DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

URUGUAY

PROGRAMMATIC COMPETITIVENESS LOAN
FIRST OPERATION

(UR-L1007)

LOAN PROPOSAL

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Annex I Policy matrix

Proposed resolution

Electronic Links and References	
Basic socioeconomic data	http://www.iadb.org/RES/index.cfm?fuseaction=externallinks.countrydata
Status of loans in execution	http://portal.iadb.org/approvals/pdfs/URen.pdf
Results matrix	http://idbdocs.iadb.org/WSDocs/getDocument.aspx?DOCNUM=849926
Means of verification matrix	http://idbdocs.iadb.org/WSDocs/getDocument.aspx?DOCNUM=859033
Policy letter	http://idbdocs.iadb.org/WSDocs/getDocument.aspx?DOCNUM=841001
RE1/F11 technical files	http://idbdocs.iadb.org/WSDocs/getDocument.aspx?DOCNUM=856946
Independent macroeconomic assessment	http://idbdocs.iadb.org/WSDocs/getDocument.aspx?DOCNUM=861002
IMF Article IV consultation	http://idbdocs.iadb.org/WSDocs/getDocument.aspx?DOCNUM=855244

ABBREVIATIONS

ANII	Agencia Nacional de Investigación e Innovación [National Research and Innovation Agency]
BCU	Banco Central del Uruguay [Central Bank of Uruguay]
CAF	Andean Development Corporation
CIACEX	Comisión Interministerial para Asuntos de Comercio Exterior [Interministerial Commission on Foreign Trade]
CN	Compromiso Nacional [National Commitment]
DGI	Dirección General Impositiva [Internal Revenue Service]
FDI	Foreign direct investment
GCI	Global Competitiveness Index
GCR	Global Competitiveness Report
GDP	Gross domestic product
ICAS	Institutional Capacity Assessment System
ICTs	Information and communication technologies
IMF	International Monetary Fund
INACAL	Instituto Nacional de Calidad [National Quality Institute]
MEF	Ministry of Finance
ONSC	Oficina Nacional del Servicio Civil [National Civil Service Office]
OPP	Oficina de Planeamiento y Presupuesto [Office of Planning and Budget]
SDR	Special drawing rights
SMEs	Small and medium-sized enterprises
STI	Science, technology, and innovation
SUANCCE	Sistema Uruguayo de Acreditación, Normalización, Certificación, Calibración y Ensayos [Uruguyan Accreditation, Standardization, Certification, Calibration, and Testing System]
UXXI	Uruguay XXI
WB	World Bank
WEF	World Economic Forum

PROJECT SUMMARY

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Financial Terms and Conditions[1]				
Borrower and guarantor: Eastern Republic of Uruguay			Amortization period:	25 years
Executing agency: Ministry of Finance (MEF)			Grace period:	5 years
			Disbursement period:	12 months
Source	**Amount**	**%**	Interest rate:	Variable
IDB (OC)	US$75 million	100%	Inspection and supervision fee:	0.0%
Local	US$0 million	0%	Credit fee:	0.25%
Total	US$75 million	100%	Currency:	U.S. dollars

Project at a Glance

Project objective:
The program's goal is to help make the country more competitive. Its purpose is to improve the business climate and the institutional structure supporting the productive sector, and to promote investment. In terms of the business climate, the program supports reforms to make markets more efficient by lowering barriers to competition, strengthening the legal framework for businesses to restructure, and simplifying procedures. In order to strengthen the institutional structure for competitiveness, actions are proposed to improve coordination, linkages, and efficiency among the different active initiatives supporting the private sector in Uruguay. The program also supports specific institutional reforms to sharpen the tools to aid businesses in the areas of exports, science and technology, and quality. Investment in Uruguay will be promoted through enhancements, reforms and greater access to the legal system.

Special contractual conditions: See Annex I, "Policy Matrix."

Exceptions to Bank policies: None.

Project consistent with country strategy: Yes [X] No [ ]
Project qualifies as: SEQ [ ] PTI [ ] Sector [ ] Geographic [ ] Headcount [ ]

Procurement: Not applicable.
Verified by CESI on: 17 November 2006.

[1] The interest rate, credit fee, and inspection and supervision fee mentioned in this document are established pursuant to document FN-568-3 Rev. and may be changed by the Board of Executive Directors, taking into account the available background information, as well as the respective Finance Department recommendations. In no case will the credit fee exceed 0.75%, or the inspection and supervision fee exceed 1% of the loan amount.[*]

[*] With regard to the inspection and supervision fee, in no case will the charge exceed, in a given six-month period, the amount that would result from applying 1% to the loan amount divided by the number of six-month periods included in the original disbursement period.

I. FRAME OF REFERENCE

A. Introduction

1.1 The Government of the Eastern Republic of Uruguay has requested Bank support in making the country's enterprises more competitive through the reform of regulations, institutions, and policies for promoting the private sector. Support will be implemented through two programmatic policy-based loan operations, each with a single disbursement of US$75 million, i.e. US$150 million for the program as a whole. This document describes the features of the first operation and sets out the conditions to be fulfilled for processing the second.

1.2 The current administration took office in March 2005 at a key moment in the country's history, marked by its successful exit from the recent economic and financial crisis and the start of economic recovery. The Bank began its competitiveness strategy with the new administration through diagnostic work and dialogue both with the government and with private sector. To supplement analyses commissioned while preparing the Bank's country strategy with Uruguay in 2004, a wide-ranging and varied set of studies were undertaken focusing exclusively on competitiveness issues.[1] These were grouped together in three different Bank documents: Topic Notes on Competitiveness and Integration, and the Technical Note on the Agricultural Sector. At the same time, competitiveness studies were also commissioned for various productive sectors, supplementing earlier analyses and creating a very complete and exhaustive set of diagnostic studies and proposals on competitiveness in Uruguay. Consultants were hired to conduct studies for the topic notes, and the Bank organized workshops and seminars to consult with the private sector, civil servants, and civil society representatives so as to identify the opinions, needs and demands of the country's various stakeholders, and thus more effectively target the studies. Once the final versions of the documents were ready, several rounds of presentation and consultation were held with technical groups from the country's main political parties; and, after the elections, a dialogue was held with the new administration's economic team.

1.3 As a result of these efforts, the new government requested a group of operations from the Bank to help strengthen competitiveness in the country. Because this program forms an integral part of that set of operations, it should be viewed in the context of measures to enhance competitiveness. Among the key challenges identified in the various studies and activities mentioned above, opportunities were detected for reforming certain parts of the institutional, regulatory and legal framework that were hampering private investment, with a view to making the Uruguayan private sector more competitive. The proposed program is structured to implement these reforms in harmony with other initiatives being undertaken in the

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[1] Most of these studies, which formed the basis for preparing this operation, are compiled in Fernández-Arias, Eduardo and Sagari, Silvia, *Una nueva era de crecimiento económico en Uruguay* [A new era of economic growth in Uruguay], IDB, 2006.

country by the Bank and other donors.[2] It therefore includes specific reforms that complement other efforts to improve competitiveness currently underway in Uruguay, together with actions to promote the institutional changes needed to support these reforms through time and create adjustments and programs in the future as needed to strengthen Uruguay's private sector.

B. Macroeconomic environment

1.4 Uruguay has experienced low rates of growth over the last 50 years, averaging 1.7% per year between 1960 and 2001, which lags both the world and the Latin American averages. Following the deep economic and financial crisis that culminated in 2002, the Uruguayan economy embarked upon a recovery process that began to gather pace in the second half of 2003. Debt restructuring in 2003, supported by favorable developments in the international economy (including high commodity prices and low interest rates), and the macroeconomic policy management by the Uruguayan authorities fueled a robust recovery of economic growth against a backdrop of price, exchange-rate, and financial stability. This setting allowed for a gradual retreat in unemployment toward precrisis levels; fiscal consolidation involving an increase in the primary surplus; reversal of the substantial capital outflow that had occurred during the 2002 crisis, and a replenishment of reserve assets held by the Central Bank of Uruguay (BCU).

1.5 Having grown by 2.2% in 2003, gross domestic product (GDP) continued on its recovery path in the two-year period 2004-2005 with a vigorous expansion of nearly 20%, such that by end-2005 GDP had regained its record levels of the third quarter of 1998. Part of this growth reflects higher levels of private investment, which, in the context of the new administration, reflects positive expectations among entrepreneurs. Although the investment rate grew from 12.6% of GDP in 2003 to 13.2% in 2005, it still remains below precrisis levels (15.9% in 1998) and will need to rise further in the next few years if the current pace of growth is to be maintained. Low investment rates are a long-standing problem in Uruguay dating back before the crisis, which suggests that there are problems in the incentives faced by the private sector when making investment decisions.

1.6 The public finance situation improved significantly in 2003-2005, with the primary surplus growing from 2.7% GDP in 2003 to 3.9% in 2005. In addition, strong capital inflows—in the form of FDI and other financial flows—made it possible to finance a gradual increase in the trade deficit, and, as the current account gap was small, also allowed for a substantial accumulation of reserve assets at the BCU. By end-2005, the current account of the balance of payments was in virtual equilibrium. In terms of external competitiveness, the Uruguayan economy remains

[2] See "Summary of main competitiveness challenges and initiatives underway or proposed to address them" in the project technical files for details of relevant interventions and/or programs being implemented by the country, the Bank, and other donors.

vulnerable to business cycles in Argentina and Brazil.[3] An 11.9% appreciation of the peso in 2005[4] made Uruguay's exports less competitive with nearly all of its trading partners, particularly those outside the region.[5]

1.7 In June 2005 the government signed a 36-month standby arrangement with the International Monetary Fund (IMF)[6] for SDR 766.3 million, key features of which include the need for fiscal consolidation by generating a large primary surplus, and the implementation of structural reforms to generate economic growth at higher-than-historical rates (below 2% per year over the last 45 years). The first five reviews of the standby arrangement were completed in 2005 and 2006, in accordance with the established timetable; the Article IV consultation was done in May 2006; and the mission for the sixth review was undertaken in November. The two latest reviews are expected to be approved by the IMF's Executive Board in December. Against this backdrop, in late November the authorities prepaid the entire outstanding debt with the IMF, reaffirmed that the agreed fiscal targets will be maintained, and asked the IMF to continue monitoring the situation of the country on semiannual basis.[7] The IMF plans to conduct its next Article IV consultation mission in the second half of 2007. Maintenance of the conditions of the standby arrangement, supported by fiscal and monetary discipline, have enabled Uruguay to gain access to international capital markets and obtain funds to repay private debt and prepay large amortizations falling due in 2006-2007 with the IDB and the World Bank, while also financing the remaining fiscal deficit.

1.8 The fall in the inflation rate and the highly favorable international financial context, allowed for lower interest rates on the local market and a sharp reduction in country risk (219 basis points in early November). In line with the government's strategy for managing the public debt and reducing vulnerabilities arising from the concentration of maturities, the Uruguayan government issued debt on the international capital market in 2005-2006 to secure its financing needs[8] for 2006-2007. Nonetheless, loans from multilateral agencies are still pending, along with funds sourced domestically. The recent successful debt swap operation, for

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[3] Devaluations of the Brazilian real in 1999 and the Argentine peso in 2002, made Uruguayan exports less competitive in MERCOSUR, thereby reducing the share of Uruguay's total external trade absorbed by neighboring countries. While Uruguay is persevering with efforts to diversify its exports, MERCOSUR still represents roughly one third of its foreign trade, albeit down from a peak of over 50% in the late 1990s.

[4] Explained mainly by the increase in FDI, the perception of stability projected by the new government, and repatriation of capital held by residents abroad (IMF, August 2006).

[5] IMF. *Uruguay: Selected Issues*. June 2006.

[6] www.imf.org/URY.

[7] Table 2 on "Financing needs," following paragraph 1.20, shows the revised figures, bearing in mind the forthcoming payment all of outstanding debt with the Fund.

[8] Uruguay's gross funding requirements during the period have been estimated at 17.9% of GDP in 2006, 5.2% in 2007, and 4.7% in 2008.

which the government made a bond issue of US$800 million, made it possible to reduce the concentration of maturities in 2011 and 2015.

1.9 Despite the progress achieved, the high burden of public debt remains the greatest problem facing Uruguay over the next few years; and the fact that 63% of this is denominated in foreign currency generates significant physical and financial constraints. Estimations of fiscal and public debt sustainability for the period 2006-2012, based on macroeconomic assumptions (growth, interest rates and currency appreciation) and a target primary surplus of roughly 4% of GDP for the period, show the balance of outstanding debt falling sharply from 69% of GDP in 2005 to 59% in 2007, before continuing to decline more gently but steadily in 2008-2010.

C. Diagnostic of the country's competitive position

1.10 A firm's capacity to maintain competitive prices, operate efficiently, satisfy quality requirements, and innovate in terms of processes and products is affected by a series of external macro- and microeconomic factors. The competitiveness indexes published periodically by the World Economic Forum (WEF) are a useful tool for comparing the performance of key factors in a country's environment that stimulate or obstruct the competitive development of its enterprises.

1.11 The 2005-2006 edition of the WEF competitiveness rankings introduced a new and broader index of competitiveness, named the Global Competitiveness Index (GCI), comprised of three subindexes that capture a more comprehensive set of growth factors. The three subindexes are: (i) **basic requirements**; (ii) **efficiency enhancers**; and (iii) **innovation and sophistication factors**. Each of these subindexes is integrated into what the GCI calls "pillars," which are groupings of a set of indicators on microeconomic competitiveness. Table 1 shows Uruguay's positions in this ranking, with values for the three subindexes, their nine pillars, and a selection of the indicators comprising each pillar.

Table 1 Global Competitiveness Index 2006 Position of Uruguay		
Position in the overall ranking		**70**
Subindex: Basic requirements		**54**
1. Institutions		**42**
2. Infrastructure		**57**
3. Macroeconomic stability		**98**
National savings rate	105	
Inflation	100	
Interest rate spread	108	
Public debt/GDP ratio	105	
4. Heath and education		**34**
Subindex: Efficiency enhancers		**71**
5. Higher education and training		**53**
6. Market efficiency		**106**
Goods market		
Extent and effect of taxation	96	
Intensity of local competition	106	
Effectiveness of antitrust policy	102	
Financial market		
Ease of access to loans	102	
Venture capital availability	112	
Soundness of banks	111	
Local equity market access	113	
7. Technological readiness		**63**
Subindex: Innovation/sophistication		**75**
8. Business sophistication		**76**
Nature of competitive advantage	90	
Value-chain presence	78	
9. Innovation		**76**
Private investment in R&D	86	
Government procurement of advanced technology	99	

Source: Global Competitiveness Report, WEF 2005-2006

1.12 Uruguay's positions in the indicators comprising each of the pillars gives an idea of the relative importance of the problems facing its firms in becoming more competitive. In the **Basic requirements** subindex Uruguay scores well on indicators in the institutions, infrastructure, health, and education pillars. Nonetheless, its position in the macroeconomy pillar is well below its overall ranking (109th out of 125), basically reflecting the impact of the 2001-2002 crisis on key macroeconomic indicators. Uruguay is poorly placed in several of the indicators comprising this pillar: national savings rate, interest rate spread, and the public debt/GDP ratio. The country is ranked below or around 100 in each case. The inflation indicator, however, recovered smartly in 2006 as the country moved up approximately 30 places in its ranking from the year before—a tribute to the government's efforts to restore stability in the aftermath of the crisis (see table 1).

1.13 In the **efficiency enhancers** subindex, Uruguay's rank is the same as in the overall GCI (73rd). Nonetheless, there is a major disparity in its rankings in the individual pillars underlying this subindex. Indicators in the higher technical education and technological readiness pillars rank Uruguay relatively highly, at 55th and 63rd, respectively; but the fact that country obtains its worst position (116th) in the market efficiency pillar, clearly identifies the areas of microeconomic reform on which it needs to focus. This pillar combines indicators from the goods, labor, and financial markets that measure the dynamism, distortions, flexibility, sophistication, and other characteristics of these markets. In the goods market, Uruguay scores worst in the following areas: extent and effect of taxation (95th), intensity of local competition (91st), and effectiveness of competition/antitrust policy (92nd). Uruguay ranks fairly poor in almost all GCI labor market indicators measured,

including: hiring and firing practices (102nd), flexibility of wage determination (121st), cooperation in employer-employee relations (122nd), pay and productivity (112th), and reliance on professional management (96th). It fares poorly in the financial market. Except for the indicator of financial market sophistication, where it is ranked 73rd, in the other four indicators comprising this pillar (ease of access to loans, venture capital availability, soundness of banks, and local equity market access), it is between 97th and 113th.

1.14 Lastly, in the **innovation and sophistication** subindex, Uruguay's position in each of the constituent pillars, business sophistication and innovation, is below its global position. In the business sophistication pillar, the indicators that rank Uruguayan firms according to their willingness to delegate authority within firms, the nature of their competitive advantages, and the presence of their products in the global value chain (68th, 93rd, and 85th, respectively) are worse than its overall rank (except for willingness to delegate authority). In the innovation pillar, Uruguay's ranking in the constituent indicators is highly varied. It performs better than average in terms capacity for innovation, the availability of scientists and engineers, and intellectual property protection (68th, 52nd, and 51st, respectively); but its indicators of the quality of research institutions and public/private collaboration are worse than its overall position (80th and 90th, respectively). Lastly, on indicators of company spending on research and development and government procurement of advanced technology products, Uruguay is ranked 92nd and 99th respectively. Its positions in the indicator rankings for each of the nine pillars show that the country performs worse on the indicators in each pillar that are most important for the microeconomic environment in which firms operate. These broadly coincide with the areas addressed by this program through regulatory and institutional reforms.

1.15 **The challenges identified**. Uruguay's position in the GCI rankings is consistent with the studies used in preparing this program (see paragraphs 1.2 and 1.3), which identify a series of competitive challenges of various types. The challenges that are raised repeatedly in the studies, and which are important for the country's long-term growth, are:

a. **Macroeconomic situation**. Uruguay has a very large public debt, the honoring of which will require a large primary surplus until at least 2015, thus calling for careful budget management.

b. **Infrastructure.** The GCI infrastructure pillar ranks Uruguay relatively highly, since its basic infrastructure compares well to that of other countries in the region. Nonetheless, Bank studies identified a number of challenges in this area, including: reducing energy vulnerability and improving the efficiency of domestic cargo transport; and reducing the burden of freight charges in overall costs—a key issue for competitiveness, given Uruguay's distance from the world's leading consumption centers.

c. **Financial markets.** The financial system suffered major impact during the 2001-2002 crisis; the banking system lost a large proportion of its deposits,

which led to the liquidation of three private banks. At the present time, there is a shortage of financial savings and limited access to medium and long-term financing, particularly for small and medium-sized enterprises (SMEs). The country's poorly developed capital market it does not provide an alternative funding source to banks.

d. **Labor market and human capital**. Uruguay suffers from a structural problem of high levels of unemployment and underemployment. The key reasons for this situation are pockets of labor market rigidity (public sector, banks, and construction), high social security rates and payroll taxes, inflexible working hours, and weak passive and active policies on unemployment.

e. **Regulatory environment**. Uruguay's private sector faces operational challenges in a number of basic regulations. One of these is bankruptcy legislation, which is out of date and ineffective, as clearly shown during the most recent economic crisis and the period preceding it, where the current legislation has not shown the flexibility needed for fluid negotiations between debtors and creditors. Another key area is antitrust policy, particularly in a small economy such as Uruguay's, which has to do its utmost to ensure markets function better. Although Uruguay prohibits certain forms of conduct that impair competition, the fact that these are spread among a variety of laws means they lack a uniform structure, and more importantly, a specific implementing authority. Lastly, the relation between the private and public sectors is mediated by bureaucratic procedures imposed by the latter, which in the case of Uruguay have proven to be an obstacle to business development.[9]

f. **Investment**. Uruguay *displays very low average rates of gross investment* (around 13% of GDP), with public investment accounting for a large proportion of the total. At the macro level, commitments assumed by the government ensure a sustainable short-to-medium-term environment that should give certainty to the investor. There are also a set of schemes for promoting private investment in general, and investment in selected sectors in particular. These special regimes have been accumulating haphazardly in recent years, unguided a national strategy and without ensuring their mutual complementarity or adaptation to private sector needs; and, more importantly, without any monitoring or evaluation of their sector-level or general impact.

g. **Engagement in global trade**. Uruguay has historically sold a large proportion of its exports in the Brazilian and Argentine markets. Reliance on these two countries has functioned as a transmitter of external shocks and has left Uruguay highly vulnerable to the performance of other regional economies.

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[9] Both the study commissioned by the Bank, *El Clima de Negocios en Uruguay* [The business climate in Uruguay] (Graciana del Castillo, in Fernández-Arias and Sagari, op cit), and the periodic assessments made by the World Bank in *Doing Business in Uruguay*, draw attention to a set of very cumbersome procedures for enterprise creation and development, and also for access to current promotional programs and regimes.

Market diversification is therefore a major challenge on the country's competitiveness agenda for the next few years.

h. **Institutional framework to support competitiveness**. Uruguay has no formal or institutional mechanism through which the public and private sectors can discuss and forge agreements on the major issues affecting the business competitive environment.

i. **Direct support for the productive sector**. The country's policies and programs to support the productive sector are weak and poorly coordinated. Programs are spread among various ministries, many of them with few staff and sparse budgets. Specific problems exist in the following areas:

   (i) **Innovation**. Uruguay has basic research capacity with major potential to contribute to the development of innovative activities. Nonetheless, recent studies[10] have revealed weaknesses in the lack of strategic public-private coordination on science, technology and innovation (STI), and an unwillingness among firms to produce and adopt technological innovations. Moreover, existing policies are poorly coordinated and there is little cooperation between universities and firms. All of this is reflected in a low number of new patents, and business behavior that has little innovation orientation.

   (ii) **Quality**. The competitiveness of Uruguay's firms in the global market is limited by their difficulties in improving and certifying the quality of their products. The main problems detected both in the Bank's analysis[11] and in dialogue with the private sector, include the lack of a quality promotion policy based on an institution providing leadership in this area, given the coexistence of the activities of the National Standardization and Accreditation Committee and the National Quality Committee.

   (iii) **Trade promotion**. Growth based on an expansion of international markets and less reliance on neighboring markets is a major challenge for Uruguay. Historically, exports have contributed roughly 20% of Uruguay's GDP, which is above the Latin American average, but still highly dependent on a few markets (Argentina and Brazil) and a small number of products. The current export promotion structure has limited

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[10] Bértola, L. et al. *Ciencia, tecnología e innovación en Uruguay: Diagnóstico, prospectivas y políticas* [Science, technology, and innovation in Uruguay: diagnosis, prospects, and policies]. Study prepared for the Inter-American Development Bank. September 2004.

[11] Villamil, R. *Servicios de apoyo para la competitividad en el Uruguay* [Services in support of competitiveness in Uruguay], Study prepared for the Inter-American Development Bank. September 2004.

impact, acts in discoordinated fashion, and is insufficient[12] to meet the challenges of market expansion and trade negotiation. Moreover, what little is done lacks strategic direction.

D. The country's competitiveness strategy

1.16 The new government took office in March 2005 with a program prioritizing investment and social inclusion, and assumed the following commitments: (i) a prudent fiscal policy aimed at a primary fiscal surplus of 3.5% in 2005 and 3.7% for 2006; (ii) a stable monetary policy with low inflation (a target of 3.5% for 2008) and a free-floating exchange rate, with intervention to absorb undue volatility; and (iii) a sector policy favorable to competitiveness and private investment (targeting an increase in private investment from the current 13% of GDP to 20%). There is political consensus on the need to maintain stable macroeconomic policies, and the government has a parliamentary majority.

1.17 In terms of working with the private sector to improve competitiveness, the strategy proposed by the government aims to overcome the traditional informality of this relationship and the fragmented way in which the Uruguayan public sector attempts to promote the private sector. Soon after taking office, the government launched an open and continuous dialogue with the private sector through a process entitled "Compromiso Nacional" [National commitment] (CN) to identify the reforms most directly affecting the performance and operation of private enterprises, and forge consensuses to improve Uruguay's competitive environment. To consolidate this dialogue, the government's strategy includes a number of actions to be implemented as part of this program. At the most aggregate level, it will legislate to create an institution for public-private collaboration, to be known as the National Economic Council (CEN); and it will set up a public office in the Ministry of Finance (MEF) to monitor policies, regulations, and programs aimed at promoting the private sector. These two initiatives relating globally to competitiveness issues are complemented by three interagency or interministerial cooperation mechanisms in the areas of international trade, innovation, and productive development, aimed at overcoming the fragmentation of public policies in support of competitiveness. Further details on each of these initiatives can be found in section II of this document.

E. The Bank's country strategy and lessons learned

1.18 The Bank's country strategy with Uruguay for 2005-2009 aims to contribute to the achievement of sustained growth and thus reverse the deterioration in social indicators caused by the 1999-2002 crisis and create conditions for a lasting improvement in the population's living standards. Based on the main challenges identified in the strategy, it was decided to target the Bank's technical and financial

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[12] See De Groote, Roberto, *Informe de Consultoría: Diagnóstico y propuesta de reforma para la institucionalidad de apoyo empresarial* [Consultancy report: Diagnosis and proposal for reforming the institutional framework for enterprise support] February 2006, (in the program's technical files), for details on the specific weaknesses of Uruguay XXI.

support on three areas: (i) improving public governance and consolidating physical sustainability; (ii) improving competitiveness and deepening the country's international engagement to achieve sustained growth; and (iii) poverty reduction and social inclusion as an anchor for sustainable growth. Based on the analysis and dialogue process with the government and private sector that the Bank has maintained since 2004 (paragraph 2.2), this program fits into the second area.

1.19 Preparation of this program has taken account of lessons learned in the design, execution, and evaluation of the Bank's sector projects[13] in Uruguay and elsewhere in the region. Numerous evaluations of the effectiveness and impact of operations to support policy reforms conclude that this type of intervention is more effective when the country itself identifies with the programs in question, and when the design of policy reforms takes account of the country's execution capacity.[14] These conditions alone will not achieve development goals, however; instead they are the result of a joint process between the Bank and the country, involving policy dialogue and capacity building to design specific national solutions.[15] The long process of dialogue and consultation with the government and the private sector, which has framed the design of this operation, has helped stakeholders identify strongly with the proposed reforms. Evidence for this is the fact that the contents of the policy matrix for this operation were proposed to the private sector in the CN context.

F. Justification for the program

1.20 This programmatic policy reform program for an estimated US$150 million (in two separate loans) is crucial for adequate implementation of the country strategy, which includes a work program that proposes an appropriate combination of the instruments available to the Bank. The proposed operation is also set in the context of the government's economic program and the agenda of reforms to improve competitiveness; it is consistent with the goal of consolidating fiscal sustainability, which underlies the five-year budget; and it provides resources within the framework of financial needs projected for 2006-2009.

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[13] Over the last few years, sector loans to improve competitiveness have been designed and executed in Peru, El Salvador, Panama, Bolivia, Ecuador, and Colombia.

[14] World Bank. *From Adjustment Lending to Development Policy Lending: Update of World Bank Policy*. August 2004.

[15] IDB. *Policy-based loans: Guidelines for preparation and implementation*, April 2005, page 4.

Table 2
Financing needs

			Projections			
	2004	**2005**	**2006**	**2007**	**2008**	**2009**
Financing needs US$ million	2,504	2,588	3,653	1,363	896	725
IDB financing US$ million	-	185	50	360	175	-
of which Programmatic Competitiveness	-	-		75	75	-
Amortization US$ million	1,711	1,859	4,271	888	777	628
of which IDB	113	220	520	139	145	164
Public debt service % of GDP	18.1	15.6	26.3	8.6	7.9	6.9

Sources: IMF and IDB.

1.21 Programmatic loans have a series of advantages that enhance the impact of proposed reforms. Specifically, the instrument's flexibility is necessary in cases such as Uruguay, where the reform process is still unfolding, so that terms can be adjusted during execution to meet the proposed objectives. It also facilitates ongoing dialogue and technical support over the course of implementation of the reform agenda. In view of these benefits, the Uruguayan government and the project team determined that a programmatic policy reform loan was the most suitable alternative, in view of the above and lessons learned from the implementation of traditional PBLs in Uruguay.

G. Program strategy

1.22 Based on all the studies undertaken for preparation of the Bank's country strategy with Uruguay and the Thematic and Technical Notes accompanying it, the problems that form the basis of this program were identified, as described in paragraph 1.15. Nonetheless, these studies do not provide quantitative indicators of the relative importance of each problem affecting competitiveness in Uruguay. A complementary tool that does use such measures is the set of competitiveness indicators published by the World Economic Forum, detailed in paragraphs 1.10 to 1.14. As there are many programs and initiatives underway on competitiveness, some of them backed by international institutions, the program's strategy is to complement those that exist by acting particularly in areas that are not already being addressed in other initiatives. For that reason, a description is provided below of other complementary programs that were considered when defining the actions of this operation.

1.23 **Complementary programs of the Bank and other international agencies.** The following information expands that presented in the technical file, "Summary of Main Competitive Challenges and Initiatives Underway or Proposed to Address

Them," and is organized on the basis of the challenges described in the background section:

1.24 **Infrastructure**: With support from the IDB, the World Bank (WB), the Andean Development Corporation (CAF), and the Spanish International Cooperation Agency (AECI), the country is investing in the energy, transport, rural access, regional, highway, and port infrastructure sectors, which have been identified as critical areas for increasing its competitiveness, since they concern the infrastructure most closely related to external trade. In addition, the Bank also has the following programs: the highway infrastructure program (1582/OC-UR) which aims to reduce transport costs; and, in preparation, modernization of the Port of Montevideo (UR-L1004) and the Montevideo ring-road program with the Uruguayan Highway Corporation (UR-L1022).

1.25 **Financial markets**: In this area, the IDB and WB are collaborating with the following objectives: (i) to increase the transparency, efficiency, and effectiveness of public institutions; (ii) to increase flexibility and improve financial intermediation through reforms to the financial sector; and (iii) to increase the operational independence of the central bank. The Bank also has several MIF projects[16] which provide support through funding, seed capital, and technical assistance to projects undertaken by companies with high potential in fast-growing sectors and access to microcredit in the rural sector. Lastly, the program to support microfinance for productive development is in the design phase.[17] This seeks to promote the economic engagement of poor population groups and to consolidate microenterprises and small businesses.

1.26 **Labor market and human capital:** At the present time, programs run by the IDB,[18] the World Bank, the European Union, and UNESCO are underway with the aim of integrating women and young people into the rural labor market, encouraging the development of ICTs, providing training for young people, and reforming the civil service.

1.27 **Regulatory framework**: The country is currently strengthening the administrative and operational capacity of the judicial system with support from the AECI; and a Bank program aims to reduce case processing times and increase systemic credibility (1277/OC-UR). The tax area is also being addressed by the Bank, the

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[16] Comprehensive support for dynamic entrepreneurship – UR-M1019 – (US$3 million); Increasing access to financing for rural and urban microenterprises – UR-M1018 (US$150,000); Institutional strengthening of saving and loan cooperatives in urban areas outside the national capital – ATN/ME-9219 (US$200,000); Expansion of microcredit outside the national capital – ATN/ME-9340 – (US$140,000).

[17] UR-L1010. The executing agency is the Office of Planning and Budget (OPP), and it has a budget of US$10 million. Approval is expected by 2007. The Bank is also supporting this area with the following currently executing programs: Multisector global loan (1407/OC-UR); and Program to strengthen the banking sector (1496/OC-UR),

[18] Bank programs include support for civil service reform (1722/OC-UR) and the job placement program (ATN/SF-7119-RG-5).

EU, the AECI, and the Organization of American States (OAS). In the Bank's case, it has just approved a programmatic policy reform (PBL) program (UR-L1021) to support tax reform and make it easier for firms to fulfill their tax obligations, increase the equity and efficiency of the system and tax administration, improve the quality of public expenditure, and promote coordinated management of human resources.[19] The program in turn involves three support facilities, one of which is the tax management support program to modernize and strengthen the functional structure of the Internal Revenue Department (DGI), and increase levels of transparency and communication with society.

1.28 **Investment.** This area is being supported by two technical cooperations, one from the MIF to improve the private investment climate and another from the Bank to improve the quality of public investment. Greater efforts are needed this area, for which reason it will be addressed by this loan.

1.29 **Participation in global trade.** The country is currently strengthening its institutional framework for providing support particularly to the livestock, crop farming, tourism and export sectors generally, with programs from the Bank, the EU, AECI, the World Bank, UNESCO, and the International Fund for Agricultural Development (IFAD). Thus far this issue has been addressed through support targeted on specific sectors, such as: (i) the program to support productivity and development of new livestock products (1643/OC-UR), which aims to strengthen the livestock value chain, stressing the development of small- and medium-scale producers through nonreimbursable support for business plans involving new livestock products; (ii) the tourist destination competitiveness program (UR-L1018), which aims to help improve the competitiveness of the tourist sector by funding investments in strategic tourism infrastructures, improving the legal and tax framework, and supporting the organization of the sector; and (iii) the agricultural services program (1131/OC-UR), which promotes agricultural and agribusiness exports, ensuring that the corresponding products satisfy the quality/health standards required by international markets.

1.30 The country is also preparing two complementary initiatives. With support from the International Trade Centre of the World Trade Organization (WTO) and the United Nations Conference on Trade and Development (UNCTAD), an international trade strategy is being prepared for Uruguay, which will provide a framework for deciding upon specific measures to support foreign trade, consistent with the strategy. In addition, with support from a Bank project currently being prepared (the program to strengthen Uruguay's foreign trade negotiating capacity (UR-L1015)), the country will work to strengthen the capacity of its trade negotiators, improve national capacities for making the most of external agreements already signed, and support Uruguayan firms in their export activities.

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[19] A program on the national public investment system (OPP) – UR-T1013 – PRODEV – is also currently under way. IDB contribution (US$700,000).

1.31 **Direct support for the productive sector.** This topic covers the following areas:

a. **Innovation.** The Bank is currently preparing a new technological development program to succeed the one that is currently executing (1293/OC-UR). The new program, which will be submitted to the Board of Executive Directors for approval in 2007, is expected to place special emphasis on incentives for business innovation. The Bank is also closely coordinating the preparation of a new operation in this area with the World Bank, which is preparing a complementary operation (both operations have the same executing unit), thereby helping to ensure that the funding from the two banks will be used to support a single strategic program of the Uruguayan government. Lastly, a technical cooperation is being prepared with financing from the Korea Fund for Technology and Innovation, to support strengthening of the new National Research and Innovation Agency (ANII), and development of a national science, technology, and innovation plan.

b. **Promotion of business development.** The country is working in this area with support from the Bank and the EU with separate programs aimed at strengthening productive clusters. The current program has been designed in close coordination with that of the cluster and production chain competitiveness program (UR-L1020), which was approved in 2006 to help improve competitiveness in various strategic clusters. The Bank, through the MIF, is also providing sector-based support to selected clusters such as: wine, rhea breeding, aromatic plants, hydroponic vegetables, and tourism; and, on a geographic basis, in Paysandú as well as several rural areas.

1.32 **Efficiency of the public sector.** The UR-L1021 program contains two facilities related to reform of the State, which will promote efficiency in public expenditure and among civil servants: (a) *Program to improve the quality of expenditure and the budgetary process*, which will strengthen citizen information systems using information and communication technologies (ICTs); and (b) *Program to support civil service reform*, which will promote flexible, merit-based, consistent, and integrated management of central government human resources. There is also the program to strengthen the e-government strategy of the Internal Revenue Department, financed from contributions by the Bank, and other initiatives of lesser importance, supported by EU and AECI programs, as described in the technical file, “Summary of Main Competitive Challenges and Initiatives Underway or Proposed to Address Them.”

1.33 This program aims to contribute to the most important of the challenges identified that are not being addressed by other projects and programs, and which also enjoy political backing for actions to address them successfully. In cases of challenges for which other programs already exist or are being prepared, this program will focus on policy or institutional reforms to improve the effectiveness and overall consistency of other initiatives and coordinate them more effectively. Despite the ambitious scope of this and the other complementary programs, there are still problems identified in the Note on Competitiveness and the other basic studies that

are being only half-heartedly tackled at the present time, and which therefore form part of the country's long-term agenda to improve its competitiveness. These include improving the general performance of the public sector, particularly public enterprises, opening up possibilities for private investment to help boost sectors in which the private sector operates exclusively, and improvements in the labor market to encourage job creation and productivity growth.

1.34 The interventions supported by the program are organized in three main action areas: (a) the regulatory framework; (b) the institutional framework of support for the private sector; and (c) investment promotion. These three aspects are closely related and mutually reinforcing. A large part of the program's action areas will also be accompanied by Bank programs that are being prepared simultaneously, and which are currently starting their execution or will do so shortly. These programs, already described in other parts of the document, are the cluster and production chain competitiveness program; (UR-L1030), the program to strengthen foreign trade policy management capacity (UR-L1015); MIF projects to support the development of private investment (UR-M1024); comprehensive support for dynamic entrepreneurship (UR-M1019); microfinance for productive development (UR-L1010); and technological development II (UR-L1030).

II. THE PROGRAM

A. Objective

2.1 The program's goal is to help make the country more competitive. Its purpose is to improve the business climate and the institutional structure supporting the productive sector, and to promote investment.

2.2 The program is structured in two stages, following Bank guidelines on programmatic policy reform loans (see documents GN-2200-13 and CS-3633). The first operation contains a number of conditions for the (single) disbursement, and it is understood that a second operation will be processed once the authorities have achieved certain indicative targets.

B. Program structure

2.3 Based on the studies mentioned in the previous chapter, the results of the public-private dialogue in the CN context, and actions underway in the competitiveness area in other Bank programs and those of other development agencies, three policy reform areas have been identified for this program: (i) improvement of the business climate; (ii) improvement of the institutional framework for productive support; and (iii) investment promotion. The special conditions associated with these three areas are described below and presented in the policy matrix in Annex I.

1. Business environment

2.4 This component seeks to improve the business climate, by promoting a stable macroeconomic framework and reducing regulatory barriers in key areas. These

relate to difficulties[20] in the registration of new firms and access to public programs to promote investment, and problems caused by a legal framework that is unfavorable for competition and business restructuring. Conditions are included in four reform areas:

a. **Stable macroeconomic environment.** The maintenance of a stable macroeconomic environment and policies that are consistent with program goals is necessary, but not sufficient, for the country to achieve and maintain a competitive position in an increasingly globalized commercial setting.

b. **Reduction of barriers to competition.** The size of the Uruguayan economy and its geographic location create natural barriers to competition in certain markets, which need to be addressed through policy measures that promote competition. For this purpose a regulatory framework is required that provides adequate antitrust legislation. **As a condition for disbursement of the first loan**, the government will submit a draft law to Congress on the promotion and protection of competition, including: (i) prohibition of abuse of a dominant position in the relevant market; (ii) prohibition of collusive practices; (iii) mechanisms for notifying mergers that could affect competition; (iv) creation of a deconcentrated government body attached to the MEF and technically equipped to adequately fulfill its function. **The trigger for starting preparation of the second loan** requires the law to be passed by Congress and promulgated by the government; and the **indicative target for a second programmatic loan** is to have the law's implementing agency established and provided with resources (human and financial) to function adequately.

c. **Strengthening of the legal framework for business restructuring.** Uruguay's insolvency regime has remained largely unchanged since the late nineteenth century. Although specific reforms have been introduced, these have not responded to the needs of either debtors or creditors. **As a condition precedent to disbursement,** the government will submit a draft law to Congress on insolvency and business restructuring, including: (i) simplification and unification of insolvency procedures; (ii) easier access to the insolvency procedure; (iii) a flexible framework enabling the parties to reach an agreement; (iv) reduction of the costs of the procedure; (v) strengthening of the judiciary; and (vi) conservation of the viable enterprise. **The indicative target for a second programmatic loan** is to have the law regulated in terms substantially similar to those presented in the first loan.

d. **Simplification of procedures.** Uruguayan firms face high costs in their dealings with the State, which their affects registration as firms and the degree to which they comply with their tax obligations or access existing benefits and

[20] For precise statistics see the World Bank's *Business Climate Initiative* and the business climate study by Graciana del Castillo, commissioned by the Bank, both of which are included in the program files.

promotional regimes. In the first two cases there are other initiatives underway to improve the situation,[21] but activities will also be undertaken to facilitate enterprise creation that go beyond the computerization of procedures. **As a condition precedent to disbursement**, the executing agency will publish a procedural guide to the creation of corporations (SAs) and limited liability companies (SRLs) on the website of the Private Sector Development and Investment Support Unit attached to the MEF. **The trigger for starting preparation of the second loan is presentation to the Bank of a plan of action for simplifying procedures and making enterprise creation less expensive;** while the indicative target for a second progressive loan is the implementation of a single window for enterprise creation. Actions will be taken to make benefits and promotional regimes easier to access, as described in paragraph 2.6.

2. Institutional framework for productive sector support

2.5 This component seeks to strengthen and improve the functioning of Uruguay's institutional framework for productive sector support. The measures envisaged will not impose significant additional costs on public administration because they mainly involve actions to formalize and systemize the coordination of support instruments. The government has a battery of instruments for providing direct support to the private sector which are not being mutually coordinated; but as there is no transparent or standardized information covering all of them, it is virtually impossible to gauge their efficiency, effectiveness, and impact. Moreover, firms are not fully aware of the set of instruments available to them, and as there are various offices located in different ministries, entrepreneurs face high transaction costs in attempting to access the benefits on offer. The conditions are grouped in six areas:

a. **Creation of the National Economic Council (CEN).** To overcome the lack of a permanent institutional framework through which to channel public-private dialogue, and to consolidate the task initiated by National Commitment (CN), the government has decided to activate an institution which was envisaged in the Uruguayan Constitution but never created, namely the National Economic Council (CEN). The CEN will provide a mechanism for dialogue and exchange between the private and public sectors, in a systematic, fluid, and institutionalized manner. The Council will consist of a broad private-sector majority together with representatives of relevant ministries and the OPP. **The trigger for initiating preparation of the second loan** is presentation to Congress of the law creating this institution; and the indicative target **for a second programmatic loan** requires it to be

[21] In addition to the conditions committed to under this component, in late 2005 an E-Government and Information Society Development Agency was created, attached to the Office of the President. The agency's objectives include putting a series of procedures online, particularly those undertaken by firms. Secondly, ongoing reforms that form part of the conditionalities of the Bank's UR-L1021 operation should make it easier for firms to fulfill their tax obligations, by reducing taxes and making the DGI more efficient.

implemented under conditions similar to those envisaged in the draft law as presented to Congress.

b. **Improvement of coordination and articulation of private sector support programs.** These actions aim to improve public support to the productive sector, giving it strategic direction, and evaluating and measuring its evolution and results. To overcome the fragmentation of current actions, their lack of coordination and harmonization of policy objectives, and the absence of information making it possible to measure results, a Private Sector Development and Investment Support Unit will be created in the MEF. **As a condition precedent to disbursement**, the MEF will issue a ministerial resolution creating the Private Sector Development and Investment Support Unit to monitor, evaluate, and propose improvements in at least the following areas: (a) business climate; (b) trade and investment promotion regimes; and (c) business promotion programs of a financial and nonfinancial type.[22] **The trigger for starting preparation of the second loan** is selection and hiring of the Unit's staff. **The indicative target for a second programmatic loan** requires the Private Sector Development and Investment Support Unit to be operating pursuant to the Ministerial Resolution that created it.

c. **Improvement of instruments to support exports and attract investments.** The aim of this area is to achieve better support for Uruguay's external trade and attract more investment, covering the following two subareas:

    (i) **Agencies and ministries involved in foreign trade.** The creation and implementation of a long-term foreign trade policy involves coordination and the search for consensus among the various agencies and ministries involved in exports. To achieve this, the government has decided to create an Interministerial Commission on Foreign Trade (CIACEX), comprising the following ministries: Foreign relations; Economic Affairs and Finance; Industry, Energy and Mining; Agriculture and fishing; and Tourism and Sports. **As a condition precedent to disbursement,** CIACEX will be established by executive branch decree. **The trigger for starting preparation of the second loan** is that CIACEX continues to function and operate in the framework of a specific plan of action, with priorities and objectives defined to improve coordination and capacities for external trade negotiation and promotion. **The indicative target for a second**

[22] The Unit will design and monitor policies in areas including the following: (i) business climate; (ii) trade and investment promotion regimes; (iii) monitoring and evaluation of business promotion programs, both financial and nonfinancial; and (iv) promotion of public-private cooperation in defining competitiveness policies. To fulfill this brief, the Unit will undertake actions such as: creation of a single register of beneficiaries, development of a "command chain" for ongoing competitiveness policies, creation and dissemination of a guide to programs that are accessible to potential clients, development of common intervention methodologies, and periodic and systematic impact evaluations. An MIF project is currently being prepared to support the creation and implementation of this unit.

programmatic loan requires the CIACEX to be making headway in implementing its action plan, showing progress in the following priority areas at least: (i) negotiation priorities defined; (ii) export strategy approved; and (iii) mechanism of analysis established for exploiting trade agreements.

(ii) **Functioning of Uruguay XXI (UXXI).** As the institution currently responsible for promoting exports and foreign investments, UXXI has historically been relatively ineffective.[23] This problem stems from a low level of commitment among Uruguay's foreign trade stakeholders, and the institution's lack of strategic direction. Once the institutional changes have been consolidated in the area, and with CIACEX operating, a plan will be designed to improve the functioning of UXXI; but as the process envisaged in this loan must be followed first, the condition in this area is only relevant to the second operation. **The trigger to start preparation for the second loan** therefore requires CIACEX to present a reform proposal for Uruguay XXI, containing the following: (a) institutional reforms of Uruguay XXI governance mechanisms; (b) improvements to mechanisms through which the private sector participates in its actions; (c) better coordination with other promotion agencies; and (d) better funding mechanisms. The **indicative target for a second programmatic loan** requires reform of Uruguay XXI to have been approved by executive decree and be under implementation.

d. **Science, technology, and innovation (STI).** The current government has made a priority of investment in STI, and has promised to introduce institutional changes to provide the country with a State policy in this area**,** by making policies and expenditure more effective and placing special emphasis on aspects of innovation in the private sector.[24] **The following will be required as conditions precedent to disbursement**: (1) Draft Act Establishing the National Research and Innovation Agency (ANII) submitted to Congress, containing the following at least: (a) strategic objectives; (b) institutional structures; and (c) financial regime; and (2) creation of the Innovation Office by executive branch decree, encompassing the Ministries of Agriculture and Fishing; Industry, Energy, and Mining; Economic Affairs and Finance; Education and Culture; and the Director of the Office of Planning and Budget (OPP). **The trigger for starting preparation of the second loan** is approval of the Act Establishing the National Research and Innovation

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[23] Bank studies obtained this critical assessment from a variety of representatives drawn from the private sector, other public agencies and the UXXI management of that time (see the report by De Groote cited in footnote 11). The diagnostic shows a lack of institutional support for UXXI from both the public and private sectors, which led to a lack of strategic direction and chronic shortage of resources.

[24] Between 1990 and 2000, Uruguay invested an annual average of 0.23% of GDP on R&D, a figure that is half the Latin American average.

Agency (ANII). The **indicative targets for a second programmatic loan are as** follows: (i) the ANII to be functioning as per the proposal and plan approved in the first loan; and (ii) the Innovation Office to be operating as provided in the decree creating it.

e. **National Quality System (SNC).** Creation in the 1990s of the Uruguayan Accreditation, Standardization, Certification, Calibration, and Testing System (SUANCCE) did not produce the desired results, because it failed to include all institutions involved, and those that did participate did not operate as expected.[25] Institutional reform is therefore needed to improve the capacity of the SNC to address the service needs of the private sector. **As a condition precedent to disbursement,** creation of the National Quality Institute (INACAL) will need to be approved, with the aim of directing and coordinating SNC actions. **The trigger to start preparation of the second loan** is that INACAL should have hierarchical staff selected and contracted. The indicative target for a second loan is that **INACAL** should be functioning as per the law creating it.

f. **Provision of business services.** Business services for SMEs in Uruguay are promoted through a variety of public and private programs that are not mutually coordinated; as a result, their operational efficiency and effectiveness are reduced. To overcome these problems, the government will establish a program coordination roundtable,[26] with periodic meetings attended by at least 50% of members, as **a condition precedent to disbursement. The triggers** for starting **preparation of the second loan are as** follows: (i) an annual work plan agreed upon between the leading members of the program roundtable; and (ii) presentation to the Bank of the final report of consulting services for the design of a single register, containing a database on firms benefiting from all competitiveness support and productive development programs. **The indicative targets for a second programmatic loan are as follows:** (i) the program roundtable continues to operate, showing improvements in the coordination of programs represented there; (ii) the single register of business support programs has been designed, with a laboratory test of execution undertaken; and (iii) the program roundtable prepares and presents an action proposal to coordinate business support institutions, containing a short- and medium-term transition plan to operate

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[25] SUANCCE consists of: The National Standardization and Accreditation Committee; the Standardization Agency, the Accreditation Agency, certification bodies, calibration and testing laboratories, and quality system auditors.

[26] The roundtable will consist of: INACAL, DINAPYME, the Interior Development Fund (FDI-DIPRODE), the cluster and production chain competitiveness program (PACC-DIPRODE), ANII, the National Employment Department (DINAE), la CND, the PACPYMES program of DINAPYME, Uruguay XXI, the Microfinance Program (DIPRODE) (in preparation), and the Ministry of Agriculture and Fisheries (MGAP).

until a new institutional framework for support to the productive sector can be implemented.

3. Investment

2.6 The aim of this component is to promote investment in the country, by making promotion regimes more efficient and effective. The need to actuate conditions in this area stems from the existence of numerous regimes resulting from the historical accumulation of general and sector-level incentives, which today are largely ineffective since they do not respond to specific quantifiable objectives or a consensus-based strategy or vision. Moreover, access by private investors to the benefits of these regimes is complex, involving ad hoc and nontransparent procedures. **Conditions precedent to disbursement** in this component require the Private Sector Development and Investment Support Unit to present a study to the MEF on the paperwork and procedures imposed on firms to access the main promotional regimes in the country, including the following: (a) sector regimes; (b) general investment promotion regime; and (c) free zone, free port, customs warehouse, and industrial parks regimes. The study should include the following aspects at least: (a) a proposal for simplification and facilitation of the investment promotion regime; and (b) identification of opportunities to increase efficiency and effectiveness, and to improve the incentives system. The **trigger to begin preparation of the second loan** is presentation of a government plan containing its decisions on the changes to be introduced in investment regimes to make them more transparent and easier for firms to access. The plan will include at least adjustments to the mechanisms for access to the systems addressed in the condition for disbursement of the first loan, so as to: (i) simplify access; (ii) make public information on the systems more transparent; and (iii) propose a mechanism for unified monitoring and evaluation. The **indicative target for a second programmatic loan** is execution of the proposal in terms substantially similar to those established in the plan presented by the government.

III. PROGRAM EXECUTION

A. Borrower, guarantor and executing agency

3.1 The borrower and guarantor is the Eastern Republic of Uruguay. The program's executing agency will be the Ministry of Finance (MEF), acting through its Macroeconomic Division, which will be responsible for monitoring the conditions agreed upon in the program and relations with the Bank.

B. Execution period and disbursement schedule

3.2 As the proposed operation is a programmatic policy-based loan, the conditions precedent to its disbursement are expected to be fulfilled before the loan contract is signed. All of the agreed conditions have now been met, and only the evidence agreed in the means of verification matrix needs to be presented to the Bank. The single disbursement is therefore expected be made shortly, once the loan contract

has been approved and signed. The second programmatic loan is expected to be prepared during the 12 months following disbursement of the first loan. Progress on this second operation will depend on the pace at which the trigger actions described above can be accomplished.

C. Monitoring and evaluation

3.3 Monitoring of the actions—both those considered conditions precedent to the first disbursement, as well as trigger mechanisms and indicative targets for disbursement of the second loan—will be the responsibility of the MEF Macroeconomic Division. The government has indicated that the Private Sector Development and Investment Support Unit will take over program monitoring and evaluation responsibilities once it becomes established and strengthened. The MEF will file semiannual reports with the Bank enabling it to monitor the different areas involved, and these will be used by the project team to evaluate the fulfillment of trigger mechanisms for starting preparation of the second operation, and to make the corrections needed to define a definitive matrix of conditions for the second loan. Additionally, the project team will maintain mechanisms for dialogue and offer ongoing technical support for the reform process, to help meet the indicative targets set in the matrix and/or identify alternative mechanisms to meet the program objectives. These activities will be supported by technical missions every four months.

3.4 The Results Matrix (see the technical files) will be monitored by the Macroeconomic Division. The Private Sector Development and Investment Support Unit will take over as soon as it is established, since one of the central objectives of creating this unit is to measure and evaluate the competitiveness of the Uruguayan economy, and the effectiveness of the various public programs proposed to improve private sector competitive development. As the institutional reforms and policies included in this operation's policy matrix will require time to demonstrate their impact, it was decided to measure the program's expected results (outcomes*)* two years after all the matrix conditions have been satisfied for the entire program, i.e. for the first and second loans. Nonetheless, the products obtained (*outputs*) will be measured at the end of each operation, since these are equivalent to the conditions agreed upon in the policy matrix.

IV. VIABILITY AND RISKS

A. Expected results on conclusion of the two operations

4.1 The program is designed to improve the investment and competitiveness environment facing Uruguayan firms by: (i) reducing bureaucratic, legal, regulatory, and institutional barriers to trade and business development in general; (ii) restructuring public support for the productive sector; and (iii) reformulating existing investment incentive schemes, to make them more efficient, effective, and transparent. As these involve essentially structural issues that improve the country's business and investment climate in both the medium and long terms, the impacts

are hard to measure; and the problems of attribution that occur in any Bank project are accentuated in an operation of this type. All competitiveness diagnostics performed recently in Uruguay identify low levels of investment as the central cause of the country's decades-old malaise: i.e. its very low rate of economic growth. Although myriad private sector decision makers weigh up a complex set of conditions before assuming the risks of investing, this program contains actions in a group of areas that should jointly improve the investment climate and elicit an increase in the investment rate that is sustainable through time. This in turn should lead to faster economic growth, with positive repercussions for employment and income. Nonetheless, given the attribution problems mentioned above, measurements of program impact will focus on the more immediate achievements, more directly related to the actions listed in the policy matrix, which can be expected for the medium term.

4.2 These impacts will be visible by the end of the second operation and can be measured two years after its conclusion. The results matrix contained in the technical files includes targets for improving the business environment that are measurable through three types of indicator: (i) quantitative and qualitative indicators obtained from the WEF Global Competitiveness Report, since these are considered good proxies of the microeconomic factors that underlie competitiveness; (ii) statistical data in the case of highly aggregated indicators such as those on foreign trade; and (iii) specific surveys conducted to measure program results, with private firms and those responsible for public programs, to capture the more qualitative improvements generated by the institutional changes being proposed.

B. SEQ and PTI classification

4.3 This operation does not qualify as a social-equity enhancing project, as described in the indicative targets mandated by the Bank's Eighth Replenishment (Document AB-1704).

C. Social and environmental impact

4.4 This document was reviewed by the Committee on Environment and Social Impact (CESI) at its meeting 45-06, held on 17 November 2006. The nature of the program means it will not generate direct environmental and social impacts, although some of the proposed measures, in an increasingly open economy, are expected to encourage firms to adopt international standards on environmental protection and social responsibility.

D. Institutional viability

4.5 The Ministry of Finance (MEF) is present and provides leadership in all of this program's reforms; and its inherent role gives it the experience and resources needed for program execution. Bank teams also analyzed the institutional viability of entities working in this program's reform areas in the course of preparing other programs that are just starting or coming to the end of the design stage. The Office

of Planning and Budget is starting to execute the cluster and productive chain competitiveness program (UR-L1020), for which its institutional viability was assessed and confirmed using the Institutional Capacity Assessment System (ICAS). A technological development operation which underwent the corresponding institutional analysis is also currently being executed; and a new operation to continue this one is being prepared which will review and strengthen the institutional capacity of entities related to the area. Lastly, during the recent preparation of the programmatic PBL UR-L1021, the Bank made institutional assessments of the executing agencies in sector facilities (OPP, DGI, and ONSC), also using the ICAS. These confirmed that the institutions have the institutional capacities that are essential for adequate program execution, although a number of administrative and management weaknesses need to be addressed. To that end, the program developed and agreed upon an institutional strengthening plan with each sector facility executing agency.

E. Risks

4.6 The success of the program will depend on significant improvements being made to the organizational and functional structure of competitiveness support, and also in certain regulations that will promote private sector investments and development. As the changes needed for the first programmatic loan were made during program preparation, the first disbursement and the attendant policy reforms are risk free. Nonetheless, the reforms for the second programmatic loan depend on the political will and capacity of the Uruguayan government, which could prove to be complex since the government is a coalition of different parties.

4.7 This risk is mitigated by the following. First, the government, as well as the political forces holding it together, has shown a consistent attitude to the reforms since the start of its term of office, as was verified by the project team during preparation of this program. Second, the MEF, which is the Bank's counterparty and will supervise fulfillment and progress on the conditions of the programmatic loan, has made the program a high priority and has several important initiatives under its control for the second operation. Third, the policy areas are included in the government's plan as a commitment with society, and have been widely discussed with the private sector. Fourth, the program design includes trigger indicators for preparing the second programmatic loan, which will make it possible to evaluate the reform process and the level of risk attaching to its satisfactory implementation. Lastly, other ongoing Bank operations will support the country in the reform process promoted by this program in the science and technology areas (technological development program II – UR-L1030), foreign trade support (strengthening of foreign trade negotiating capacity – UR-L1015) and private sector development (cluster and production chain competitiveness program – UR-L1020); MIF project to support private investment – UR-M1024.

4.8 A somewhat related risk, concerning the coalition government's capacity to implement far-reaching reforms, stems from the fact that this government has decided to tackle a large number of problems that have been affecting Uruguay for

years. This opens up a series of potential conflicts which could undermine the overall effectiveness of the reform effort. Until now, the government has succeeded in maintaining the reform momentum and social support for the changes and reforms proposed, taking great care to foster the necessary social consensus before undertaking major reforms—something that was neglected in the past and resulted in many badly needed reforms being halted.

4.9 The foundations for improving competitiveness include good relations between workers and employers, which Uruguay has traditionally enjoyed. Nonetheless, the depth of the most recent crisis, compounded by a number of regulatory amendments introduced in 2005, heightened the intensity of labor disputes and is having an effect on the business climate. This risk appears to be largely transitory, however, since labor disputes have been declining since mid-2006, and the government is committed to creating conditions to ensure labor relations in Uruguay regain their traditional harmony.

4.10 An additional risk associated with reform of promotion regimes is that the change may adversely affect certain interests, creating additional obstacles to effective reform. This potential risk will be mitigated by the following factors: (i) execution of the MIF operation to support the Private Sector Development and Investment Support Unit will provide it reform tools to better overcome barriers to change; (ii) the government has affirmed—both to the Bank and publicly— its commitment to implement the reforms regardless of resistance; (iii) a diagnostic assessment has been done to clearly identify problems with the regimes, and general support for change has been observed in the business community.