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.

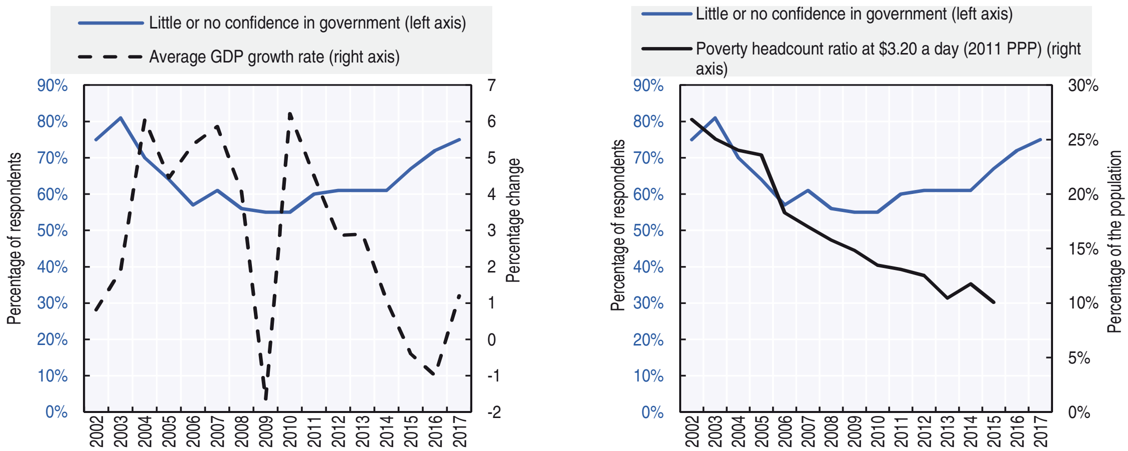
Two factors help explain this disconnect: the rising aspirations of a larger middle class and the difficulties for public institutions to address existing and new challenges. LAC's remarkable socio-economic progress and improved standards of living have raised expectations and aspirations. At the same 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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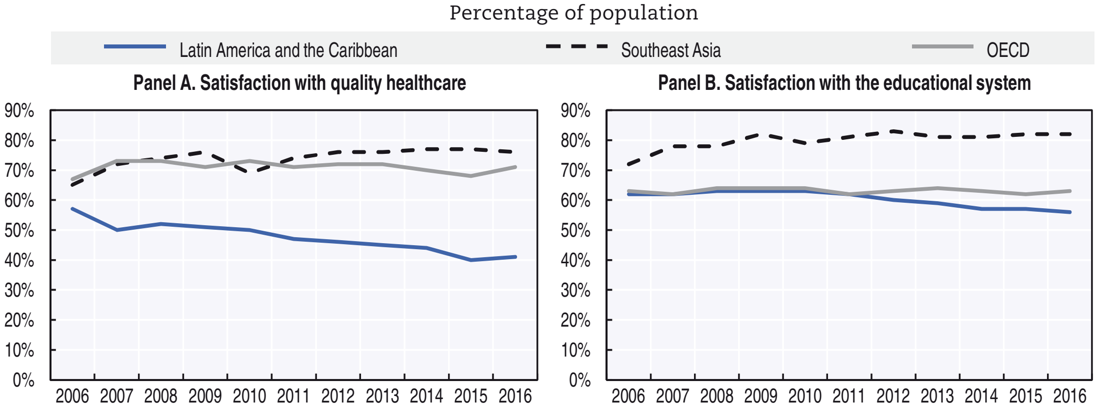
Satisfaction with public services has also deteriorated. Over 2006-16, the share of the population satisfied with the quality of healthcare services fell from 57% to 41%, well below levels in OECD member countries (stable at around 70%) (Figure 2, Panel A). Likewise, satisfaction with the quality of 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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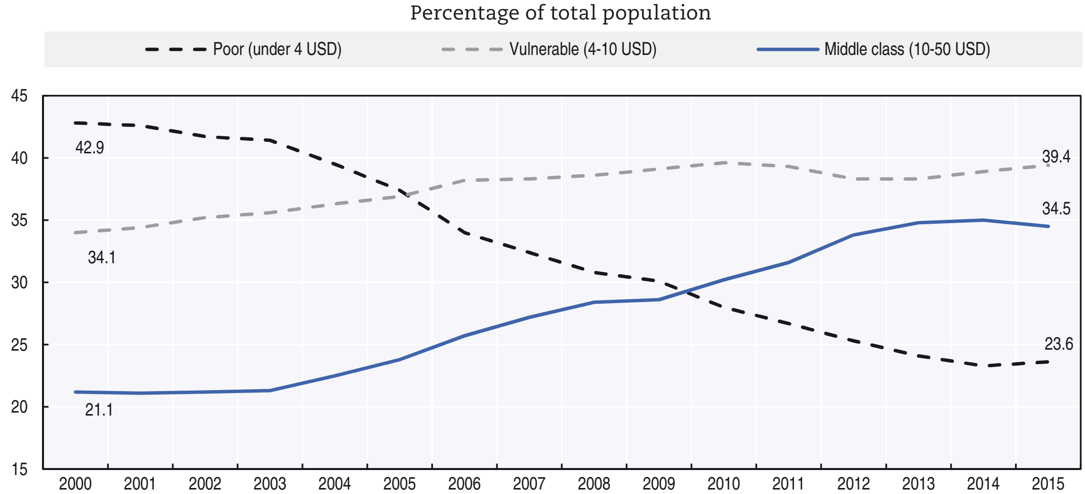
Throughout a long period of economic and social progress in LAC, poverty rates declined sharply, inequalities fell and living standards improved. However, despite these positive trends, trust in public institutions and citizen satisfaction declined. There are two forces behind this apparent discrepancy. 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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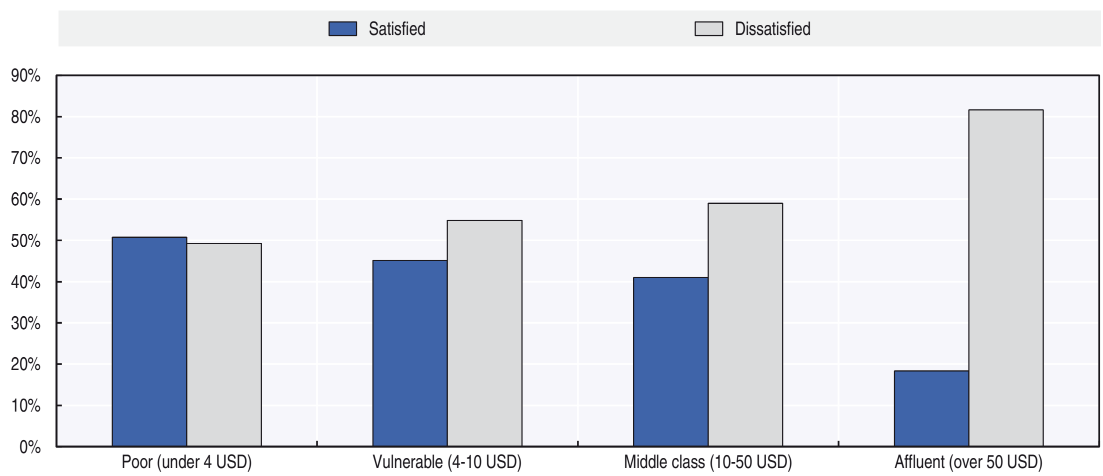
The expansion of the middle class has brought with it a change in values that may partly explain the decreasing levels of citizens' trust and satisfaction in LAC. Middle-class citizens are believed to be strong supporters of democracy, while at the same time being critical of how it functions (OECD, 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.

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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).

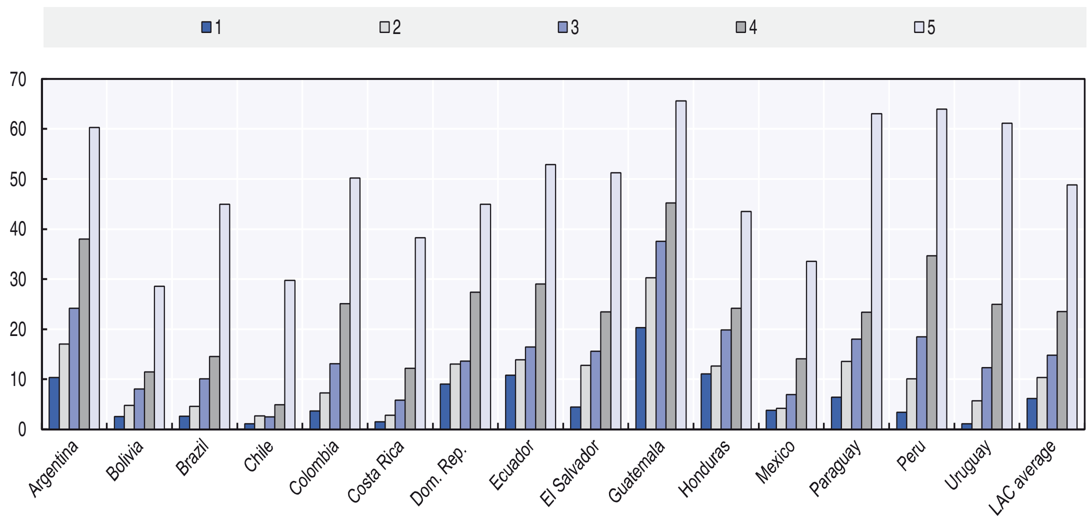
Social contracts are generally characterised by explicit and implicit agreements that determine what each socio-economic group gives to the state and receives in return. Citizens engage firmly in these agreements with three conditions. First, they must believe the agreements are reliable (i.e. they trust 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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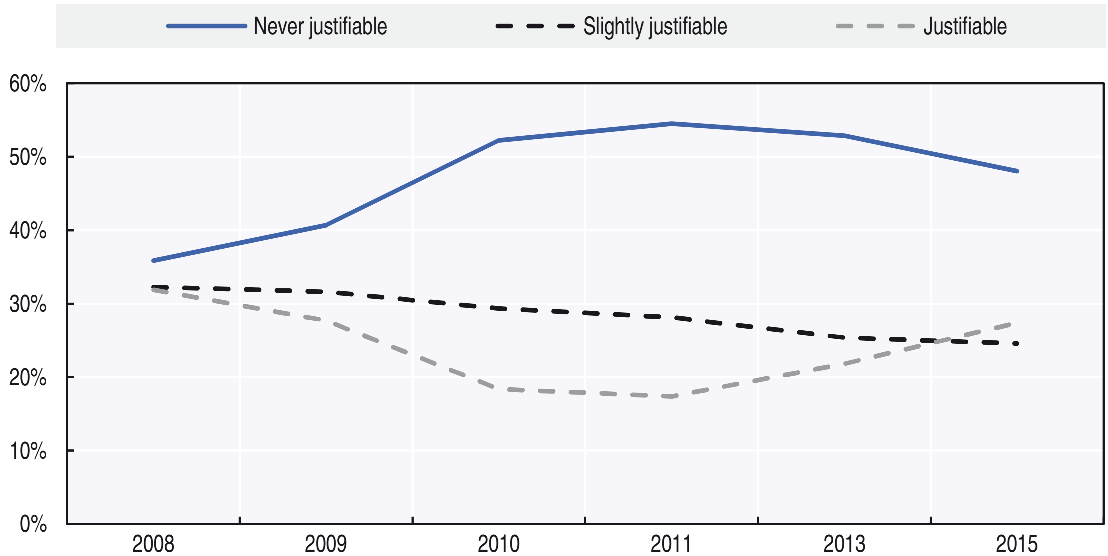
Dissatisfaction with public services and the subsequent opting out of those with sufficient resources create a dynamic that weakens the social contract. On the one hand, individuals from high- and middle-class households usually channel their dissatisfaction with public services by *opting out*, moving 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.

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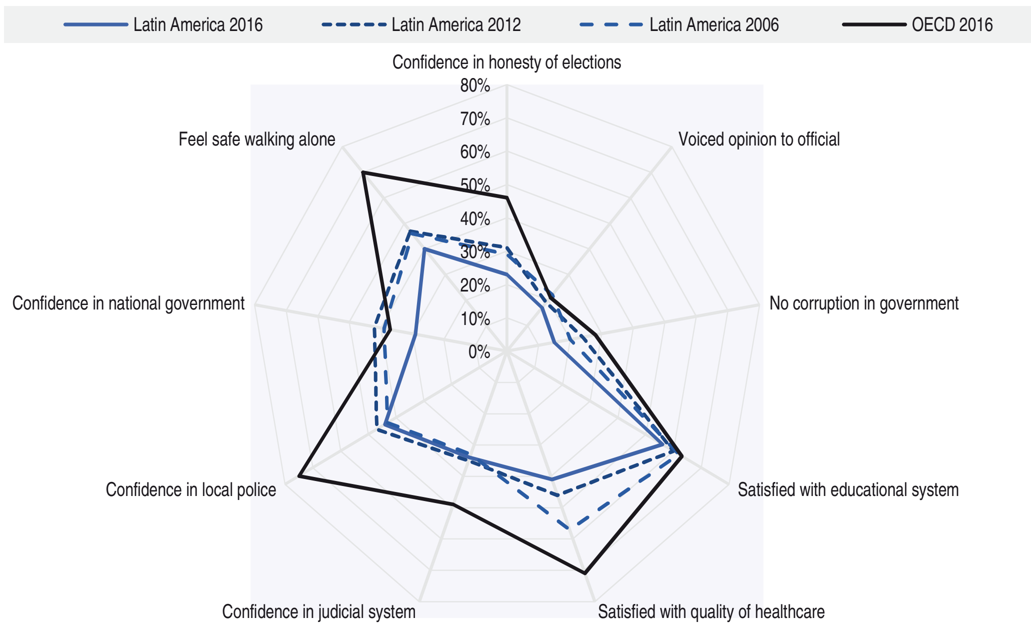
The redistributive function of fiscal policy appears to be less clear for Latin Americans than for citizens in other regions. According to the *World Value Survey*, in LAC in the mid-2010s almost 20% of the population believes that taxing the rich and subsidising the poor is not an essential characteristic 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).

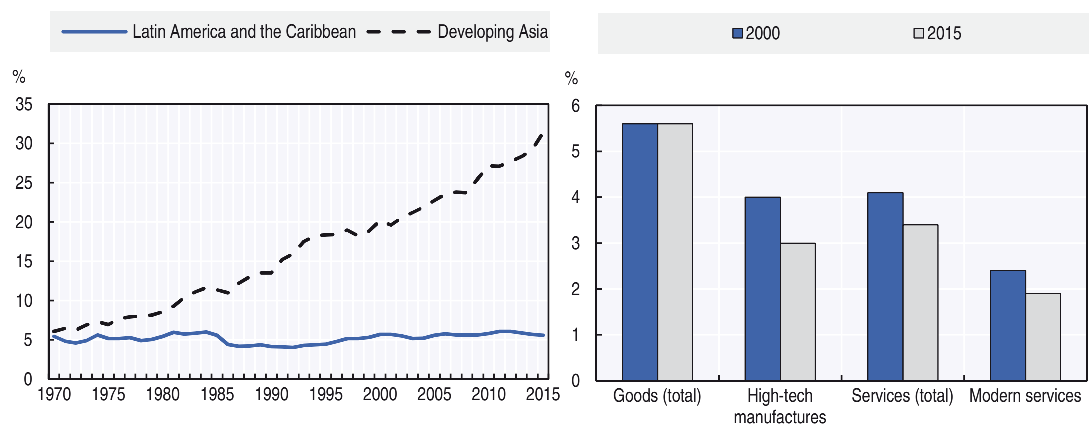
Institutions to navigate a challenging global trading environment and boost inclusive growth

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**

Panel A. LAC and developing Asia: share in world exports of goods, 1970-2015

Panel B. LAC: share in world exports of goods and services, 2000 and 2015



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.

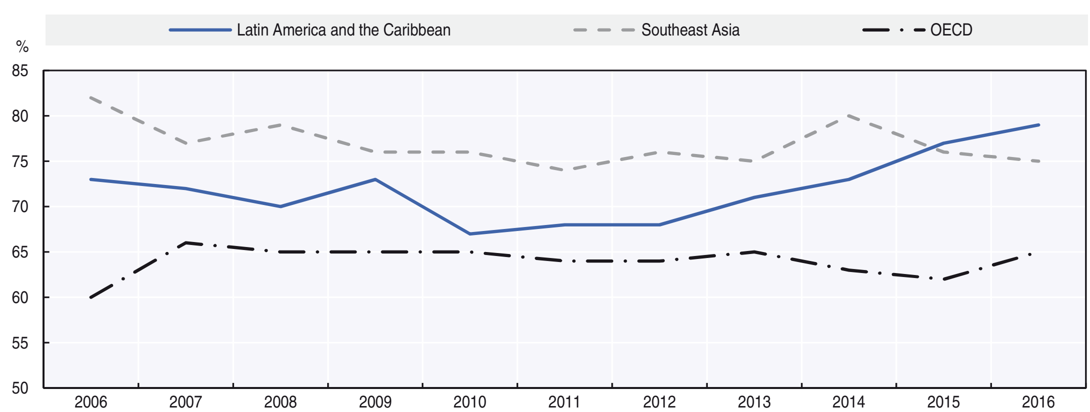
Towards trustworthy states: Strengthening the rule of law and regulatory systems

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).
StatLink http://dx.doi.org/10.1787/888933649658

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

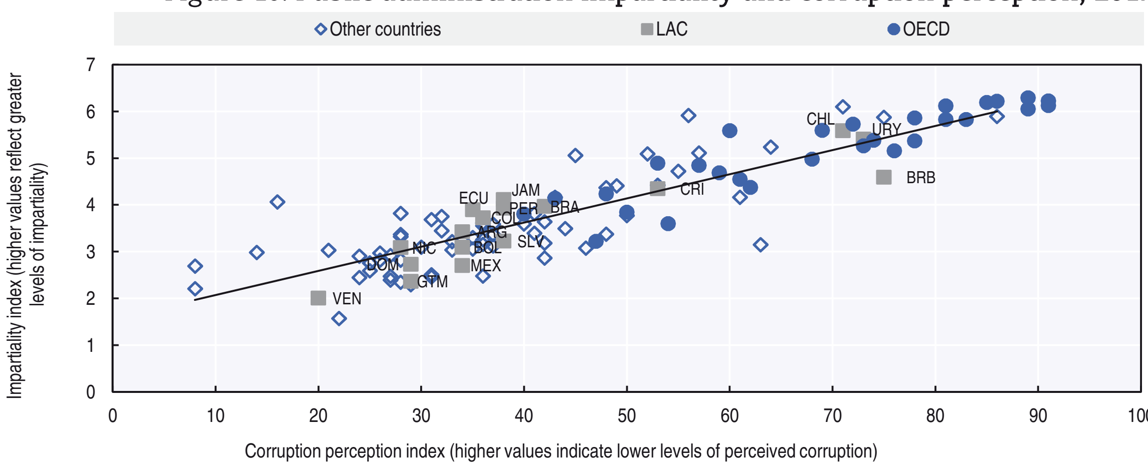
Improving a state's capacities requires *strengthening its fiscal muscle,* both by improving the efficiency in public spending and mobilising more tax revenues. Spending more efficiently and rationalising subsidies by improving targeting mechanisms are critical. On average, this process could deliver 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.

StatLink http://dx.doi.org/10.1787/888933649677

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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