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Remarks: Distributed herewith is the profile that marks the launching of the preparation process and lays out an initial proposal of the key elements of the Institutions for Growth and Social Welfare Strategy.

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SECTOR STRATEGY INSTITUTIONS FOR GROWTH AND SOCIAL WELFARE

Revised Profile

Institutional Capacity and Finance Sector (ICF)

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**SECTOR STRATEGY
INSTITUTIONS FOR GROWTH AND SOCIAL WELFARE
PROFILE**

I. OBJECTIVES

- 1.1 The Ninth General Capital Increase (GCI-9) outlines key objectives and strategic goals for the IDB to follow in years to come, focused on a partnership with its member countries to confront the two main challenges faced by the region: reducing poverty and inequality, and achieving sustainable growth. The Bank's institutional strategy to develop this partnership calls for action along five sector priorities: (i) social policy for equity and productivity; (ii) infrastructure for competitiveness and social welfare; (iii) institutions for growth and social welfare; (iv) competitive regional and global international integration; and (v) protection of the environment, response to climate change, promotion of renewable energy, and food security¹. The GCI-9 Report further expands on sector priority (iii), calling for the development of "a strategy for institutions for growth and social welfare with a special focus on access to financial markets, particularly for SME's."² Management intends to present the Strategy to the Board of Executive Directors in March 2011.
- 1.2 The objective of this Strategy is *to improve the effectiveness of the Bank in strengthening the institutional basis for development in the LAC region by focusing its resources in areas of high value added and comparative advantage*. This Profile marks the launching of the preparation process and will lay out an initial proposal of the key elements of the Strategy.
- 1.3 The document will first develop a conceptual framework to understand the main concepts that underlie the Strategy. This is necessary due to the amplitude of interpretations to the term "institutions" and the need to develop a precise understanding of the scope of the Strategy. This is done with reference to the Bank's overarching objectives in GCI-9 and with support of the literature and practical experience in this area. This is a first step towards closing in more specific areas where the Bank will concentrate its attention. From this starting point, the Strategy will narrow down the broad catalogue of issues in the area of institutions into a subset that is aligned with (i) the main development gaps of the region; (ii) country priorities, and (iii) the Bank's comparative advantages. In this fashion, the Strategy is expected to reflect the notion of areas of business development as defined in the GCI-9 Report³, that is, high value development areas where the Bank can expand its lending activity in the next few years on the basis of accumulated knowledge and experience.
- 1.4 While the Strategy will provide the analytical basis for the focus on areas of business development, specific action plans will be needed for the areas that make up this subset. Such action plans will further elaborate on operational targets and will pay special

¹ Chapter III of the GCI-9 document (AB-2764)

² Para. 3.20, AB-2764.

³ Para 3.19, AB-2764

attention to the synergies between knowledge management, technical assistance and lending activity⁴.

II. CONCEPTUAL FRAMEWORK

- 2.1 The Bank's Institutional Strategy in GCI-9 justifies institutions for growth and social welfare as a sector priority by arguing that *"The presence of strong and effective institutions is a determining factor of a country's development. There is ample evidence that countries that have benefited the most from economic reforms are those that have advanced the furthest in implementing successful institutional reforms"*. In this connection, the GCI-9 extends the notion of institutional development beyond conventional projects related to reform of the state to include, for instance, institutions that are indispensable for the development of credit and financial markets.
- 2.2 Contemporary sociologists use the term "institution" to refer to complex social forms that reproduce themselves such as governments, the family, human languages, universities, hospitals, business corporations, and legal systems⁵. Economists, in turn, tend to think of institutions as the constraints that structure human interaction, which are made up of formal constraints (rules, laws, and constitutions), informal constraints (norms of behavior, conventions, and self imposed codes of conduct) and their enforcement characteristics. Together they define the incentive structure of societies and, specifically, economies⁶. The growing field of New Institutional Economics is largely based on the principle that institutions that reduce transaction costs promote an enabling environment for growth and are therefore essential for economic development⁷.
- 2.3 For the purpose of this strategy, we borrow from sociology and economics and address the two overarching objectives defined for the Bank in GCI-9 –sustainable growth and reduced poverty and inequality. In this strategy, we understand institutions as deliberate arrangements that shape human interaction, and will focus on a subset of them that have a role (either explicit or implicit) in promoting economic growth and social welfare. This subset includes laws, regulations, organizations and contractual arrangements, both in the public and private sector.
- 2.4 There is overlap between institutions that promote social welfare and those that promote economic growth. And many indeed serve both purposes. In addition, there is plenty of evidence that social welfare, equity and economic growth are interdependent dimensions of development. Notwithstanding this overlap, a distinction can be made between those institutions most aligned with social welfare from those aligned with growth, or more specifically, with fostering the productivity of the economy.
- 2.5 **Institutions for Social Welfare.** Citizens obtain social welfare from three basic sources: market, family, and government. Esping-Andersen (1990) identifies different welfare regimes depending on the mix of public-private provision of welfare services, its outcomes

⁴It should be noted that there is no exclusive relationship between the Strategy and a particular Bank sector department; although the Institutional Capacity and Finance Sector (ICF) is its focal point, close collaboration with other Bank units working with both the public and private sectors will be exercised in the preparation of the Strategy and will be necessary for its implementation.

⁵ "Social Institutions" in Stanford Encyclopedia of Philosophy, 2007

⁶ Douglas North: Lecture to the memory of Alfred Nobel, December 9, 1993

⁷ Ronald Coase (1937)

or results, and the impact on the political process of welfare distribution^{8,9}. Sustainable welfare regimes are those able to generate welfare levels that are acceptable to citizens and can be reinforced over time.

- 2.6 Latin America and the Caribbean is one of the most unequal regions in the world. The highly unequal distribution of income parallels high inequalities in the access to services, including education, health, political representation, safety from crime, and basic services such as water, sanitation and electricity¹⁰. In this region, the promotion of social welfare requires proactive measures to reduce or compensate structural disparities by generating voice, opportunities and rights for the less favored segments of society with the support of institutions.
- 2.7 Social welfare hence depends to a great extent on the capacity of the State to deliver essential public services. Institutions determine the volume, composition, quality and timeliness of services that are provided to the population, and the ability of institutions to level the economic and social playing field to influence the distribution of opportunities among the population.
- 2.8 **Institutions for Growth.** Since Ronald Coase argued that institutions that reduce transaction costs are essential for economic development, there has been abundant specialized literature exploring the multi-faceted relationship between institutions and growth. Even though there are authors that hold that institutional development depends upon the level of economic development, most claim that adequate institutions are actually a precondition for development. There is also abundant empirical evidence that shows how institutional variables are closely and positively correlated with economic development or with certain aspects of it (labor productivity, quality in investment, efficiency of public goods, etc.).
- 2.9 The interpretation of institutions for growth that will be the focus of this strategy has two faces: on the one hand, institutions that lower transaction costs (or, more generally, remove constraints) for businesses growth and productivity, with the objective of minimizing those costs, and, on the other hand, institutions that, through concrete policy or investment interventions, can compensate market failures, bring growth opportunities to sectors of the economy that would not otherwise have them, and contribute to an improvement in the standard of living. A reduction in transaction costs can be, for example, the reform of a financial regulatory framework that may place unreasonable obstacles to borrowing, while a concrete intervention could be a partnership with a second-tier bank to channel funds to small and medium enterprises.

⁸ Esping-Andersen identifies three welfare regimes in developed countries: the “liberal” regime proposes minimal public intervention under the assumption that the market can provide adequate welfare to most citizens; the “social-democratic” regime emphasizes universal inclusion and a comprehensive definition of social entitlements, and the “conservative” regime is built upon social insurance, often along narrowly defined occupational distinctions. (Esping-Andersen, Gosta, *The three Worlds of Welfare Capitalism*).

⁹ Studies for Latin America propose different characterizations and emphasize their transitional stage. See, for instance, Gough, Ian and G. Wood, *Insecurity and Welfare Regimes in Asia, Africa, and Latin America: Social Policy Development*, Marcel, M. and E. Rivera, *Regímenes de Bienestar en América Latina*, In E. Tironi (ed). *Redes, Estado y Mercados. Soportes de la Cohesión Social Latinoamericana*; and Segura-Ubiergo, Alex, *The Political Economy of the Welfare State in Latin America. Globalization, Democracy and Development*.

¹⁰ Source: De Ferranti, Perry et. al: “Inequality in Latin America and the Caribbean: Breaking with History?”, World Bank, 2003. The document states that the results for safety from crime are ambiguous.

III. DIAGNOSIS

- 3.1 Institutions in Latin America and the Caribbean have advanced considerably over the last decades. Democracy has consolidated and governments have implemented reforms to broaden access and quality of services, promote transparency and accountability, strengthen institutions and improve regulatory frameworks. However, institutional development in the region still lags other regions in the world and citizens' perceptions on the quality of institutions is very poor. For example, the 2008 Worldwide Governance Indicators published by the World Bank place Latin America behind East Asia, the Middle East/Northern Africa, and Eastern Europe (and considerably behind the OECD) in terms of its Government Effectiveness indicator¹¹, which captures perceptions on quality of public services, and the *Latinobarómetro* survey shows that 67% of respondents in the region have little or no trust in their public administrations¹².
- 3.2 There clearly remain major challenges that need to be addressed, in particular considering that LAC is mostly a middle-income region with the resources to do much better. In many areas where the region has partnered with the IDB or other multilateral institutions over the years, sustained progress is being made but new challenges emerge as new technologies and best practices become commonplace. Many other areas that are now being better understood in terms of their causes and effects on development have institutional roots that need to be addressed.
- 3.3 **Regional Challenges.** Below we illustrate some of the challenges that are still faced by the region that have significant institutional roots. A full diagnosis of the challenges in the areas of action selected for the Strategy will be developed in the final document.
- a) Public Administration and Fiscal Management. The provision of public services, both in quality and quantity, depends to a large extent on the public sector's capacity to mobilize resources and ensure their most efficient use in the service delivery process. Despite significant progress at the national level throughout the region, new technologies and good practices are emerging, expanding the frontier in areas such as public expenditure management and setting new paradigms for management for results. Resource mobilization in general is still far from its potential; the tax burden in Latin America hovers around an average of 18.3% of GDP, at least 2% below its potential, and with serious imbalances across countries¹³.
- The decentralization process has taken root in the region and is progressively expanding the responsibilities and fiscal relevance of subnational governments. Nearly 50% of public investment is already under the watch of states and municipalities throughout Latin America and the Caribbean. However, the process of transferring financial and service responsibilities has been faster than the institutional strengthening of these governments. The gap between new responsibilities and actual capacity to manage them places significant challenges to service delivery at the local level.
- b) Citizen security. Crime erodes social and human capital, discourages business, and undermines democracy, and LAC has some of the highest crime statistics in the world.

¹¹ Kauffman et. al., *Governance Matters 2009*, in www.worldbank.org

¹² "Confianza en la administración pública" indicator at www.latinobarometro.org

¹³ Jiménez, J., Gomez Sabini, J.C., and Podestá, A., "*Evasión y Equidad en América Latina*", CEPAL, 2010.

Citizen security has been identified as one of the three most important development challenges in a survey implemented as part of the GCI-9, alongside quality in education and social security¹⁴. In addition to the human cost, crime increases expenditures on health services, legal costs, worker absenteeism, investment in private security, and an overall decline in productivity. An example of the fiscal cost of violence is reflected in a UN report on Guatemala which found that in 2005, the Government's efforts to combat civilian insecurity cost approximately \$2.4 billion, around 7.3% of GDP¹⁵.

- c) Rights of Citizenship and Property. Only people that are properly registered and documented can access most public services and exercise rights (such as voting) across the region. Furthermore, participation in the formal economy (including access to work and credit) is greatly restricted to those without proper documentation. Despite progress over the last decades, millions of people in LAC remain unregistered; at least 11% of children are not registered before their 5th birthday¹⁶. Furthermore, processes for registering property and establishing businesses remain cumbersome and susceptible to corruption, leaving many without the opportunity to raise capital, carry out transactions or enter the formal economy.
- d) Financial Inclusion. It is well established that countries that have deeper and more efficient financial markets tend to grow faster and have less income inequality compared to countries that do not have well functioning financial markets. Over the last three decades access to credit in Latin America and the Caribbean, often from semi-formal sources, has improved somewhat but some types of financial services, such as savings, insurance, and payments, are still underdeveloped. Only around 33% of households in the region are banked, 10% have access to credit, 16% to savings and only 1% to insurance¹⁷.
- e) Innovation. Available evidence shows that investments in R&D are a key source of productivity growth. (Rouvinen, 2002; OECD, 2002). Despite modest improvements, R&D efforts in LAC remain extremely low compared to those of more developed countries¹⁸. Moreover, LAC firms are investing less in innovation as a percentage of their sales than most comparison countries (Innovation Surveys¹⁹ and OECD data). In addition, R&D efforts in LAC are heavily concentrated in the public sector²⁰, where impact on industry productivity growth and national competitiveness can be less

¹⁴ As reflected in the Report on the Survey for the 9th General Capital Increase

¹⁵ Source: UNODC.

¹⁶ Source: UNICEF.

¹⁷ Various sources, including Westley and Tejerina (2006), and Levine et.al. (2001)

¹⁸ The LAC region has increased R&D expenditure from 0.53 to 0.67 percent of GDP from 1997 to 2007 (RICYT, accessed 2010). By comparison, in 2007 R&D expenditure in Korea was 3.47 percent, the United States 2.68 percent, EU27 2.29 percent, and Ireland 1.31 percent of their respective GDPs (OECD, accessed 2010).

¹⁹ Innovation Surveys (Argentina: 1998-2001; Brazil: 2005; Chile: 2004- 2005; Colombia: 2003-2004; Costa Rica: 2008; Panama: 2008; Uruguay: 2005-2006).

²⁰ The majority of R&D is financed by the business sector in countries such as Korea (75 percent), China (69 percent), and the United States (66 percent), whereas in LAC less than half (37 percent) of R&D funding comes from the business sector (OECD and RICYT, accessed 2010). Furthermore, LAC firms are investing less (as a percentage of sales) in innovation and R&D than most comparison countries (Innovation Surveys²⁰; OECD and Eurostat, accessed 2009).

substantial²¹. Innovation systems in the region suffer from: (i) weak interaction between institutions, universities and firms, both at national and regional levels; (ii) an insufficient number of researchers; (iii) a lack of ICT infrastructure; (iv) economic exclusion in access, knowledge and use of science and technology; and (v) inadequate regulatory policies which limit the benefits of key ICTs.

- f) The “missing middle” of SMEs. Latin America’s private sector accounts for as much as 90 percent of overall economic activity. Hence, to be effective, growth-oriented policies must foster private sector productivity growth. Over the last 25 years, productivity growth in Latin America has been slower than in other regions of the world²². In this regard, SMEs are relevant, since they offer an important source of productivity growth as they account for 20% to 40% of private sector jobs, and for 25% to 40% of private sector production²³. Yet this sector is not only smaller than in the developed world²⁴, but it also faces wider gaps with larger firms: on average, the productivity of Latin American SMEs is less than 40% that of the larger firms in the region, compared to 65% in Europe and the United States²⁵. This has led some observers to characterize SMEs as a “missing middle” in the productive structure of the Region. There are two important constraints to SMEs growth: i) their limited access to credit financing: wherever firms are less credit constrained, evidence points to higher profits and productivity²⁶; and ii) the competition with smaller, informal firms (which are the largest sector in LAC in number of firms). As it has been shown by IDB’s research, preferential tax regimes for smaller firms and informality act as a brake on SMEs growth.

IV. BANK RESPONSE AND LESSONS LEARNED

- 4.1 The IDB has long held the view that institutions play a key role in development. The 1994 report on the Bank’s eighth replenishment states that “In order for the countries of the region to be internationally competitive and address social needs, it is essential that they modernize their production structures and their public sectors; they must also have appropriate financial and legal institutions.”²⁷ In 1996 and following up on the IDB-8 mandate to support institutional development, the Bank approved the “Frame of Reference for Bank Action in Programs for Modernization of the State and Strengthening Civil

²¹ Guellec and Van Pottelsberghe de la Potterie (2004) show that business R&D is very highly correlated with multifactor productivity and that public R&D, while positively associated, has a weaker correlation (.675 and .383 respectively).

²² A thorough account on productivity in the region can be found in the 2010 IDB Development in the Americas publication, “The Age of Productivity: Transforming Economies from the Bottom Up” (C. Pagés, ed.)

²³ “Políticas y Buenas Prácticas del Financiamiento de la Pequeña Empresa,” IDB, 2009

²⁴ Though the size and number of SMEs varies across the region, empirical evidence indicates that their numbers are correlated with income levels. The number of SMEs per each 1000 people is 50 for high-income countries, 30 for upper-middle countries and less than 25 for lower-income countries. In LAC, for upper middle countries, the number is 26.4 for Argentina, 27.1 for Brazil, 29.3 for Mexico, and in Chile 35.7. For lower income countries, LAC has a small number of SMEs in comparison to other developing regions worldwide. (Database background information for Ayyagari, Beck and Demirgüç (2005). “Small and Medium Enterprises across the Globe”. World Bank, Washington, DC.)

²⁵ See European Commission (2000) and Peres and Stumpo (2000)

²⁶ Guirking and Boucher (2007) and McKenzie and Woodruff (2006)

²⁷ GN-1763-2, para. 2.30.

Society” (GN-1883-5), and in 2003, this frame of reference was updated through the approval of the “Strategy for Modernization of the State” (GN-2235-1), which focused on four areas of action for the Bank: Democratic System; Rule of Law and Justice Reform; State, Market and Society; and Public Management.

- 4.2 The 1999 Institutional Strategy reinforced the Bank’s comparative advantage in supporting Modernization of the State and makes a case for enhancing the Bank’s interventions, indicating that *“While the region has made an impressive commitment to democratic forms of government, much of the institutional infrastructure of democratic governance remains weak. Citizen security and corruption are issues of national debate, judicial systems are less than fully effective in sustaining the rule of law, legislatures lack the professional support needed to effectively interact with the executive branch on a broad range of questions, civil services are not yet fully modern meritocracies, and transparency is not always the norm in public decision making. Reform of the public sector is, however, clearly on the agenda in the region.”*²⁸
- 4.3 In 2007, the reorganization of the Bank brought together four key areas related to institutional development under one roof: Modernization of the State (including public financial management, citizen’s security, judicial reform, statistics, anti-corruption, etc.), Capital Markets and Finance (including financial sector reform, access to finance, productive development and business climate issues), Fiscal Management (tax policy and administration), and Sub-National/Municipal Management and Urban Issues (fiscal decentralization, sub-national administration, local governance, etc.). In 2008 and 2009, the new Institutional Capacity and Finance sector approved 83 loans with for a total of \$8,067.4 M, equivalent to 34% of the value of the Bank’s total sovereign-guaranteed approvals for those years.
- 4.4 Since the time of the eighth replenishment, through the most recent reorganization and to this day, the Bank has been developing comparative advantages to support the region in institutional modernization and reform. In certain areas, the Bank has already become or is becoming the first option for governments in the region; for example, 71% of the total financial flows from multilateral organizations in support of citizen security projects come from the IDB, while in the area of tax administration, the financial flows between the IDB and the World Bank are roughly equal²⁹.
- 4.5 Over the years, the IDB has accumulated a wealth of knowledge and experience that is directly relevant to the objectives of this Strategy. In 2010 alone, close to \$9 million³⁰ is being invested in related Knowledge and Capacity Building Products (KCP), adding to an already extensive stock of books, working papers, and other publications produced over the years. The DataGov database, managed by the Bank, is a valuable resource for the study of institutional issues throughout the world, bringing together around 800 indicators for supporting research. In addition, the Bank engages in constant policy dialogue with its

²⁸ GN-2077-1, paras. 3.48, 3.49

²⁹ Source: Reyna, J.J. Baseline Report for ICF Niches of Excellence, 2009.

³⁰ Includes KCP funded from all sources.

clients, including through a Regional Policy Dialogue mechanism that includes topics such as debt management and management by development results³¹.

- 4.6 In the preparation of GCI-9, the Bank carried out a survey of over 3,000 representatives of civil society organizations, opinion leaders, and government authorities to identify opinions regarding Bank priorities, comparative advantages, and areas for improvement. From the ten development challenges identified as most important by the respondents, at least four have clear institutional content: public expenditure management, the fight against corruption and money laundering, financing for SMEs and citizen security.
- 4.7 Beyond modernization of the State. The concept of institutions that was discussed in the previous section is deliberately broad in that it includes not only organizations, but also regulatory frameworks and markets. Releasing institutional constraints to growth, for instance, has much to do with understanding the environment in which the private sector operates not only in terms of fiscal or administrative costs, but also in terms of accessing financing at competitive rates. Effective regulatory capabilities are indispensable for the development of credit and financial markets, which have a direct effect on the emergence of strong private sector institutions³². In contrast with previous strategies, the Strategy derived from this mandate goes beyond the concept of modernization of the state towards a broader vision of institutional development that also touches on the private sector.
- 4.8 Lessons Learned. To achieve the output contribution committed in IDB-9 and enhance its support to the region in other important areas that do not have explicit quantitative targets, the Bank must first take stock of the lessons learned. This is a critical part of the strategy design process since the track record of institutional strengthening and reform programs has been mixed and valuable lessons are contained in external evaluations and project completion reports.
- 4.9 There is a substantial body of knowledge in OVE reports produced throughout the years. The Bank intends to review these carefully and incorporate those lessons most relevant to the Strategy. Some of the key OVE documents that will be reviewed are the evaluations of the Bank's work in the fiscal sector (2006), in citizen security (2010), the PRODEV Special Program in Management for Development Results (2008), and several country-specific evaluations of institutional programs.
- 4.10 In terms of general lessons learned from project completion reports, some of the most commonly seen are:
- Institutional reforms take time and persistence. A long-term perspective is necessary with particular emphasis on change management.
 - The political economy needs to be understood. Institutional reforms often carry winners and losers; risks must be clearly assessed and weighed against expected benefits.

³¹ For example, the PRODEV Special Program in management for development results has organized 122 national and regional events (courses, seminars, workshops, forums, conferences) since its creation, reaching more than 6,800 government officials, policymakers, lawmakers, opinion leaders, academicians, evaluators, development partners from bilateral and multilateral development organizations, civil society and nongovernmental organizations.

³² AB-2764, para. 3.16. Examples of private sector institutions are contracts, arbitration mechanisms and codes of conduct.

- The Bank can successfully help address market failures. This is particularly evident in financial intermediation towards small and medium enterprises, which may otherwise be crowded out of credit.
- Institutional reform is a transversal, cross-sector issue. Expertise in identifying and resolving institutional constraints is an important element in project design and supervision across all sectors.

V. AREAS FOR BANK INTERVENTION

5.1 Table 1 describes the wide array of institutional topics covered in the literature and policymaking. Overall, some 40 topics are distributed over five different areas: political system, rule of law, public management, economic institutions and civil society. Most topics can be broken down into sub-topics. Public financial management, for instance, can be disaggregated into sub-systems as budget, treasury, procurement, asset and liability management.

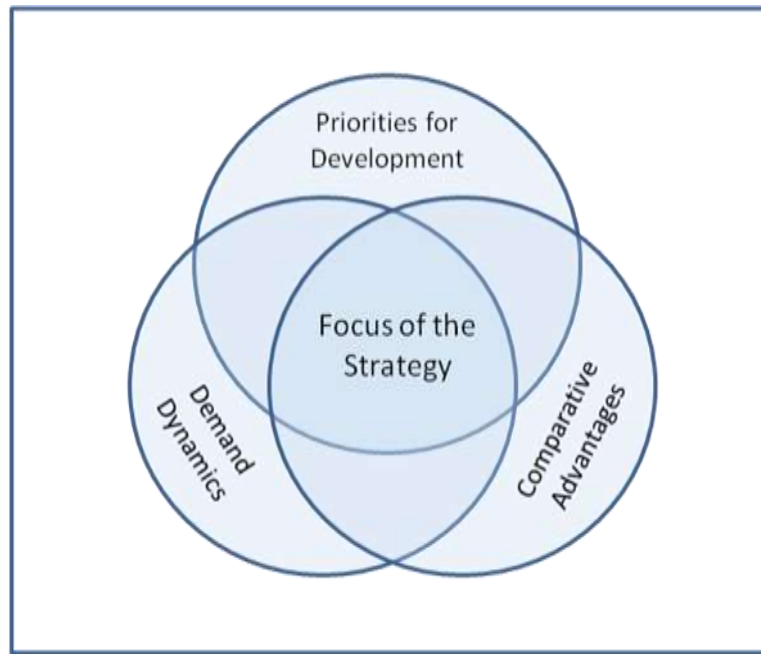
Table 1: Catalogue of institutional topics by area

AREA	TOPICS
Political system	<ul style="list-style-type: none"> • Constitutional system • Electoral system • Political parties • Legislature
Rule of law	<ul style="list-style-type: none"> • Legal framework • Justice administration • Law enforcement • Criminology and forensic services • Penal system • Prevention of crime and violence • Human rights • Organized crime, drug trafficking and money laundering
Public management	<ul style="list-style-type: none"> • Government organization • Policy decision-making and coordination • Development planning • Public financial management • Civil service and human resources management • Control systems • Public transparency and anti-corruption • Decentralization and relations between levels of government • Subnational administration
Economic institutions	<ul style="list-style-type: none"> • Property rights • Contracts, arbitration and dispute resolution • Property and business registration • Bankruptcy law • Corporate governance • Competition oversight and consumer protection • Certification and norms • Anti-trust and regulation • Capital markets and financial institutions • Business development services • Innovation and intellectual property • Cross-border investment, trade and dispute resolutions
Civil society	<ul style="list-style-type: none"> • Identity registration, public records and privacy protection • Civil rights • Civil society organizations

	<ul style="list-style-type: none"> • Charities, foundations, volunteer and nonprofit organizations • Citizens' participation and petition rights • Mediation and conflict resolution • Media, public opinion and free speech
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- 5.2 However rigorous, this list would entail excessive dispersion for a Bank agenda, which should be in principle limited by the Bank's legal authority as some types of institutions (such as political parties) fall outside the scope of the Charter. From this starting point, a substantial part of the preparation of the strategy will be dedicated to the selection of actual areas of focus through the application of three filters: (i) regional economic and social development priorities; (ii) demand from countries, and (iii) comparative advantages of the Bank. The resulting subset of areas will be where the Bank will invest substantially in further knowledge generation, recruitment, and development of innovative products and services for our clients.

Graph 1: Criteria for Selecting the Areas of Focus



- 5.3 Defining these areas of focus of the Strategy cannot be done in isolation. In addition to an open consultation process through the Bank's website, there will be a focused exchange with a group of regional experts to validate the dimension of priorities for development and a special survey of Bank representatives to better gauge demand dynamics. Finally, the process will be matched with a thorough assessment of comparative advantages based on the Bank's track record, resources, and market assessments, yielding the final set of focus areas of the Strategy.
- 5.4 In the meantime, Management offers a preliminary list of topics that we believe have a strong potential of becoming the backbone of the Strategy. These are areas where there

has been a long-standing partnership with the region with a potential for further growth, as well as emerging areas whose effect on development is now being better understood or where the Bank is building a more robust response capacity. These are:

- 5.5 **Strengthening Public Sector Management and Taxation.** *The Bank will continue to support the region's national, sub-national, and local governments in their modernization efforts to improve public management and taxation capacity and promoting Management for Development Results concepts (MfDR).* The Bank will generate knowledge and operational capacity to support innovation in the strengthening of public management and related policies. An emphasis of this strategy will be placed on public expenditure management (financial management, procurement, treasury, accounting and debt), MfDR concepts like Strategic Planning and Monitoring and Evaluation, and public service delivery mechanisms at all levels of government. The Bank will also continue to provide advice on tax reforms and tax administration modernization projects based on new academic research and best practices and to support leading research on a vast agenda of relevant topics such as fiscal equity, tax expenditures, strengthening tax courts, and modern transfer pricing.
- 5.6 **Assisting the region in facing Citizen Security challenges.** *The Bank will strengthen its partnership with the countries in the region to reduce violence through a comprehensive approach that addresses both the public and private sectors.* As a result of a networking with think tanks, private sector and leading public agencies, the Bank has identified priorities which are included in the new guidelines for action in the citizen security sector (GN-2535): (i) the alliance of cities and local governments to prevent violence; (ii) young people as subjects of inclusive prevention strategies³³; (iii) the impact of new technologies on prevention mechanisms; (iv) standardized information systems for quality decision-making; (v) the prevention of addiction and its relationship to comprehensive strategies for violence prevention; (vi) impact evaluation systems for interventions and consolidation of empirical evidence in the sector. Each of these elements is addressed from the perspective of the value chain, focusing on the justice system and police, inclusion of community participation and promotion of social policies that will lead to the development of key partnerships for an effective violence prevention policy.
- 5.7 **Enhancing citizenship and property rights by Strengthening Public Registries.** *The Bank will enhance its knowledge of public registries and deepen its support to the region with emphasis on citizen, business, and property registries. This will enable the Bank to provide state-of-the art advisory and training services as well as knowledge products on these three repositories of critical information for the improvement of the population's quality of life and the development of a vibrant market economy.* Having a legal identity is a basic human right, and birth registration and identity documents are essential to participate in the formal economy, provide access to public services and exercise citizen's rights. The lack of such basic documents severely limits the potential economic and social development of both the undocumented person and the country. At the same time, cumbersome and expensive business and property registration processes encourage corruption and informality and limit business growth potential, credit access, job creation, and tax revenues. Efficient public registries are a pre-condition to ensure rights and the

³³ The issue of youth-at-risk is a key element of the Social Sectors Strategy currently under preparation, and reflects an area of interaction between these two strategies.

basis for better targeted and more effective public policies. Therefore, the Bank's strategic efforts in this area should focus on providing support for knowledge generation that contributes to the modernization and institutional strengthening of citizen, business, and property registry systems. While several technical and organizational issues are likely to be shared across the three types of public registries, any solution shall take into account the specifics and inherent distinctions of each type of registry.

- 5.8 Supporting countries in their efforts to Combat Corruption and increase Transparency.** *The IDB will scale up its efforts working at the country, sector and institutional level, in order to identify opportunities to strengthen institutions and to spot potential points of corruption and lack of transparency at an early stage.* In November 2009, the Board of Directors approved the Action Plan to support member countries in their efforts to combat corruption and enhance transparency (PAACT), GN-2540. The PAACT sets forth a strategic framework to integrate, update and deepen existing capacity and mechanisms to enhance effectiveness in the prevention, control and sanction of corruption. At an external level, specific efforts include: (i) generating greater diagnostic capacity in the area of prevention and control of corruption; (ii) facilitating identification of the needs and priorities of the countries, as well as sustained assistance for their anticorruption efforts; (iii) promoting consideration for the issue of anticorruption and governance in all of the Bank's sectors of intervention; and (iv) supporting the creation of opportunities for regional and international cooperation and dialogue. At an internal level, specific efforts include (i) supporting greater continuity and effectiveness in programmatic and dialogue processes with the countries; (ii) promoting interdepartmental cooperation, utilizing the advantages offered by the Bank's matrix structure; (iii) supporting strengthening of corruption prevention mechanisms in the project cycle, particularly in project design; and (iv) consolidating organized and coordinated intervention between the fiduciary and operational functions, facilitating feedback.
- 5.9 Promoting broad access to Financial Services.** The strategy will aim at promoting broad-based financial market development to improve the range, quality, efficiency, and sustainability of financial services available to the moderate and low-income segments of the population. The emphasis will be on removing the constraints to, and increasing the incentives for, the development and provision of both credit and non-credit services (savings, insurance, investment, transfers and payments). A sound legal and regulatory framework and supervision of intermediaries combined with the effective protection and education of consumers will be critical to making progress in creating deeper and more inclusive financial markets. The Bank will work closely with the public and private sectors to ensure greater private sector provision of these services to underserved sectors. Another aspect of broadening access to financial services is the development of innovative financial services and products that can address challenges posed by climate change and the risk of natural disasters. The strategy will pinpoint the specific types of policy advice, technical assistance, and financing that would accelerate greater financial inclusion in the region.
- 5.10 Strengthening Innovation and Technological Capabilities: Transforming Ideas into Economic Solutions.** *The Bank will promote the transformation of ideas and knowledge into productive innovations and economic solutions that address key barriers to growth and social welfare in the region.* It will do so through policy dialogue, financial

investments, technical assistance and knowledge generation and dissemination aimed at strengthening the institutions, networks, firms and human capital whose activities and interactions lead to the acquisition, adaptation, development and diffusion of new technologies, and to the generation of innovations in products, processes, marketing and organizational models. In addition to activities related to the development of human capital, primarily through its Social Sector Strategy, the IDB will focus its action on promoting innovation along three specific objectives: (i) *Increase firm investment in R&D, especially in SMEs and in the service sector, as a means to increase productivity and competitiveness.* To accelerate adoption of technology and investment in R&D+I by firms, obstacles identified by firms themselves (such as weak S&T institutions, liquidity constraints, access to human capital and lack of protection of intellectual property) will be addressed; (ii) *Improve Policies and governmental action in the ICT sector.* Efforts should be made to assist countries in development of key ICT infrastructure to increase network coverage as well as the ‘reach’ of ICTs, especially broadband, in the poorest countries and households; and (iii) *Strengthen institutions and networks.* The capacity to generate networks between institutions, universities and firms is a critical element of successful innovation systems. Actually, human capital and networks are important not only for innovation, but also to accelerate the widespread diffusion of general purpose technologies (GPT) such as biotechnology and ICT (Aghion, et.al, 2009).

- 5.11 **Enhancing Small and Medium Enterprises’ Productivity and Growth.** *The Bank will develop instruments that raise SME productivity and growth by improving access to finance.* The Bank’s approach to SME finance will highlight two complementary perspectives: the *supply of funds* by financial intermediaries and the *demand for funds* by firms. The supply of funds is often constrained by structural or institutional barriers that raise the cost of funds and limit credit provision to SMEs. While the demand for funds is constrained by the creditworthiness of firms owing to the inherent weaknesses of smaller firms, absence of guarantees or collateral, and other factors that make projects “unbankable.” Experience shows that policies focused solely on supply may lead to unsound credit allocation and in some cases introduce moral hazard issues; while policies designed to increase firms’ demand can face credit rationing as supply constraints become binding. As a result, policies and programs that support SME access to finance must address both the supply and demand side of the equation.
- 5.12 The strategy will address the market and government failures that arise from the presence of externalities, coordination issues, and asymmetric information that affect the returns to productive factors and the government’s ability to formulate and implement appropriate policies. To overcome these requires the creative use of new instruments (public and private) and improvements in the institutional setting that enhance access to credit, equity, and other financial instruments. Credit programs can finance underserved market segments; credit bureaus can overcome information gaps; start-up capital can lead to firm creation and expansion; insurance schemes can improve market signaling and expand access to finance. In addition, upgrading the regulatory framework for financial institutions can lower administrative and funding costs for SME financing. Other steps include better market regulation, simplified rules and procedures related to firm creation and operation, as well as targeted programs to lower firms’ transactions costs. Markets also typically

undersupply services that improve firm productivity such as training programs, product and process upgrading, improved linkages to export markets, and greater access to technology. Finally, the role of informality among firms, particularly smaller firms that are unregistered and/or fail to meet labor and tax rules, will be a focus of the strategy.

- 5.13 The proposed approach will integrate both demand and supply factors for finance, and will lay out the strategic directions to guide IDB Group operations in lending, technical assistance, and knowledge-based activities. Such a coordinated approach will ensure that the Bank makes best use of its instruments to provide timely and effective support to its clients. The preparation of the strategy should integrate the talents and resources of the entire IDB Group (IDB, MIF, and IIC). Among the strategic areas to be covered are: (i) SME finance and regulatory environment; (ii) business environment and informality issues; (iii) the role of productivity-enhancing policies and programs for SMEs; and (iv) knowledge creation and dissemination issues for SME policymaking. As part of this effort a SME Finance and Development Guideline will also be prepared.
- 5.14 This list is put forward as a preliminary approach and will be reviewed in the course of the public consultation. Topics not singled out as business development areas will not be necessarily excluded from Bank lending. The Bank may continue supporting clients on a case-by-case basis to other institutional areas not specified in the scope of this Strategy, given sufficient capacity and resources.
- 5.15 Furthermore, the Strategy does not seek to develop standardized intervention strategies in the above areas to be applied across countries. There are fundamental differences across countries that require careful understanding of the political economy of institutional reforms, stakeholder incentives, and the unintended consequences that particular interventions may have. As part of the know-how needed for successful and sustainable reforms, the Bank will deepen its knowledge regarding the complexities of institutional interventions from a “general equilibrium” perspective and incorporate it into the design of strategies and projects.

Enhancing institutional capacity support

- 5.16 In addition to supporting a development agenda along the lines described above, the Bank will also develop ways to improve the development effectiveness of Bank-financed projects that face important institutional challenges. These challenges go beyond the traditional fiduciary support (procurement and financial management) that is currently well served by the Bank, and will focus instead on issues of such as inadequate coordination among stakeholders, insufficient planning, monitoring and evaluation tools, or the political economy of a particular reform or policy. In this regard, the Bank intends to build upon existing techniques for evaluability of institutional components of projects as well as strengthening its capacity to address institutional constraints in interventions across sectors.

VI. INDICATORS AND TARGETS³⁴

- 6.1 The Strategy will contain specific indicators and targets as part of the action plans developed for each of the areas of focus. The results framework contained in GCI-9 presents the following estimated output contributions to regional development goals, assuming a sustained level of \$12 billion of annual lending and countries' demand in priority areas³⁵:

Table 2: IDB-9 Development Goals and Estimated Bank Output Contribution, 2012-2015

Regional Development Goals		Planned Bank Output Contribution	
Goal	Baseline	Results	Output
Percent of firms using banks to finance investments	19.6%	Micro/small/medium enterprises financed	120,000
Ratio of actual to potential tax revenues	78%	Public financial/tax systems implemented/upgraded	28
Percent of children under 5 whose birth was registered	90.6%	Persons incorporated into civil or identification registry	3,000,000
Public expenditure managed at decentralized level	20%	Municipal/sub-national governments supported	1,000
Homicides per 100,000 inhabitants	27.5	Cities benefited with citizen security projects	32

³⁴ In addition to the indicators presented here, the cross-sectoral nature of the strategy will contribute directly to the achievement of the IDB-9 lending program and priority targets. The broader vision of institutions beyond modernization of the State will enable interventions that support lending targets in the areas of climate change and regional cooperation and integration.

³⁵ See AB-2764, Annex 1.

VII. ROADMAP FOR THE ELABORATION OF AN INSTITUTIONS FOR GROWTH AND SOCIAL WELFARE STRATEGY

Phase	2010				2011		
	September	October	November	December	January	February	March
Revised Profile	30						
Sec (TRA)		1					
OPC (Revised Profile)		4-8					
PEC (for consideration)		14-28					
COW (For approval of the Consultation Strategy)			3				
Consultation 1			4	4			
Consultation IADB WEBPAGE			4	4			
Presentation to CSOs in Quito			4				
Special Consultation with regional experts key stakeholders and Representatives			4	4			
Internal Bank consultations			9-26				
Consultation 1 Results on the IADB webpage				9			
Preparation first draft final document				1-10			
Reviews and QRR first draft final document				13-17			
Reviews and VPS clearance for distribution to OPC					10-12		
OPC					13-20		
Consultation 2					27	27	
OPC*						29	
Preparation third draft after Consultation 2						29	4
VPS clearance for distribution to PEC							8
Sec (TRA)							8
PEC							19-29

*If material changes after consultation

Annex I: Strategy for Institutions for Growth and Social Welfare

Consultation Strategy

The team tasked to prepare the Strategy consulted with EXR and VPS regarding the mechanisms to conduct the public consultations of the Strategy, as currently required by CP-2916-1 and in line with guidelines issued by VPS. Following are the key elements of the consultation process to be undertaken for this particular Strategy:

1. **There will be a two-phase consultation process:** Phase One for the Strategy Profile and Phase Two for the Strategy document itself.
2. **Both phases will be conducted through the Web.** The respective documents will be posted and advertised on the Bank's website along with a feedback submission form designed to guide the respondents and focus their inputs along the most important elements of the Strategy. This format will not preclude more general or free-form feedback.
3. **The launch of Phase One will be announced at a meeting with Civil Society Organizations in Quito, Ecuador, on November 4.** The Bank will make a presentation at this meeting to explain the scope of the proposal and alert participants to the opening of consultations through the Bank's website.
4. **Phase One will be complemented with a focalized consultation to a group of individuals who can provide particularly valuable feedback.** These will include a small group of recognized experts in the field of institutional development and private sector opinion leaders who also have good knowledge of the Bank's business, as well as Bank representatives in the countries who can in turn provide feedback on the emerging areas of demand from their clients. This focalized consultation will be carried out in parallel to the Web-based Phase One.
5. **A process of internal Bank consultations will also take place given the cross-sectoral nature of the Strategy.** Given the importance of agreement and commitment across the Bank for moving ahead with the Strategy, a series of internal Bank events, such as brown-bag lunches and presentations, will take place during Phase One. The feedback received will be recorded and included into the preparation of the Strategy.
6. **Both Phase One and Phase Two will last for 30 days each.** The estimated dates are 11/4 to 12/4 for Phase One and 1/27 to 2/27 for Phase Two.

Summary: Consultation Process*		
Event	Mechanism	Dates
Phase I: Profile	IDB Website	Nov. 4-Dec.4
Phase I: Profile	Special Consultation with regional experts key	Nov. 9- Dec.4

	stakeholders and Representatives	
Presentation to CSO	Regional Meeting, Quito	Nov. 4
Internal Bank consultations	BBLs, Workshops, etc	Nov. 4-Nov19
Phase II: Strategy	IDB Website	Jan. 27-Feb.27

*The documents to be use during the consultation process are available in this link: [Public Consultation ICF \(Documents, templates, Survey\)](#)