



Better Policies Series

PROMOTING PRODUCTIVITY FOR INCLUSIVE GROWTH IN LATIN AMERICA









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OECD

BETTER POLICIES FOR BETTER LIVES

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On 7 January 2016 Argentina's National Institute of Statistics and Census published an official decree (https://www.boletinoficial.gob.ar/pdf/linkQR/QlFlS1dmVmpOWXMrdTVReEh2ZkU0dz09) temporarily suspending the publication of certain data in the National Statistics System. As a result, figures for Argentina contained in this publication should be treated with caution.

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Foreword

The 21st century has so far seen Latin America and the Caribbean make great strides in terms of social and economic development. Even after the global financial crisis struck, growth in the region held up rather well. The combination of relatively strong GDP growth and policy innovations to tackle poverty and inequality has delivered broad-based improvements in living standards.

Notwithstanding recent improvements in Latin America and the Caribbean, the region still has the highest income inequality in the world. While unemployment in the region is relatively low – and its workers put in long hours – there is a very high incidence of informality, and the productivity gap with respect to more advanced economies is daunting. Even in Chile, the best performing country in the region, labour productivity is around one-third less than the OECD average. And as the external economic environment has recently become more challenging, underlying structural weaknesses in many of the region's economies have become more visible, with some countries having experienced very low or even negative real GDP growth.

These twin challenges – large productivity and inclusion gaps – underline the imperative for urgent action. The challenge for governments in the region is to put their economies back on a stronger, fairer and more sustainable growth trajectory by undertaking comprehensive structural reforms. This Better Policies Series brochure aims to help the region with this endeavour by identifying reform priorities in six policy areas: human capital, labour market, business environment, innovation, infrastructure and public governance. Focusing mainly on the more advanced countries in the region, it draws on successful initiatives and best practices from across the region and beyond.

The brochure has been prepared on the occasion of the launch of the Latin America and the Caribbean Regional Programme at the OECD's 2016 Ministerial Council Meeting. The launch of this programme marks the latest of several milestones in the organisation's deepening engagement with the region. The OECD is already extensively working with Mexico and Chile, which are both members of the organisation, as well as Colombia and Costa Rica, which are in the process to accession. Peru participates in an OECD Country Programme, and Brazil, one of our Key Partners, recently signed a Co-operation Programme with the organisation. Ten countries from Latin America and the Caribbean are members of our Development Centre, and the number of countries from the region participating in our committee meetings and through adherence to OECD instruments is constantly rising.

The new Regional Programme will provide a platform for policy dialogue at both a high political level and at the technical level and will provide policy advice tailored to the needs of countries and subregions. We look forward to the opportunity that this Programme offers for increasing OECD co-operation with governments in Latin America and the Caribbean, in order to design, develop and deliver better policies for better lives across the region.



Angel Gurría
Secretary-General, OECD

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1 Introduction

After a period of relatively robust growth that has allowed tens of millions of poorer households to join the global middle class, growth in Latin America has slowed recently, partly as a result of external factors. To close the still large gaps in living standards in relation to advanced economies, the region needs to significantly raise productivity growth while making sure that everybody has the opportunity to benefit from it. This will require comprehensive structural reforms, supported by a pro-productivity policy framework that incorporates social inclusion considerations from the outset.

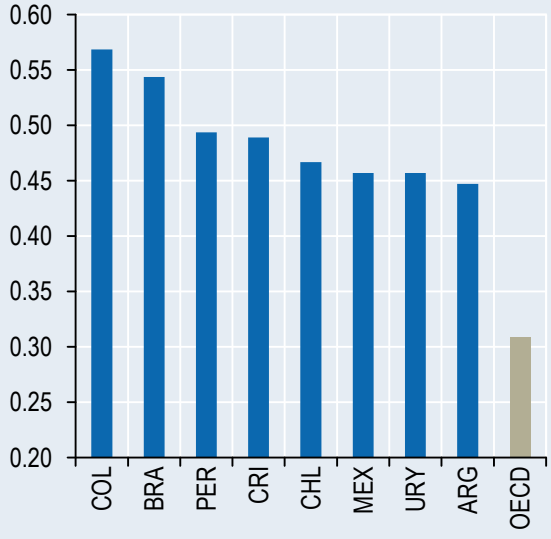
Growth in Latin America and the Caribbean has recently started to slow down

Between 2000 and 2014, average GDP growth in Latin America and the Caribbean amounted to over 3% per year. Bucking global trends, income inequality also declined in many countries in the region during this period, not least due to policy innovations like Brazil's *Bolsa Familia*. The same applies to poverty. Extreme poverty fell from 29% to 16% in 2013, and moderate poverty from 17% to 14% over the same period. However, income inequality in the region (as measured by the Gini coefficient) remains high (Lustig, 2016; Figure 1.1, Panel A), and it is 65% higher than in high-income countries, 36% higher than in East Asian countries, and 18% higher than in sub-Saharan Africa (UNDP, 2010).

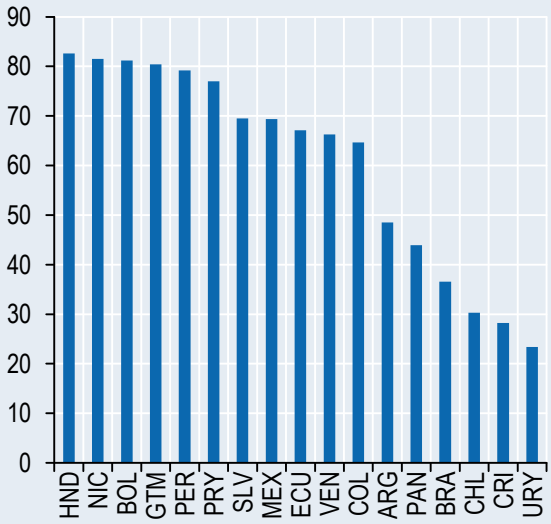
More recently, the region as a whole has faced a barrage of external challenges as the commodity super-cycle ebbs, Chinese growth slows, and US monetary policy approaches normalisation. Notwithstanding intra-regional heterogeneity, convergence in living standards towards those in advanced countries has therefore slowed, or even gone into reverse in some countries. The region as a whole grew by only 1% in 2014, well below the 5% growth rates seen in the mid-2000s. It is expected to have contracted slightly in 2015 before expanding modestly in 2016, albeit at a rate below the OECD average.

FIGURE 1.1. **INEQUALITIES REMAIN HIGH IN MOST LATIN AMERICAN COUNTRIES**

A. Gini coefficient from 0 (perfect equality) to 1 (perfect inequality), 2012 or latest available year



B. Informal workers in % of all workers, around 2013

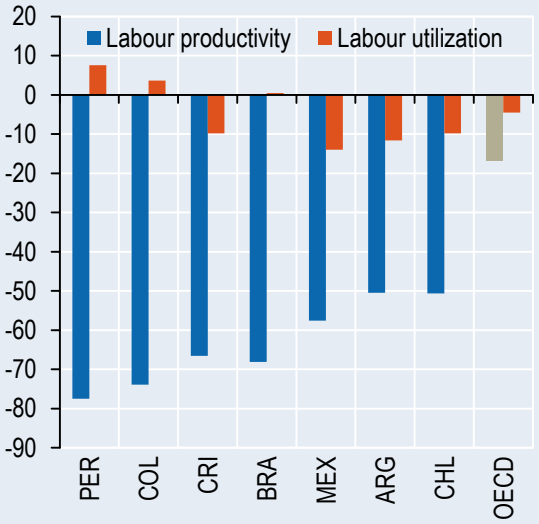


Note: Informal workers are defined as workers not contributing to a mandatory pension scheme.

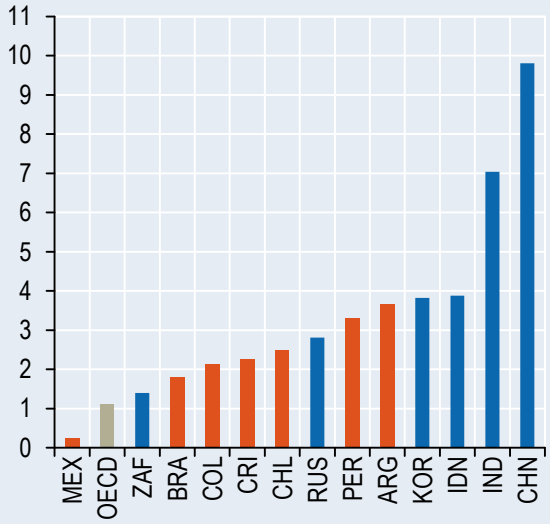
Sources: OECD Income Distribution Database (www.oecd.org/social/income-distribution-database.htm); Inter-American Development Bank Labour Markets and Social Security Information System (SIMS) based on household surveys; and Lustig, N. (2016), "El impacto del sistema tributario y el gasto social en la distribución del ingreso y la pobreza en América Latina: Argentina, Bolivia, Brasil, Chile, Colombia, Costa Rica, Ecuador, El Salvador, Guatemala, Honduras, México, Perú y Uruguay", CEQ Working Paper No. 47, Commitment to Equity Institute, Tulane University, forthcoming in El Trimestre Económico, Fondo de Cultura Económica.

FIGURE 1.2. **GDP PER CAPITA GAPS WITH ADVANCED COUNTRIES ARE MAINLY DUE TO LOWER LABOUR PRODUCTIVITY**

A. Percentage difference in levels with the OECD average, 2014



B. Average annual labour productivity growth, 2004-14



Note: In Panel A, labour productivity is measured as GDP per employee. Labour resource utilisation is measured as the share of employment in the total population. In Panel B, labour productivity is measured as GDP per hour worked.

Sources: OECD National Accounts Database; OECD Economic Outlook Database.

Moreover, the previously benign external environment had in many cases shielded countries from pressures to introduce the structural reforms and make the investments necessary, as the bedrock of sustainable and inclusive prosperity. To cite just one example, individuals with fewer skills are often confined to operate in low-productivity, precarious jobs, frequently in the informal economy (Figure 1.1, Panel B).

Increasing productivity and inclusiveness are key challenges for Latin America

In Latin America, as in most emerging-market economies, raising productivity growth is key to closing the large gap in living standards in relation to advanced economies, and thereby escaping the middle-income trap. Official statistics suggest that, on average, Latin Americans spend more time in work activities than the OECD average, but that this comparatively high contribution of labour resource utilisation to GDP per capita is more than offset by the huge gap in productivity levels (Figure 1.2, Panel A). A look at the average labour productivity performance over the past decade shows that in most cases, productivity has barely grown fast enough to keep pace with advanced economies, let alone to significantly close the gap (Figure 1.2, Panel B).

These twin challenges – of closing the inclusivity and productivity gaps – underscore the challenges that governments now face in addressing deep structural weaknesses that recent external headwinds have laid bare. When promoting productivity growth, policy makers need to embrace policies that focus on a more inclusive concept of productivity growth, one that enables all people and firms to fulfil and raise their productive potential so as to yield improved aggregate productivity growth as well as a more equitable share of the proceeds. This can set in motion a virtuous circle. The past has shown that technological advances, and the related innovations in processes and business models, do not *automatically* diffuse throughout an economy to yield broad-based and sustainable economic growth, nor will gains in well-being necessarily be broadly shared across regions, firms, and the population. Enhancing productivity for inclusive growth requires a more holistic approach that considers the interactions between well-being, inequalities and productivity.

Improving the skills levels of Latin Americans is crucial to tackle the region's twin challenges

A better use of existing skills among the population will help to increase efficiency and productivity in the near term, but a higher rate of productivity growth will prove difficult to sustain in the longer run without a massive

improvement in educational attainments to raise skills levels (**Section 2**). Inequalities in access to quality education and opportunities to develop skills result in a massive waste of potential talent and contribute to the region's very high degree of income inequality. This problem is reinforced by a low degree of income redistribution, which further entrenches inequalities. While taxes and transfers reduce inequality by 19 Gini points in Europe, for example, the difference is less than two Gini points in Latin America.

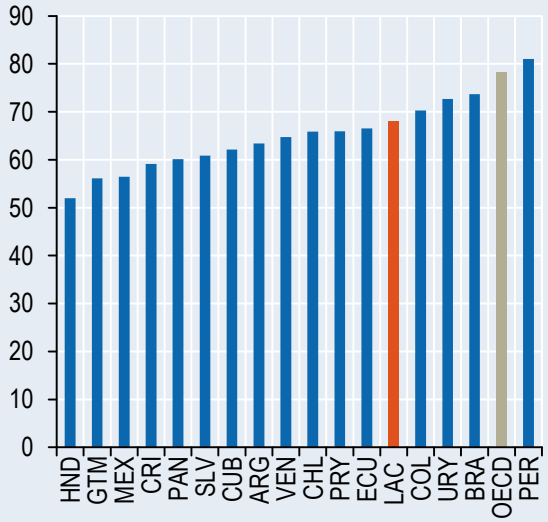
The region suffers from widespread resource misallocation

Another factor contributing to poor productivity performance is the misallocation of resources – the trapping of labour and capital resources in low-productivity firms and sectors as well as the slow process of reallocation towards more dynamic ones. This prevents the most innovative and productive firms from reaching the necessary scale to operate in global markets and fulfilling the high growth potential that comes with the commercialisation of successful ideas. Symptoms of widespread resource misallocation in the region include the large size of the informal economy and the challenge firms face to recruit staff with the necessary skills as well as striking gender inequalities (Figure 1.3). Improving the efficiency of resource allocation will require lowering the barriers to market entry, firm growth and job creation in the formal economy. Boosting formal employment will also contribute to higher job quality, as formal jobs tend to be characterised by higher pay, lower job insecurity and better working conditions than jobs in the informal economy. Increasing job quality in the region is therefore an important objective, not only to increase workers' well-being, but also to enhance their productivity (**Section 3**).

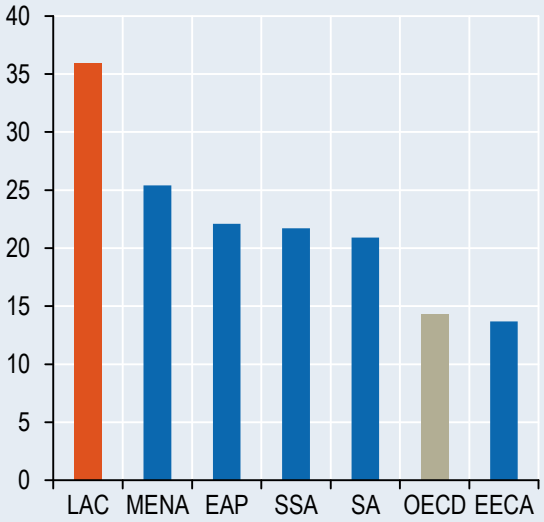
The potential for inclusive productivity gains associated with policy reforms may be largest among Latin America's small and medium-sized enterprises (SMEs). Accounting for some 70% of employment in the region, SMEs generate only 30% of GDP, which is approximately half the OECD average. This reflects particularly large productivity gaps between large and small enterprises. The share of exporting SMEs is also only half of that recorded in Eastern Europe, and one-third lower than in East Asia, suggesting significant scope for gains for SMEs from integrating into regional and global value chains. Yet, SMEs face some specific challenges regarding their ability to participate in international activities, especially in the areas of innovation, compliance with standards, skills and resources, or information gaps. SMEs are also more likely to operate in the informal sector.

FIGURE 1.3. **LATIN AMERICAN COUNTRIES SUFFER FROM AN INEFFICIENT ALLOCATION OF RESOURCES**

A. Ratio of female to male labour-force participation rate, 2014



B. Share of firms identifying an inadequately educated workforce as a major constraint, 2014 or latest available year

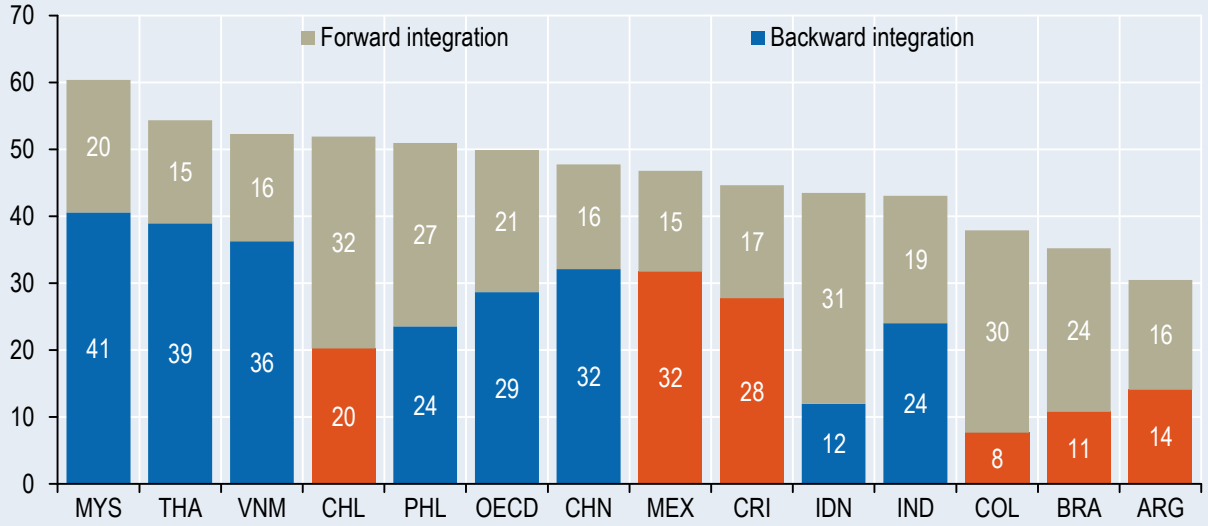


Note: LAC refers to Latin America and the Caribbean, MENA to Middle East and North Africa, EAP to East Asia and Pacific, SSA to Sub-Saharan Africa, SA to South Asia and EECA to Eastern Europe and Central Asia.

Sources: World Bank, World Development Indicators; OECD/CAF/ECLAC (2014), Latin American Economic Outlook 2015: Education, Skills and Innovation for Development, based on enterprise surveys.

FIGURE 1.4. **LATIN AMERICAN COUNTRIES COULD BE BETTER INTEGRATED INTO GLOBAL VALUE CHAINS**

In percent of the country's exports, 2011



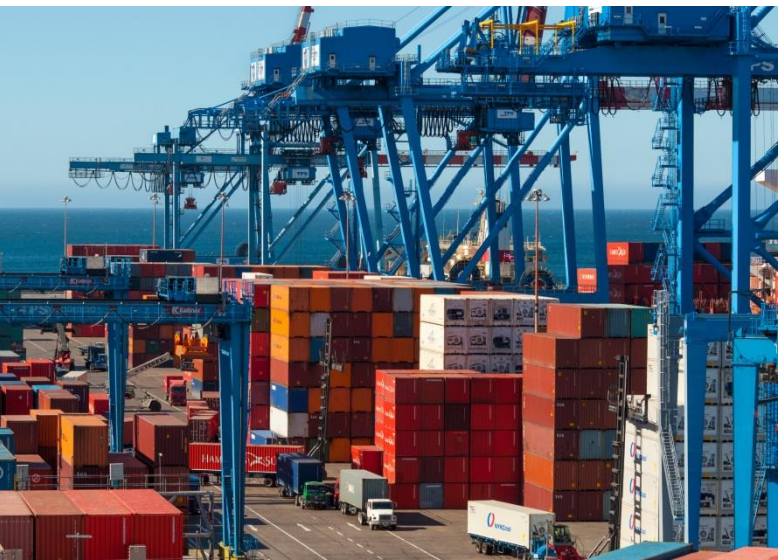
Note: The backward linkage corresponds to the foreign value added that is embodied in a country's exports. The forward linkage corresponds to the domestic value added that is used for other countries' exports.

Source: OECD TiVA Database.

This is partly a result of regulatory and administrative burdens as well as, in some cases, heavy tax burdens. Informality perpetuates inefficiencies, as companies remain small to avoid these burdens (**Section 3**). It also breeds inequalities, as employees in the informal sector do not benefit from social security coverage.

Some Latin American countries are not well integrated into global and regional supply chains

Productivity can also be enhanced by strong connections to external knowledge and technologies via trade, foreign direct investment (FDI), and participation in regional and global value chains (GVCs) as well as the international mobility of skilled labour. For instance, openness to trade and strong participation in GVCs has helped countries from Central and Eastern Europe to maintain high productivity growth and a steady pace of catch- up growth.



In the case of Latin America, the picture is more mixed, with Mexico and Chile being relatively well integrated into GVCs via trade, while Argentina, Brazil and Colombia lag behind (Figure 1.4). Geographic factors such as the distance to large markets and the reliance on natural resource exports explain part of cross-country differences in trade intensity and GVC participation, but the latter are also influenced by regulatory barriers to foreign trade and investment, including in services, which tend to be relatively high in most Latin American countries. There is particular scope to boost intra-regional trade and value chains (**Section 4**).

Weak innovation performance is holding back growth

To a large extent, the disappointing productivity performance of Latin America results from a poor return on investment in physical capital as well as under-investment in intangible assets (Daude and Fernández-Arias, 2010), in particular knowledge-based capital (KBC). One important element for boosting productivity is for national firms to vastly improve their ability to harness the forces of knowledge diffusion from firms operating at the frontier, essentially large multinationals. For this to happen, complementary investments in R&D, skills, organisational know-how (i.e. managerial quality) and other forms of KBC are needed

(OECD, 2015a). Moreover, investment promotion strategies can play an important role (OECD, 2011; OECD, 2015b). Available data indicate that Latin American countries typically trail other emerging economies in R&D spending and other innovation-related investments, contributing to relatively weak innovation ecosystems. Strengthening the region's innovation performance will require mobilising all actors and paying particular attention to SMEs (**Section 5**).

The region's infrastructure is of rather poor quality

Insufficient transport and digital infrastructure also hamper the region's integration into global value chains as well as broader social and economic development (**Section 6**). Transport and logistics costs remain high, with the strong preference for road transport preventing countries from exploiting the comparative advantages of different modes of transport. And measures of digital infrastructure development, such as broadband penetration, put the region well behind OECD countries and emerging economies in Asia. Not only do infrastructure gaps hold back potential growth, but they can also undermine social cohesion by restricting the dividends people can draw from their skills, efforts and experience. Investments are needed to improve intra-regional connectivity. Moreover, all countries could benefit from further improvements in their underlying governance framework for the planning, financing and operation of infrastructure projects.

Trust in government and public institutions is low as a result of weak public governance

Productivity growth and social inclusion are also undermined back by weak public governance and the associated lack of trust in governments and public institutions (**Section 7**). The weaknesses in public governance are explained, in part, by capacity constraints and co-ordination failures across different levels of government. This is particularly problematic given the high level of decentralisation in many Latin American countries. Moreover, bribery and corruption remain widespread, undermining trust in governments and public institutions. Similarly, tax evasion is a common problem in the region, depriving governments of valuable financial resources that are urgently needed to finance public investment and social spending programmes.



2 Improving the human capital base

Broad access to quality education and training is essential for increasing social cohesion and boosting aggregate labour productivity. Developing the skills of young people and adults and preparing them for lifelong learning must therefore be a priority. While Latin American countries have made important progress over the past decade in improving the quality of skills, there is still significant room to do better. In all three subjects tested in the OECD's Programme for International Student Assessment (PISA), the participating countries from Latin America rank in the bottom third of all countries. In addition, the region needs to reduce the wide disparities in people's access to good-quality education and skills. National success requires that everyone has the potential to fully participate in society and share in prosperity.

School enrolment and performance remain low

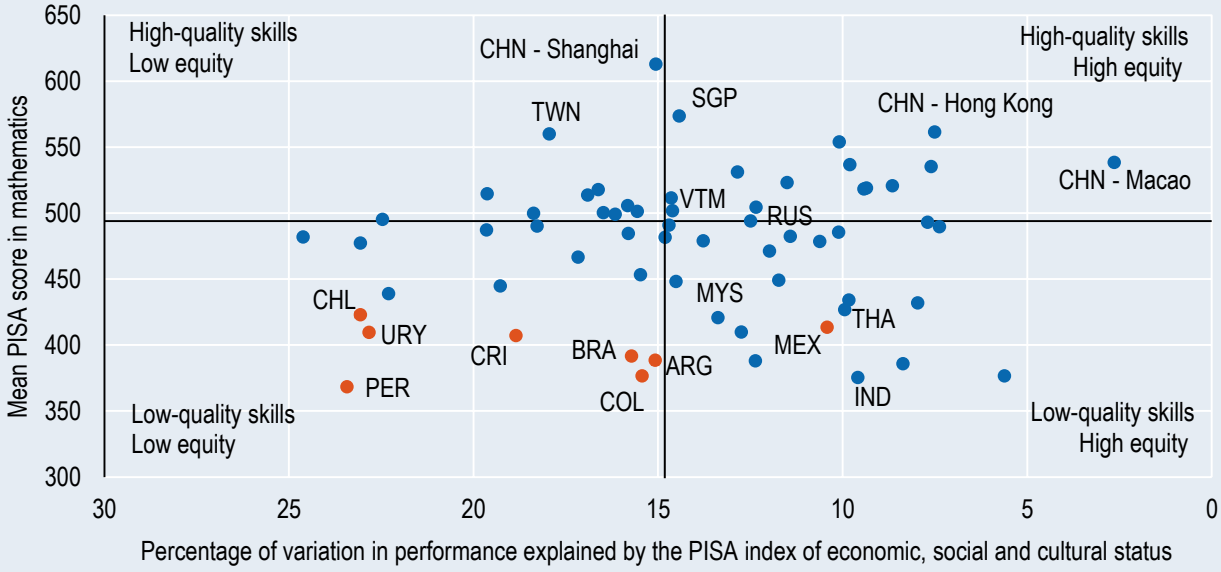
Despite improvements in education outcomes, Latin American countries lag behind the OECD average. School enrolment remains low, both in secondary education (74%, 17 percentage points below the OECD average) and tertiary education (42%, 29 percentage points below the OECD average). The average school performance of 15-year-olds is well below the OECD average, with a gap that is equivalent to almost two years of education. More than half of 15-year-old Latin American students do not acquire the basic level of competencies to perform well in the labour market, and less than 2% of them are "top performers" in mathematics, compared to the average of 13% in OECD countries. This skills gap remains a binding constraint for businesses in Latin America.

Strong disparities in the provision of and access to education are a major challenge

Average skills outcomes hide large dispersions within Latin American countries, where many people suffer from unequal access to good-quality education and skills. Student outcomes in Latin America are more dependent on socio-economic background than the average in OECD countries (Figure 2.1). In Brazil and Costa Rica, for example, children who belong to the bottom income quintile have almost 50% less likelihood to access secondary education than those from the uppermost quintile. Gender and spatial inequalities in the provision of and access to education also pose major challenges.

FIGURE 2.1. **LATIN AMERICAN COUNTRIES HAVE AMPLE ROOM TO BOOST THE QUALITY AND EQUITY OF EDUCATION**

2012



Note: The two black lines depict the OECD averages (494 for the mean PISA score and 14.76 for the strength of the relationship between performance and socioeconomic status).

Source: OECD (2013a), PISA 2012 Results: Excellence Through Equity (Volume II): Giving Every Student the Chance to Succeed.

Latin American countries thus need to build stronger and more suitable skills through the education system and lifelong learning, especially for children and youth in lower-income households. Skills policies also need to focus on demand-side issues, strengthening the linkages between education and the labour market, bolstering technical training programmes and providing guidance on skills needed in the labour market.

A particularly important role is played here by the vocational education and training (VET) system, which should provide good foundation skills, be responsive to the needs of the labour market and have strong elements of work-based learning. Where possible, the social partners should be actively involved in developing VET programmes to make sure they are relevant to current labour market requirements. Countries also need to properly assess and anticipate skills needs, ensuring that this information feeds effectively into policies to reduce skills mismatch and shortage.

Important programs are being implemented in various countries to tackle the problems

A number of initiatives have been launched in Latin American countries in recent years that go in the right direction. In Brazil, the *Bolsa Escola* school-allowance programme and the National Partnership to Strengthen Secondary Education (*Pacto Nacional pelo Fortalecimento do Ensino Médio*) aim to reduce regional inequalities in school access and performance. In Colombia, conditional cash transfer programmes such as *Familias en Acción* and *Estrategia de Cero a Siempre* seek to improve the quality of early childhood education programmes. In Mexico, *Oportunidades*, the cash transfer programme that began in 2002, has already helped to decrease poverty, encourage educational attainment and cushion income. Going forward, it is taking a positive step by completing the conditional transfers with a new programme, *Prospera*, which promotes active labour market policies to improve beneficiaries' productive potential, through tools such as scholarships for college or technical college, priority listing in the National Employment Service for job-seekers and access to financial education, savings, insurance and credit.



Teachers' policies have also been intensified as a key ingredient to boost performance. Brazil has implemented various training programmes for education staff, including the *Profuncionario* programme, and the Peruvian government has recently introduced an incentive mechanism to recognise the performance of teachers. The improvement of assessment frameworks has also been a priority for some countries. One example is the 2012 Pact for Mexico (*Pacto por México*), which has promoted the independence of the National Evaluation Body (*Instituto Nacional para la Evaluación de la Educación)*.

Key recommendations

- Build stronger and more suitable skills through the education system and adult training, with specific attention to lower income households.
- Increase investment in education to improve school infrastructure and the quality of instructional time.
- Promote stringent, transparent recruitment and evaluation procedures for teachers, along with attractive career paths and mobility mechanisms.
- Adopt cost-effective educational measures in the classroom and better feedback from the school principal to teachers.
- Strengthen the linkages between education, training and the labour market.
- Properly assess and anticipate skills needs, ensuring that this information feeds effectively into policies that reduce skills mismatch and shortage.

3 Promoting high-quality jobs

Good jobs are not only important for people's well-being, they can also raise their productivity. Despite improvements over the past decades, many jobs in Latin American countries are still characterised by low pay, strenuous or hazardous working conditions and long working hours. This is particularly true for the large share of the labour force employed in the informal economy, outside the reach of regulation and without access to social protection.

The lack of good quality jobs is a key challenge for the region

Focusing exclusively on how many jobs an economy generates delivers a very partial picture of the situation, since workers' well-being also depends crucially on the quality of their jobs. Moreover, through better access to opportunities for skills development, better health outcomes and higher workers' commitment, better quality jobs can also contribute to higher productivity. This observation appears all the more important in the context of emerging markets, where the main issue is not the lack of jobs as such, but the shortage of quality jobs.

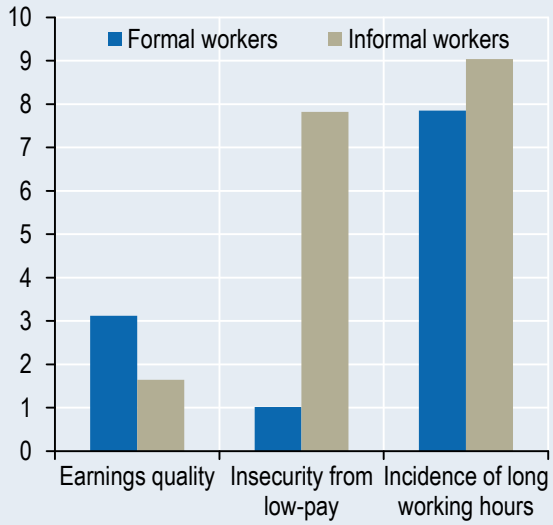
The quality of people's jobs hinges to a large extent on their skill levels. Low-skilled workers are typically in jobs with lower earnings, longer hours, higher insecurity, poorer working conditions and poorer access to training. Data for six Latin American countries show that, on average, low-skilled workers earn one-third of what high-skilled workers do per hour of work, and face combined risks of job loss and extreme low pay that are almost four times higher. Workers in informal jobs – many of whom are low skilled – are particularly affected by poor job-quality (Figure 3.1). In these six Latin American countries, workers in informal jobs – who account on average for more than 1 in 3 workers – lack access to social protection and earn less than two-thirds of what workers in formal occupations earn. They also face a risk of extremely low pay that is nearly eight times higher than for formal workers.

A varied range of programs are available to support people in their career paths and should be used more widely

To help workers get on a good career path early on, policy makers should consider making use of the range of available active labour market programmes, including training schemes and entrepreneurship incentives. Among the structural measures proposed, strengthening the education system, including vocational education and training, should be a priority (**Section 2**). Apprenticeships can also give workers a better start in their careers. The limited evidence available highlights the positive experience of some Latin American countries in this domain, notably Argentina and Mexico, where apprenticeship completion rates reach about 80%. The engagement of employers has also proved a crucial element for the success of apprenticeship schemes. In Brazil, *Aprendiz*

FIGURE 3.1. **INFORMAL WORKERS IN LATIN AMERICA HAVE LOWER QUALITY JOBS**

OECD Job Quality Indicators, 2013



Note: Earnings quality is a combination of average earnings and earnings inequality and insecurity from low pay is the probability of falling below a threshold of extreme low pay (see *OECD Employment Outlook 2015*, Chapter 5 for details). Figures represent country averages across six emerging economies in Latin America (Argentina, Brazil, Chile, Colombia, Costa Rica and Mexico). Figures represent 2013 values, except for Chile (2011) and Mexico (2012).

Source: OECD calculations based on national household and labour force surveys.



Legal, an apprenticeship programme based on a legal requirement for firms to hire apprentices, has been successful in expanding the number of apprenticeships.

More generally, training schemes, job subsidies, entrepreneurship incentives, but also public work programmes, can promote job quality and productivity. In Latin America, specific work schemes and training programmes exist that can complement apprenticeships. They include the BECATE programme in Mexico and the *Joven* programmes in Chile, Argentina and Colombia, which combine education, job training and internships. These programmes have generally been shown to have a positive impact on labour market formality.

Workers need to be better protected against key labour market risks

In promoting access to quality jobs across socio-demographic groups, policy makers in Latin America should also place priority on measures that protect workers against the main labour-market risks they face and increase the quality of their working environment. These include improving social protection schemes and expanding their coverage, as well as enhancing safety standards and labour regulations. The key challenge is to strike the right balance between protection and work incentives. The introduction of a system of unemployment benefits based on individual savings accounts in Chile is a good example of reforms that aim to strengthen the link between benefits and individual incentives.

Reducing informality is a top priority for the region

To promote productivity and improve the quality of jobs in the region, countries can provide better incentives for formal employment. To this end, governments should improve the quality of the public services they deliver. There is also a need to strengthen the link between contributions and benefits in social protection schemes, while ensuring adequate safety nets. Fiscal incentives may also play an important role in promoting formalisation. Simplified tax and administrative systems, streamlined registration processes and a reduction in red tape are important steps to lower the costs of formality for employers and the self-employed. Mexico's new *Regimen de Incorporation Fiscal* includes incentives to join the formal sector, such as reduced personal, social security, value added and excise tax obligations in the initial decade of operation (Dougherty, 2015). Brazil also adopted a number of policy measures to reduce the costs of formality, such as the *Simples Nacional* that introduced a more progressive tax structure and simplified the collection of taxes and social security contributions. It is estimated that these measures contributed to the formalisation of 500 000 microenterprises accounting for 2 million jobs from 2000 to 2005 (Delgado et al., 2007). Finally, Colombia's 2012 tax reform that

reduced taxes and contributions (*Parafiscales*) on labour has had a positive impact on formal job creation.

Latin America needs to catch up with international labour standards

Policy makers also need to enhance the effectiveness of labour laws (including health and safety rules) and working-time regulations, converging to international labour standards. Very often, employment protection legislation in emerging economies is strict in a legal sense, but poor enforcement renders the legislation ineffective. In many Latin American countries, the failure of employers to make legally mandated severance payments, for example, is an important issue. Moreover, labour inspection systems should be given sufficient resources to carry out their work effectively. The number of workers per labour inspector remains very high in countries like Colombia and Mexico (28 000 in Colombia and about 192 000 in Mexico) (OECD, 2015b). In Mexico, the 2012 labour law reform strengthened inspections and increased penalties for non-compliance. It also established mechanisms to expedite justice in labour disputes, and modernised the labour court system. Improved co-ordination among different government agencies is another necessary ingredient for success.

Key recommendations

- Expand access to and make greater use of active labour-market programmes and strengthen the education system.
- Provide incentives, which could include legal requirements, for firms' engagement in active labour-market programmes.
- Increase workers' job security and the quality of their working environment through better social protection schemes and enhanced safety standards and labour regulations.
- Improve the quality of public services and strengthen the link between contributions and benefits in social protection schemes.
- Simplify tax and administrative systems.
- Improve the enforcement of labour laws and regulations, including by equipping labour inspection systems with adequate resources.



4 Putting in place sound, open and competitive business environments

Making Latin America's institutional framework and business climate more conducive to competition, trade and investment can help bridge the large gap in productivity levels in relation to the advanced economies. This could also help boost participation in regional and global value chains, allowing for more economic actors, and SMEs in particular, to share in the gains from trade. There is also scope for well-designed pro-competition product market reforms to improve social inclusion, directly by reducing the prices poorer people pay for basic goods, as well as indirectly through stronger economic growth that boosts the incomes of all households.

Latin America is not yet taking full advantage of global value chains

Global value chains (GVCs) have created opportunities to participate in international commerce without having to develop a complete product or value chain and to draw on knowledge of firms operating at the technological frontier, thereby learning by doing. Latin America has failed to fully seize these opportunities, however, with limited participation in GVCs. Intra-regional supply chain links are particularly weak with only 9% of foreign value added used for exports on average sourced from within the region, as compared to 49% for the European Union and 40% for Southeast Asia.

There are large differences in economic and geographic circumstances across the region, and individual Latin American countries play complementary roles in regional and global supply chains. Mexico and Costa Rica, and, in general, other Central American nations located in greater proximity to North American manufacturing hubs rely more extensively on foreign inputs coming predominantly from North America and increasingly from Asia, and specialise in processing them for further exports, mostly to North America. Importing for processing is less prevalent in Chile and much less in Argentina, Brazil and Colombia. These countries, along with others in South America, tend to specialise more strongly in exporting natural resource-based intermediates which are processed abroad, increasingly in Asia. In fact, the share of foreign inputs from China used in Latin American value chains increased by a factor of ten times between 2000 and 2011, while the share of Latin American inputs into Chinese value chains increased three times, demonstrating the dynamic growth in extra-regional value chains.

There is room to further reduce barriers to international trade

Maximising opportunities for productivity-enhancing growth through better linking into GVCs requires an enabling business and regulatory environment, access to high-quality manufacturing and service sector inputs, as well as adequate human capital and infrastructure (**Sections 2 and 6**). This complementarity and the fact that regional trade tends to be more diversified and settled, suggest that further regional integration holds promise. For example, there are already 68 preferential trade agreements (PTAs) involving at least one Latin American country, while 32 of these are intra-regional. This complicated regional web of PTAs could be usefully consolidated and harmonised in order to reduce overlap, duplication and conflicts of different rules and technical standards. The Pacific Alliance is a notable initiative in this regard. The OECD's Services Trade Restrictive Index (STRI), which covers Brazil, Chile, Colombia, and Mexico, suggests that some countries in the region would benefit from converging towards best practice by further liberalising their services sectors, and by prioritising those sectors like transport, telecommunications and courier services which are crucial to participation in GVCs. Already, Colombia is among the best performers in this regard, having the least restrictions in 5 of the 18 sectors measured, and below average in 17.

Reducing barriers to international trade would contribute to stronger productivity because competition with foreign suppliers would encourage firms to become more efficient. Improvements in the areas of trade facilitation and logistics performance, the quality of infrastructure and institutions, intellectual property protection, workforce development and the creation of an efficient services sector and innovation-friendly business environment

would also support GVC integration.

Diversifying FDI is a priority for the region because of the decline in commodity prices

Foreign direct investment is another important dimension of GVC integration. Overall, Latin America has enjoyed high levels of FDI growth, but it has been highly concentrated in natural resource sectors and is therefore sensitive to commodity cycles. The steep decline in commodity prices has significantly affected investments into many resource-rich countries: after years of sustained growth, FDI flows to Latin America contracted by 12% in 2015, in contrast to a 25% global expansion. The diversification and sophistication of FDI is thus a pressing priority in the region. FDI could also have a significant developmental component to the extent that it supports the integration of SMEs into GVCs and establishes R&D facilities. Although Latin American countries are generally open to FDI, the OECD FDI Regulatory Restrictiveness Index suggests that there is also scope for liberalising policies further in some markets, such as Mexico and Brazil, particularly in services sectors like transport. Some countries, such as Chile are also developing new investment promotion strategies (OECD, 2015c), based on the experience of other countries in the region and globally. These can help attract FDI, but they require policy coherence, transparency and rigorous programme evaluation to achieve intended results (OECD, 2015d).

Latin America needs to implement pro-competitive product market reforms

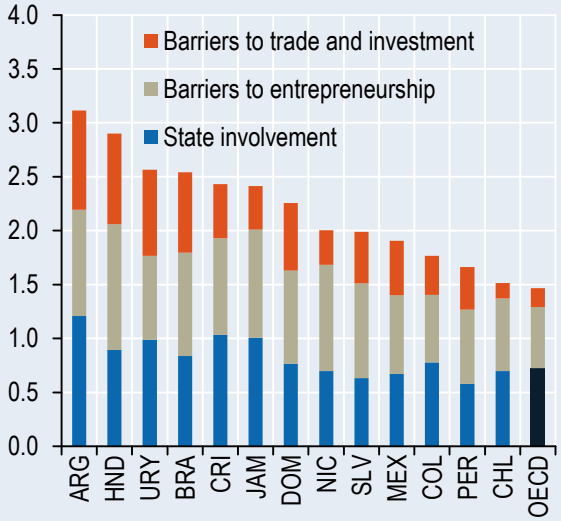
Strengthening competition can boost productivity while supporting social inclusion. Competition brings discipline to firms in terms of costs and strengthens incentives among incumbents to invest in innovative products and services. This benefits consumers in the form of a broader choice of better quality products at a lower price. Insofar as it is mainly young firms that bring growth in jobs and employment, regulatory and other forms of obstacles to new firm entry are particularly damaging to growth and social inclusion.

The impact of reducing competition-hampering regulation is sizable. Moving towards best-practice regulations has the potential to raise GDP by an average of 9% in the OECD and by as much as 30% in some large emerging economies (OECD, 2013b). The scope for such competition-enhancing measures to improve social inclusion outcomes is also illustrated by an OECD study on Mexico that shows that the relative negative effect of monopoly power is greatest among poor households (Urzúa, 2013).

These observations are particularly relevant in a Latin American context. where product market regulations tend to be more restrictive than is typically the case in OECD countries (Figure 4.1). The removal of regulatory restrictions in product markets to stimulate competition, using existing OECD tools, such as the Competition Assessment Toolkit, has been used effectively in several countries, including Mexico.

FIGURE 4.1. **PRODUCT MARKET REGULATIONS TEND TO BE MORE RESTRICTIVE IN LATIN AMERICA**

Scale of 0 to 6,
with 6 being the most restrictive, 2013



Sources: OECD Product Market Regulation Database for the OECD average; OECD-WBG Product Market Regulation Database for all other countries.

Countries in the region have also started to invest in good regulatory practices to improve the quality of regulation (OECD/IDB, forthcoming). Most countries have set the institutional basis by establishing bodies responsible for co-ordinating the government's efforts to improve regulatory quality. While countries have also adopted formal requirements for the use of different regulatory tools, their implementation in practice varies greatly. For instance, stakeholders are not systematically engaged in the development of regulations, and the use of evidence in regulatory impact assessments remains limited in scope and focused on regulatory costs. By



contrast, administrative simplification measures are very common in the region, even though the potential of *ex post* evaluation to ensure regulations work in practice remains mostly unexplored.

Improvements in corporate governance are also essential

Productivity and growth in the region can be further supported by improved corporate governance of both state-owned enterprises (SOEs) and listed companies in Latin American equity markets. For SOEs, there has been growing attention, notably in Argentina and Colombia, to the need for stronger government co-ordination to promote better governed SOEs. In the private sector, Latin American companies are historically dependent on bank financing or intra-group financing within conglomerates, which are often the dominant economic actors (OECD, 2015e). With a relatively small number of companies making use of equity market finance, capital markets tend to be illiquid, limiting their appeal to growth companies as a source of financing. Strong frameworks for corporate governance, including effectively enforced regulation and national best-practice corporate governance codes, are increasingly being used as a way to promote trust in Latin American stock markets, to spur greater interest by both investors and companies to use local equity markets as a source for investment financing.

Key recommendations

- Consolidate and harmonise intra-regional preferential trade agreements (PTAs) and support global initiatives for trade liberalisation.
- Prioritise the further liberalisation of FDI in sectors – notably services sectors like transport – crucial to participation in GVCs.
- Consider coherent and transparent investment promotion strategies that aim to attract high-quality and diversified foreign investment.
- Reduce barriers to entrepreneurship, trade and investment to foster competition.
- Strengthen corporate governance of SOEs to achieve a level playing field between SOEs and private sector competitors.
- Build confidence in equity markets through effective regulation and national corporate governance codes that promote transparency and good corporate governance practices.
- Strengthen institutional oversight, including the capacity to review implementation of regulatory policy and check the quality of impact assessments, in order to ensure an effective rule-making process based on evidence.
- Build on existing initiatives in specific areas or institutions to gradually expand the use of regulatory tools such as Regulatory Impact Assessment and public consultation.

5 Strengthening innovation frameworks

Latin American countries lag behind in terms of their innovation performance, not only in relation to OECD countries, but also in relation to emerging countries in other regions. Making progress will require improvements in the framework conditions and more effective research and innovation policies, including stronger co-operation between business and research institutions, a comprehensive digital agenda to seize the potential benefits of technology, strengthening the necessary skills for innovation, and better co-ordinated governance.

Improving the weak innovation performance of the region requires a comprehensive approach

Latin America invests less in research and development (R&D) and other forms of innovation than OECD countries. Brazil is the only Latin American country that spends more than 1% of GDP on R&D (Figure 5.1), with about half of that coming from the business sector. In addition, patent registrations are relatively low in the region. On average, OECD countries registered 50 patents per year per million inhabitants in the early 1990s and by the early 2010s this number had risen to 132. In contrast, in Latin American countries, patents per year per million inhabitants were only 0.3 in the early 1990s and 0.9 by the early 2010s.

Strengthening the region's innovation performance will require a co-ordinated and inclusive approach that mobilises all actors and pays particular attention to the creation of new firms and the needs of SMEs, whose productivity and innovation gaps with regard to large firms are larger on average than in OECD countries. Support for business innovation should be well balanced and not rely only on tax incentives. Well-designed, competitive grants need to complement tax incentives and are better suited to the needs of young innovative firms. Strong commitment and sufficient capacities to monitor and evaluate policies to foster innovation will also be crucial, together with appropriate structures to ensure that the lessons learned from experience translate into more efficient government actions.

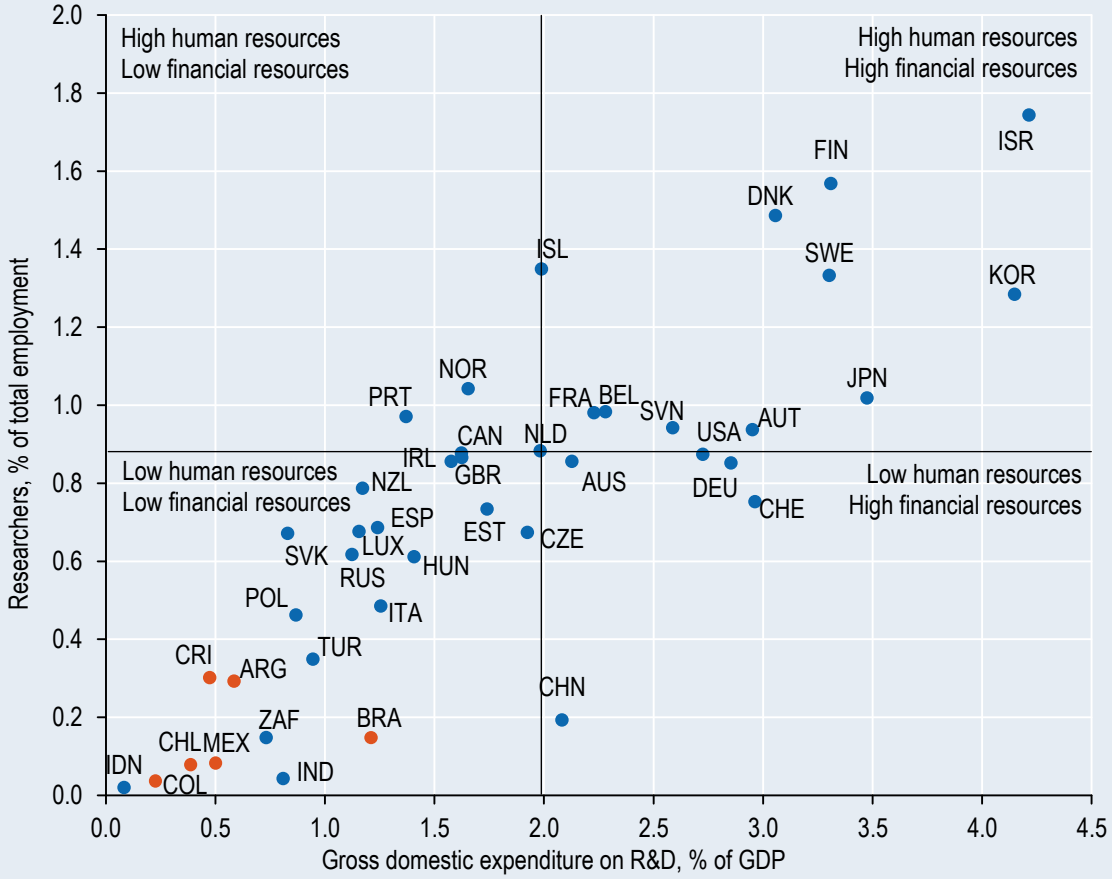
Traditional sectors and SMEs should be central to any strategy to boost innovation

Well-designed programmes that upgrade productivity in traditional sectors have been found to be particularly useful to support innovation. Examples include virtual training programmes, innovation and training subsidies, digitalisation and e-commerce programmes, rapid enterprise diagnostic assessments which analyse strengths and weaknesses through online self-assessment tools or face-to-face



FIGURE 5.1. **INVESTMENT IN KNOWLEDGE-BASED CAPITAL IS LAGGING**

Research and development spending and number of researchers, 2013



Note: The two black lines depict the OECD averages (2% for the GDP share of gross domestic expenditure on R&D and 0.9% for the share of researchers in total employment).

Sources: OECD Main Science and Technology Indicators Database (www.oecd.org/sti/msti.htm) and UNESCO Institute for Statistics.

interviews with business support managers, and programmes specifically conceived for informal enterprises. In Chile, the PROFO (*Proyectos Asociativos de Fomento*) programme aims to improve the technical, financial, and managerial capabilities of SMEs. Several programme evaluations have shown a positive impact in terms of adding value to products and growth in the productivity of participating SMEs (Cortes-Lobos, 2013).

Measures to boost SMEs' participation in innovation also include enhancing access to financial resources for innovation-oriented SMEs, facilitating knowledge and technology flows between research institutions and small entrepreneurs, investing in knowledge and technology infrastructure for SMEs (**Sections 2 and 6**), and fostering the use of public research outcomes among small businesses. In Chile, the National Corporation for Industrial Development (CORFO) has improved technology transfer programmes for SMEs by identifying international best practices in technology adoption, fostering partnerships with research institutes and SMEs, and promoting technology adoption in SMEs. In Colombia, through the Fund for the modernisation and innovation of micro, small and medium-sized enterprises (MSMEs) (*iNNpulsa Mipymes*), the government supports small businesses in meeting supply chain requirements and developing innovative products and services to enter new markets.

Innovation policy can also help to promote inclusiveness

Inclusive innovation policies can also support lower-income and excluded groups by meeting their needs at an affordable cost and by providing new education and work opportunities. Argentina offers up to 30 000 scholarships a year for tertiary education for low-income students through its two

programmes (*Becas Bicentenario and Becas TICs*), which aim to increase participation in scientific studies. Colombia has recently launched a similar programme (*Ser Pilo Paga*) offering 10 000 scholarships for low-income students to pursue undergraduate studies. In Panama, the National Secretary for Science, Technology and Innovation (SENACYT) manages *Infoplazas*. These are structured as community centres, and provide public access to the Internet and to e-learning platforms, as well as training in information and communication technologies. *Infoplazas* also help to reduce the digital gap and to address social exclusion and territorial inequality (OECD, 2015f).

Several Latin American countries already use innovation policy to leverage innovation in support of inclusive growth. For example, Colombia's National Development Plan for 2010-14 emphasised the role of innovation as a tool to "align its economic development to its social development", notably by providing incentives for and removing barriers to inclusive innovation (OECD, 2015g). One such initiative is *Ideas para el Cambio*, an open call for ideas issued to the scientific innovation community to solve priority challenges faced by disadvantaged communities. Chile has also developed a cross-cutting initiative to encourage policy discussion around the subject and provides funding for inclusive innovations. The National Institute for Entrepreneurs in Mexico (INADEM) is promoting women's entrepreneurship and financial inclusion for start-ups and MSMEs. Efforts to strengthen participation in innovative activities by a wide range of economic actors are also crucial at the regional level. One example of such policies is the use of intellectual property to support the innovation capabilities of lagging sectors of the economy, such as traditional and informal sectors (OECD, 2014a).

A more inclusive approach to innovation that can help empower SMEs and lagging regions will also require good governance to align the various policies that are needed for innovation (OECD, 2013c; OECD, 2015h). While in most of the region progress has been made in institution building and in co-ordination among agencies, a long road still lies ahead to consolidate that progress (OECD/CAF/ECLAC, 2014). Promoting innovation requires co-ordination of different actors at national, regional and local levels, as well as across different ministries and agencies, especially between agencies in charge of innovation and those in charge of industrial and production development policies. In addition, consultations with the private sector are needed to facilitate implementation. Many countries in Latin America have started to create competitiveness or innovation councils where different actors convey their priorities so as to shape a shared agenda, such as in Colombia, Costa Rica, and more recently Chile, with the National Productivity Commission that was founded last year (Banks, 2015). It is also crucial to work towards a clear agenda for implementation, starting for example by addressing a specific challenge and working out a plan and the associated resources. A good example is Costa Rica's Presidential Council for Competitiveness and Innovation as well as the country's skills upgrading agenda.

Key recommendations

- Encourage business investment in R&D and other knowledge assets through a balanced and well-designed mix of direct and indirect support measures that do not disadvantage young, innovative firms.
- Increase the effectiveness of public investment in research and innovation by enhancing knowledge flows between research institutions and firms.
- Improve the framework conditions for innovation and entrepreneurship, in co-ordination with programmes to sustain upgrading in domestic manufacturing and service delivery.
- Design programmes that have sufficiently broad reach and low per-enterprise cost to enhance productivity in SMEs in traditional sectors.
- Further consider the development of more inclusive innovation policies that would enable women, small entrepreneurs, poorer households and indigenous populations to seize the opportunities of new technologies.

6 Connecting people and firms through better infrastructure

High-quality infrastructure is key to both raising productivity levels and improving social inclusion. Physical and digital connectivity facilitates social interactions and labour mobility, allowing people to draw higher dividends from their skills, efforts and experiences. Such connectivity, as well as improved logistics performance, are also critical to underpin trade in goods and services across value chains, and thereby to spread economic benefits from trade. Despite significant progress in recent decades, the quantity and quality of infrastructure in Latin American countries is still a barrier to inclusive growth.

Transport infrastructure weaknesses impede productivity growth and social inclusion

Latin America has made great strides in providing basic access to services in some dimensions, such as water supply and electricity. However, the region ranks relatively low in several international infrastructure indicators, such as the Global Competitiveness rankings (WEF, 2015). The perceived quality of overall infrastructure ranks Latin America for the period 2015-16 at 3.3 points on a scale of 1-7 (where a higher score means better quality of infrastructure). That is well below the OECD average (5.3 points) and average for emerging Asian economies (4.7 points).

Weak transport links in particular are an impediment to productivity growth and social inclusion in the region (OECD/CAF/ECLAC, 2013). The quality of road transport lags behind the standards of typical middle-income countries. Moreover, the strong preference for road transport over other modes (the concentration of road transport in Latin America is 15 times greater than in the United States, for example), prevents the region's move to a greener growth model, and increases logistics costs by hampering the development of co-modal transport options. This reduces countries' competitiveness and their participation in national, regional and global value chains. Logistics costs in the region represent 18-35% of a product's value, compared to around 8% in OECD countries.

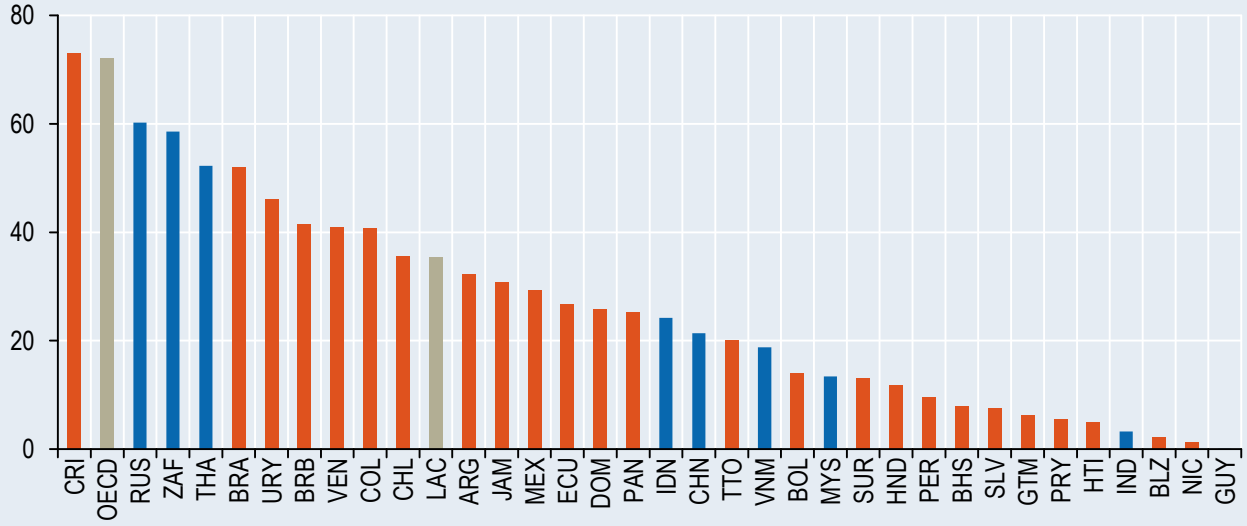
The quality of ports is low in Latin America and their size small, while the absence of exclusive freight carriers often creates logistical difficulties and impedes the exports of perishable goods. Moreover, rail transport is concentrated exclusively on bulk trade. Addressing these "behind-the-border" constraints thus requires the same or greater policy attention as the free-trade agreements that many countries in the region have been pursuing. Over the 2012-14 period, the ratio of freight costs to tariffs was approximately 9, compared to an average ratio of less than 3 in the OECD (OECD/CAF/ECLAC, 2015). Similarly, to take advantage of some recent regional integration initiatives, such as the Pacific Alliance, there is a need to increase connectivity among Latin American economies. At the same time, investing in public transport systems could help reduce urban congestion and greenhouse gas emissions while increasing rural connectivity, thereby improving well-being and contributing to a reduction in spatial inequalities. By improving access to labour markets and to opportunities for education and training, better public transport could also have a positive twin impact on both labour productivity and social inclusion.

Gaps in digital infrastructure are also striking

In 2013, the average penetration in Latin America was 35% for mobile and 9% for fixed broadband, compared to the OECD average of 72% for mobile and 28% for fixed broadband (Figure 6.1). Having sufficient quantity and quality of digital infrastructure – such as broadband, Internet addresses and data – is key to integrating into global value chains and to harnessing the next production revolution. Moreover, advances in connectivity and telecommunications infrastructure also help improve social inclusion. Social media, for example, allows governments to communicate more effectively with citizens and, at the same time, digital tools (e.g. online petitions, mobile applications) allow citizens to participate more actively in government. Digital technologies have also encouraged the development of massive open online courses, which provide enhanced access to educational and training opportunities. Colombia has defined the development of

FIGURE 6.1. **MOBILE BROADBAND PENETRATION IS LOW IN LATIN AMERICA**

Subscriptions per 100 inhabitants, 2013



Note: OECD average includes Chile and Mexico.

Sources: OECD (2014a) for OECD countries and ITU World Telecommunication/ICT Indicators 2015 for LAC countries.

domestic content and applications serving the need of low-income groups in its *Vive* Digital Strategy 2014-18 and Bolivia has incorporated the promotion of local content development as a key objective of its national telecommunication programme for social inclusion.

The region needs to increase the efficiency of investment in infrastructure

Latin America's infrastructure gaps can be closed through more and better investment. Total infrastructure investment in the region amounts to less than 3.5% of GDP. To meet medium-term infrastructure needs, this would need to be increased to about 6.2%, and achieving an infrastructure stock of Asian countries like Korea and Malaysia would require significantly more (Perrotti and Sánchez, 2011; ECLAC, 2014). This will require greater public-sector investment, potentially backed by initiatives such as earmarking royalties from commodity production, as in Colombia (OECD, 2013c), or designing fiscal rules so as to shift the balance of the government budget towards investment, as in Peru (Carranza, Daude and Melguizo, 2011). Private sector investment, both domestic and foreign, also has a key role to play. Chinese financing has already become an important source of infrastructure financing in some countries of the region, and is expected to play a bigger role in the coming decades (OECD/CAF/ECLAC, 2015).

There are also governance challenges around infrastructure investment. First, aligning infrastructure investments requires a more cross-sectoral and strategic approach to planning investment. Governments in Latin America have trouble putting together well-integrated strategies to guide investment because of sectoral silos and poor co-ordination across levels of government. Second, delivering projects on time and on budget requires increased and co-ordinated government capacity at all stages to provide the necessary agility to respond to risks and opportunities, from project design and approval to execution and appropriate communication of outcomes. Strengthened frameworks to ensure good corporate governance of state-owned enterprises, which play a key role in sectors such as energy and transport in most Latin American countries, are also needed. Further efforts are needed to improve the policy framework for infrastructure investment, such as improvements in value-for-money analysis, in the preliminary phases of concession contracts, and in designing the fiscal accounting system so that it does not inappropriately favour concessions over public projects. Of the 61 highway concessions signed up to 2010 in Colombia, Chile and Peru, for example, 50 have been renegotiated at least once, resulting in more than 540 renegotiations in total (Bitran, Nieto-Parra and Robledo, 2013). More should be done to avoid unexpected fiscal costs of



Public-Private Partnerships (PPPs) and to improve control, efficiency, transparency and integrity of procurement processes related to infrastructure projects.. Some countries in the region have already updated their public procurement, PPP and concession laws and set up new agencies or specialised units within existing institutions (e.g. Chile, Colombia, El Salvador, Mexico and Peru). This should help better co-ordinate public efforts and the delivery mode of infrastructures and mobilise private sector investment.

Other policy initiatives that could reduce transport costs by making the most of existing infrastructure include introducing an integrated logistics policy, providing modern storage facilities, making customs and certification procedures more efficient, using ICT for logistics, and promoting competition in the transport sector (OECD/CAF/ECLAC, 2013).

Key recommendations

- Increase investment in transport infrastructure to improve connectivity, giving priority to co-modal transport options.
- Prioritise investment in digital infrastructure, especially broadband and data, and promote data sharing and reuse.
- Strengthen governance mechanisms in integrated infrastructure investment planning, co-ordination across sectors and levels of government, identification of realistic delivery modalities and timeframes.
- Strengthen the transparency and integrity of frameworks for infrastructure investment and delivery, including public procurement processes.
- Increase the efficiency and effectiveness of the preliminary phases of infrastructure and PPP contracts through strategic procurement and value-for-money analysis and streamlining of the grant process for land, environmental and social licenses.

7 Strengthening public governance

Good public governance is key to establishing and maintaining citizens' trust in governments, particularly their ability to deliver public services to all. While Latin American countries have been consolidating their democratic institutions in recent decades, less than half of their citizens are either "very" or "somewhat" satisfied with how their democracy works in practice, according to the latest Latinobarómetro public opinion survey. Low trust in government undermines growth and social cohesion by reducing investor and consumer confidence, as well as the effectiveness of public policies, programmes and regulations that depend on co-operation and compliance of citizens. To enhance public governance in the region, a whole-of-government approach is needed that aligns vision, incentives (including through fiscal policy) and delivery mechanisms across the policy cycle.

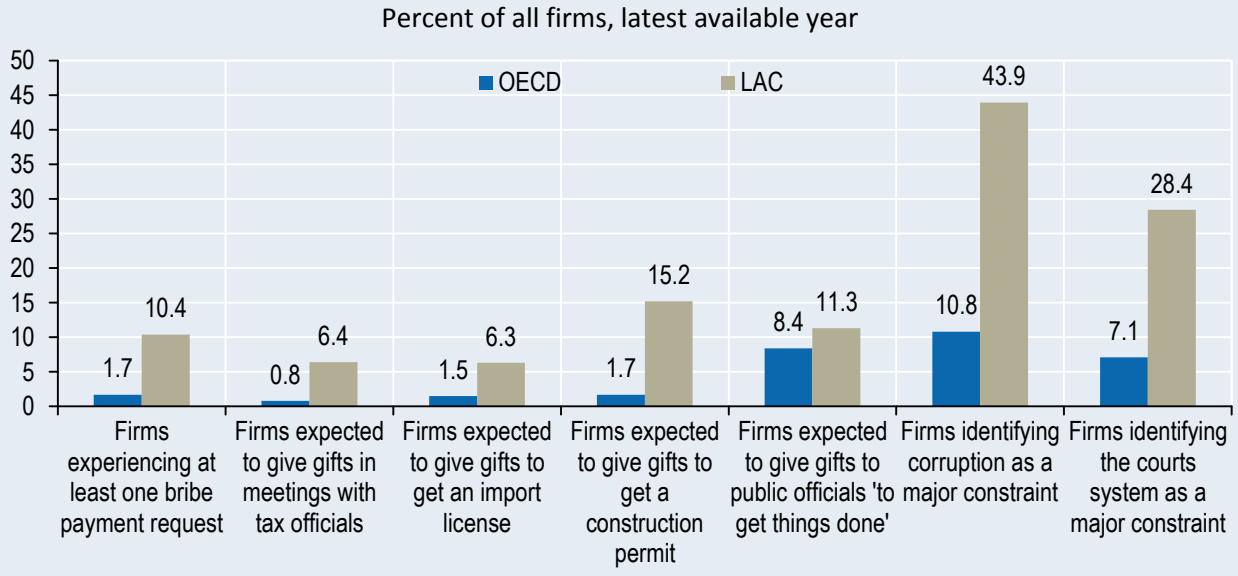
Having an effective centre of government can help improve the government's capacity to deliver public goods and services.

Institutional and methodological constraints on effective whole-of-government co-ordination and decision-making in Latin America are limiting governments' ability to improve outcomes and achieve concrete results for citizens and business. An effective centre of government (CoG) can help address this problem by strengthening strategic planning, implementation and performance monitoring, enabling more effective national-sub-national relationships and steering priorities towards common objectives such as inclusive growth. Latin American countries are increasingly recognizing this potential role for the CoG, with CoG actors moving from providing narrow administrative support to the Head of Government to engaging more proactively in integrated strategic policy development and implementation. In countries such as Colombia, Costa Rica and Peru, multi-year strategic planning and performance monitoring, including results-based budgeting, and cross-cutting inter-ministerial initiatives are being led by CoG institutions to design and deliver on increasingly complex multidimensional policy challenges.

Open government policy can significantly improve policy outcomes

The implementation of open government policies has improved significantly in Latin America in recent years according to the OECD Report on Open Government in Latin America (OECD, 2014b). Open Government, defined by the OECD as "the transparency of government actions, the accessibility of government services and information, and the responsiveness of government to new ideas, demands and needs", is a key driver of inclusive growth.

FIGURE 7.1. **CORRUPTION IS A WIDESPREAD PROBLEM IN LATIN AMERICA**



Source: World Bank (2016), Enterprise Surveys, http://www.enterprisesurveys.org.

TABLE 7.1. **MANY LATIN AMERICAN COUNTRIES LACK A MEDIUM-TERM PERSPECTIVE IN THEIR BUDGETING PROCESS**

Medium-term perspective in the budget process at the central level of government, 2013

	Existence of a Medium-Term Expenditure Framework	Length of ceilings (incl. upcoming fiscal year)	Target of expenditure ceilings		
			Total expenditures	Programme of sector expenditures	Organisational expenditures
Argentina	No				
Barbados	Yes, in a strategy/policy	3 years	x		
Brazil	No				
Chile	Yes, in a strategy/policy	3 years	x		
Colombia	Yes, in a law	4 years		x	
Costa Rica	No				
Dominican Republic	No				
Ecuador	No				
El Salvador	No				
Guatemala	Yes, in a law	3 years			x
Haiti	Yes, in a strategy/policy	3 years	x		
Honduras	No				
Jamaica	Yes, in a strategy/policy	5 years	x		
Mexico	Yes, in a law	5 years	x		
Panama	No				
Paraguay	Yes, in a strategy/policy	2 years			x
Peru	No				

Source: OECD (2013), OECD Survey on Budget Practices and Procedures, OECD Publishing, Paris.

Capacity levels vary across the region, but many countries have embraced open government principles. For instance, countries such as Costa Rica are leading the way by including the executive, legislative and judiciary branches, as well as sub-national governments, independent institutions and civil society organisations in their efforts to promote transparency, accountability and citizen participation. The move towards an "open state" reflects the creation and implementation of a state-wide policy to promote the principles of open government. By better linking national efforts, Latin American countries can exploit synergies and tackle common challenges, including through the OECD Network on Open and Innovative Government in Latin America and the Caribbean.

Open government initiatives can greatly benefit from innovative uses of digital services. For example, in Mexico, the Ministry of Finance launched an online platform to allow users to visualise geolocated public investments for infrastructure through an open-data-based map. The platform increases openness and transparency by allowing citizens to audit federal investments. OECD Reviews of Public Sector Innovation, including in countries such as Chile, have underscored that skill development, incentive systems and adequate organisational environments are key to fostering innovative capacities in government.

Improving integrity is crucial to restoring trust in governments and public institutions

Promoting integrity and fairness in the delivery of public services, in the access to markets, and in the policy-making processes is critical to stop the erosion of trust, credibility and legitimacy of governments observed in many Latin American countries. Among entrepreneurs in Latin America, 43.9 per cent identify corruption as a major constraint on doing business – almost four times as high as in OECD countries (Figure 7.1). The problem of corruption is compounded by the historically high concentration of political and economic power in Latin American countries. To fight corruption, countries in the region have strengthened their legal systems in order to define responsibilities, accountabilities and penalties for individuals and firms found to have engaged in fraudulent or corruption practices.

Fighting corruption is particularly pertinent in

public procurement. Public procurement accounts for a large percentage of GDP (up to 20%) and government spending (26% on average across countries) in most Latin American countries. Reforms to increase the public availability of procurement information have been developed in recent years to tackle corruption and collusion. In Mexico, for example, Compranet, the procurement information system for federal government procurement procedures, started in 2009 to publish information such as annual procurement programmes, tender procedures, contract awards history and formal complaints. In addition, Latin American countries have improved the efficiency of public procurement through e-procurement systems, even though such systems are not yet used as full-fledged efficiency and accountability tools that allow two-way communication with citizens, bidders and the general public.

A high level of decentralisation makes strong multi-level governance critical for effective public policy making

Sub-national governments are key economic actors in many Latin American countries. Mutual dependency across levels of governments is an important feature in all institutional contexts, from federal countries like Mexico or Brazil to centralised ones like Chile, requiring a flexible framework for multilevel governance mechanisms.

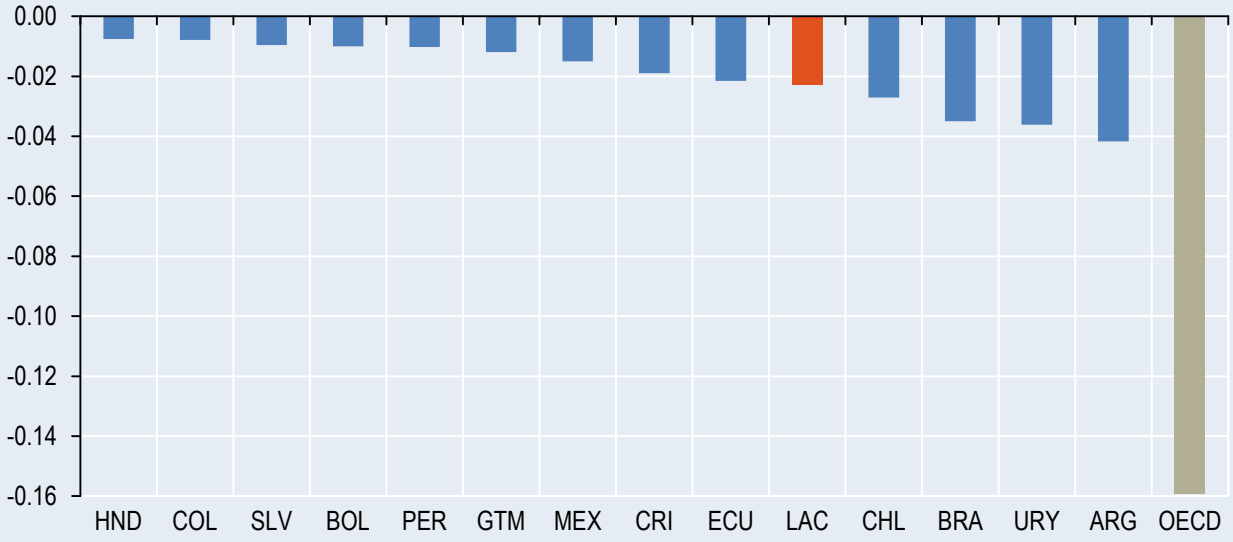
In such a context, strong co-ordination mechanisms across levels of government as well as sub-national fiscal and management capacities are essential for effective and inclusive public policy making. Latin American countries have put in place specific mechanisms to improve co-ordination across levels of government and between jurisdictions. Colombia and Chile, for example, have developed contracts arrangements between the central government, regions and municipalities to foster co-ordination in investment agendas.

Budget processes could be strengthened

Improving the link between medium-term strategic plans and annual budgets will ensure policies directed towards improving inclusive growth are prioritised in practice. More often than not, national development plans have very little influence on annual budgets, and funds are not always directed to the areas identified as priorities. Several Latin American countries have adopted some form of Medium-Term Expenditure Framework (MTEF) (Table 7.1). However, very few actually use these as the starting point for the following year's budget, therefore undermining their utility, and the MTEF information is typically not published. There is therefore scope for improving and

FIGURE 7.2. **THE REDISTRIBUTIVE EFFECT OF TAX AND TRANSFER SYSTEMS IS VERY LOW IN LATIN AMERICA**

Difference in Gini coefficients, disposable versus market income, 2012 or latest available year



Source: OECD Income Distribution Database (www.oecd.org/social/income-distribution-database.htm) and Lustig, N. (2016), "El impacto del sistema tributario y el gasto social en la distribución del ingreso y la pobreza en América Latina: Argentina, Bolivia, Brasil, Chile, Colombia, Costa Rica, Ecuador, El Salvador, Guatemala, Honduras, México, Perú y Uruguay", CEQ Working Paper No. 47, Commitment to Equity Institute, Tulane University, forthcoming in El Trimestre Económico, Fondo de Cultura Económica.

developing the use of MTEFs to help align budgets with medium-term strategic priorities of government.

Broad tax reforms can help raise revenues while reducing distortions

Despite a period of steady increases since the 1990s, tax revenues reached only 21.7% of GDP on average across Latin American countries, significantly lower than the OECD average of 34.4%. There is wide heterogeneity across the region, with tax revenues in 2014 ranging from 35.2% of GDP in Brazil (above the OECD average) to 12.6% of GDP in Guatemala (OECD/ECLAC/CIAT/IDB, 2016). Some countries in the region thus have ample room to increase fiscal revenues in order to close funding gaps in critical public policy areas. Continued efforts to strengthen tax administration in order to reduce tax evasion should be part of any strategy to raise tax revenues.

In addition, almost all Latin American countries would benefit from a structural and fiscal tax reform to strengthen incentives for entrepreneurship and innovation, and also to increase the impact of taxes on reducing income inequality, by reducing regressive tax benefits and more effectively taxing high-income earners (Brys et al., forthcoming). Currently, taxes and transfers reduce market income inequality by only 7.7 percentage points, well below the OECD average of 15.9 percentage points (Lustig, 2016; Figure 7.2). The region should also strive to achieve a more balanced tax mix that enhances the business climate by shying away from excessively high taxation on businesses within the formal economy on the one hand and overly generous tax incentives for high-income earners and firms (e.g. special trade zones) on the other hand.

Key recommendations

- Create an effective CoG that can steer priorities towards inclusive growth objectives.
- Link national open government efforts across countries to exploit synergies and tackle common challenges.
- Take action to strengthen the rule of law and to stamp out public and private sector corruption.
- Strengthen public procurement through capacity building, greater focus on the strategic objectives of public procurement, and the implementation of e-procurement.
- Strengthen co-ordination mechanisms across levels of government to identify investment opportunities and bottlenecks and manage joint policy competencies.
- Enhance sub-national fiscal and management capacities.
- Improve the link between medium-term strategic plans and annual budgets.
- Broaden the tax bases of direct and indirect taxes by eliminating tax exemptions and improve the progressivity in the tax system.



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