

## 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 through 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.



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