006**	**2016**	**2006**	**2016**
Share of population that perceives corruption as being widespread in the country	32.0	54.0	73.0	79.0	60.0	65.0
Share of population that expresses confidence in the country's judicial system and courts	46.0	41.0	33.0	34.0	50.0	49.0
Share of population that expresses confidence in the national government	65.0	42.0	39.0	29.0	43.0	37.0

	Uruguay		LAC	
Satisfaction with public services (%) (7)	**2010**	**2015**	**2010**	**2015**
Share of people that expresses being "satisfied" or "very satisfied" with public education	59.5	52.0	54.3	53.8
Share of people that expresses being "satisfied" or "very satisfied" with public hospitals	66.1	66.5	48.0	40.7
Share of people that perceive citizen security as being "good" or "very good"	18.1	21.8	16.1	16.0
Share of people that expresses being satisfied with the city (overall) (8)	83.0	77.0	78.0	72.0

	Uruguay		LAC	
Tax morale indicators (7)	**2005**	**2015**	**2005**	**2015**
Tax morale weighted index	7.98	8.91	7.70	7.94
Share of population that declares tax evasion as never justifiable (%)	44.99	71.37	39.2	48.1

III. TOOLS FOR BRIDGING THE GAP STATE-CITIZENS-MARKET

	Uruguay		LAC (17)		OECD	
Efficient	**2004**	**2012-2015**	**2004**	**2012-2015**	**2004**	**2012-2015**
Civil service merit (9)	53.0	73.0	33	45	-	-
	2013		**2013**		**2013**	
Economy-wide Product Market Regulation (10)	2.57		2.40		1.47	
Trustworthy (11)	**2016**		**2016**		**2016**	
Anti-corruption policy (11a)	9.0		5.12		6.91	
Impartial public administration (11b)	5.41		3.68		5.15	
Open and innovative	**2016**		**2016**		**2016**	
OUR (Open, Useful, Reusable Government Data) index (12)	0.72		0.44		0.56	

	Uruguay		LAC (17)		OECD	
Governance indicators (13)	**2005**	**2015**	**2005**	**2015**	**2005**	**2015**
Voice and accountability	0.89	1.12	0.12	0.18	1.22	1.12
Political stability and absence of violence/terrorism	0.79	0.99	-0.32	-0.09	0.71	0.64
Government effectiveness	0.51	0.54	-0.23	-0.17	1.35	1.3
Regulatory quality	0.34	0.45	-0.11	-0.05	1.28	1.28

	Uruguay		LAC (17)		OECD	
Quality of government (11)	**2005**	**2015**	**2005**	**2015**	**2005**	**2015**
Indicator of quality of government	0.47	0.56	0.45	0.44	0.79	0.78

Footnotes and sources can be found in the technical note at the end of the country notes.

Technical notes

1. Source: OECD (2017), *Revenue Statistics in Latin America and the Caribbean 2017*. Excludes local government revenues. The LAC average represents a group of 24 Latin American and Caribbean countries. The average is calculated using calendar year data, except for the Bahamas, and Trinidad and Tobago, where fiscal year data are used. The OECD average is calculated by applying the unweighted average percentage change for 2015 in the 32 countries providing data for that year to the overall average tax to GDP ratio in 2014.
2. Source: For LAC countries: Lustig (2016); for OECD countries: *Income Distribution Database*. The LAC average represents a group of 12 Latin American and Caribbean countries that include: El Salvador, Uruguay, Argentina, Brazil, Chile, Ecuador, Costa Rica, Mexico, Colombia, Bolivia, Peru and Guatemala. Inequality is measured by the Gini coefficient.
3. Source: World Bank (2016), *World Governance Indicators*. The Rule of Law indicator reflects perceptions of the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, property rights, the police and the courts, as well as the likelihood of crime and violence. This indicator ranges from -2.5 (weak) to 2.5 (strong) in terms of government performance.
4. Source: BTI (2017).
5. Source: OECD (2016) and the International Labour Organization's ILOSTAT database. Data for Argentina are for 2010 and 2014 rather than 2009 and 2016. Data for Brazil are for 2011 rather than 2009. Data for Costa Rica are for 2010 rather than 2009. Data for the Dominican Republic are for 2014 rather than 2016. LAC average includes Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, the Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Panama, Paraguay, Peru, Uruguay and Venezuela. Data for Argentina refer to urban areas only. OECD average includes Australia, Belgium, Canada, Chile, Denmark, Estonia, Finland, France, Greece, Hungary, Ireland, Japan, Latvia, Mexico, Norway, Poland, the Slovak Republic, Slovenia, Spain, Sweden, Switzerland and the United Kingdom due to missing time-series.
6. Source: LAC Equity Lab tabulations of SEDLAC (CEDLAS and the World Bank) and World Development Indicators (WDI), 2017. The LAC aggregate is based on 17 countries in the region for which microdata are available. According to the classes defined by the World Bank, individuals are categorised according to their daily income in the following way: poor when income is less than USD 4, vulnerable when income is between USD 4-10, middle class when income is between USD 10-50, and rich when income is more than USD 50. All monetary values are reported as USD in 2005 purchasing power parity. Data for Argentina and Uruguay refer to urban areas only.
7. Source: Latinobarómetro (2015). The Tax Morale indicators shown here are based on the question "Based on a scale from 1 to 10, where 1 is 'not justifiable at all' and 10 is 'totally justifiable', how justifiable do you think it is to evade taxes?".
8. Source: Gallup (2017).
9. Source: IDB (2014). Scale 0 to 100, with 100 being the best possible score.
10. Source: OECD Product Market Regulation Database for the OECD average; OECD-WBG Product Market Regulation Database, 2016. Scaled 0 to 6, with 6 being the most restrictive.
11. Source: Dahlberg et al. (2017), The Quality of Government Basic Dataset, version Jan. 17, University of Gothenburg: The Quality of Government Institute, www.qog.pol.gu.se doi:10.18157/QoGBasJan17.

11a. The Anti-Corruption Policy indicator oscillates between 1 and 10, according to what extent the incumbent government is successful (10) or fails (0) in containing corruption and all integrity mechanisms are in place and effective.

11b. The Impartial Public Administration index measures the extent to which government institutions exercise their power impartially and oscillates between 1 and 10.

12. Source: OECD Survey on Open Government Data 2.0. Data for Chile, Colombia and Mexico refer to 2014 rather than 2016. Composite index, from 0 lowest to 1 highest.
13. Source: World Bank (2016), *World Governance Indicators*. All governance indicators range from -2.5 (weak) to 2.5 (strong) in terms of government performance.

    * The LAC 17 average includes 17 countries: Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, the Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, Uruguay.

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Latin American Economic Outlook 2018

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