Republic of Uruguay
Policy Notes

March 31, 2005

Poverty Reduction and Economic Management Unit
Latin America and the Caribbean Region
**CURRENCY AND EXCHANGE RATE**
*(As of March 1, 2005)*

**Currency Unit = Uruguayan Peso (UYP)**

1 US Dollar = 25.44 Pesos

**Fiscal Year**
January 1 – December 31

### ABBREVIATIONS AND ACRONYMS

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
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<tbody>
<tr>
<td>ADME</td>
<td>Electricity Market Administration/ Administración del Mercado Eléctrico</td>
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<tr>
<td>AFAP</td>
<td>Private Retirement Savings Account Administrator/ Administradora de Fondos de Ahorro Provisional</td>
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<td>AFE</td>
<td>State Railway Administration/ Administración de Ferrocarriles del Estado</td>
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<tr>
<td>ANCAP</td>
<td>National Administration of Fuels, Alcohol and Portland/ Administración Nacional de Combustibles Alcoholes y Portland</td>
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<tr>
<td>ANCEL</td>
<td>Public Mobile Phone Company (ANTEL Subsidiary)</td>
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<td>ANEP</td>
<td>National Public Education Administration/ Administración Nacional de Educación Pública</td>
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<td>ANP</td>
<td>National Ports Administration/ Administración Nacional de Puertos</td>
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<td>ANTEL</td>
<td>National Telecommunications Administration/ Administración Nacional de Telecomunicaciones</td>
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<td>ASSE</td>
<td>Public Health Services Administration/ Administración de los Servicios de Salud del Estado</td>
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<td>BRU</td>
<td>National Mortgage Bank/ Banco Hipotecario del Uruguay</td>
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<tr>
<td>BPS</td>
<td>Social Security Fund/ Banco de Prevención Social</td>
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<td>BROI</td>
<td>Republic Bank/ Banco de la República Oriental del Uruguay</td>
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<td>BSE</td>
<td>National Insurance Bank/ Banco de Seguros del Estado</td>
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<td>CAIF</td>
<td>Center for Comprehensive Children and Family Attention</td>
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<tr>
<td>CIU</td>
<td>Chamber of Industry/ Cámara de Industrias del Uruguay</td>
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<tr>
<td>CODICEN</td>
<td>National Directive Council (for Education)</td>
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<td>CONCYT</td>
<td>Ministry of Education and Culture/ Ministerio de Educación y Cultura</td>
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<td>DGI</td>
<td>Tax Administration Department/ Dirección General Impositiva</td>
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<td>INV</td>
<td>National Roads Department/ Dirección Nacional de Vialidad</td>
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<tr>
<td>EMPRETEC</td>
<td>Integral Entrepreneurial Skills Formation Program/ Programa Integral de Formación de Capacidades Empresariales</td>
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<tr>
<td>FIEL</td>
<td>Latin American Economic Research Foundation</td>
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<td>FNR</td>
<td>National Healthcare Fund/ Fondo Nacional de Recursos</td>
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<td>FOMIN</td>
<td>Multilateral Investment Fund/ Fondo Multilateral de Inversiones</td>
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<td>FTAA</td>
<td>Free Trade Area of the Americas</td>
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<td>FTSC</td>
<td>Full Time School Program</td>
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<td>GAP</td>
<td>Good Agricultural Practices Program</td>
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<td>GDP</td>
<td>Gross Domestic Product</td>
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<tr>
<td>IADB</td>
<td>Inter-American Development Bank</td>
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<td>IAC</td>
<td>Collective Medical Care Institutions/ Instituciones de Asistencia Médica Colectiva</td>
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<td>IMF</td>
<td>International Monetary Fund</td>
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<td>INDA</td>
<td>National Food Institute/ Instituto Nacional de Alimentación</td>
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<td>INE</td>
<td>National Statistical Institute/ Instituto Nacional de Estadística</td>
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<td>LATU</td>
<td>Uruguay Technological Laboratory/ Laboratorio Tecnológico del Uruguay</td>
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<td>LPG</td>
<td>Liquefied Petroleum Gas</td>
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MDG
Millenium Development Goals

MIF
Multilateral Investment Fund

MFN
Most Favored Nations

MERCOSUR
Common Southern Market/ Mercado Común del Sur

NBC
New Commercial Bank/ Nuevo Banco Comercial

OECD
Organization for Economic Cooperation and Development

OPP
Office of Planning and Budget/ Oficina de Planeamiento y Presupuesto

ORT
ORT University

OSE
Public Sewerage Works Administration/ Administración de las Obras Sanitarias del Estado

PAE
School Food Program

PISA
Program for International Student Assessment

PPP
Purchasing Power Parity

PRENADER
National Resource Management and Irrigation Development Program/
Programa de Manejo de Recursos Naturales y Desarrollo del Riego

R&D
Research and Development

SEBRAE
Brazilian Service to Support Small and Medium Enterprises

SICE
Integrated State Purchasing and Contracts System/ Sistema de Información de Compras Estatales

SME
Small and Medium Enterprise

TCC
Thermal Combined Combustion Plant

UI
Inflation Unit

UN
United Nations

UNICEF
United Nations Childrens Emergency Fund

UdelaR
Republic University/ Universidad de la República

URAGUA
Private Water Concessionaire in Maldonado

URSEA
Energy and Water Regulator/ Unidad Reguladora de Servicios de Energía y Agua

URSEC
Telecommunications Regulator/ Unidad Reguladora de Servicios de Comunicaciones

UTE
Public Electric Company/ Administración Nacional de Usinas y Transmisiones Eléctricas

VAT
Value-Added Tax

WHO
World Health Organization

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<tr>
<th>Vice President:</th>
<th>Pamela Cox</th>
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<tr>
<td>Country Director:</td>
<td>Axel van Trotsenburg</td>
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<tr>
<td>Lead Economist &amp; Sector Leader</td>
<td>James Parks</td>
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<td>County Lead Economist</td>
<td>Daniel Oks</td>
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Acknowledgements

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URUGUAY: POLICY NOTES

INTRODUCTION AND MAIN MESSAGES

1. As a newly elected government prepares to take office, Uruguay is still struggling to recover from the social and economic consequences of the prolonged recession over 1999-2001 recession and the 2002 deep crisis. Indications are that initial measures to combat the crisis have taken hold. A successful restructuring of public debt has provided financial relief. The severe poverty impact of the crisis was cushioned, albeit not averted, by a well established social safety net. Some of the lost ground has already been regained and GDP is expected to grow by about 11 percent in 2004. Unemployment declined from nearly 20 percent in 2002 to 12.5 percent in late 2004. However, much more needs to be done to consolidate the recovery and set the country on a path of sustained growth with equity.

2. As a result of the economic crisis, a number of weaknesses in the economic fabric of Uruguay have been revealed more clearly. In the run up to the elections, action to address difficult issues of policy and structural reform was put on “hold” and they now call for urgent attention from the new administration.

3. The economic crisis revealed with exceptional clarity how vulnerable is Uruguay to adverse shocks from abroad and, in particular, from its two largest neighbors. A number of factors combined to make that vulnerability greater than it need be. Trade was concentrated heavily with the MERCOSUR partners of Uruguay. The banking system made wide use of the dollar for many financial transactions without proper regard for exchange rate and country risks. A large offshore banking industry was vulnerable to capital flight. Since 90 percent of all bank deposits, including domestic deposits, were denominated in foreign exchange, the banks were vulnerable to risks that had not been fully understood. Similarly, a high level of public debt denominated in foreign exchange exposed the public finances to unforeseen risks. In parallel, a small open economy such as Uruguay will never be entirely immune to events from abroad but steps can and should be taken to better shield the country from external shocks. Policy options to reduce macroeconomic and financial vulnerability will be a recurring theme of these Policy Notes.

4. In spite of Uruguay's well known broad-based system of social protection, as a result of the deep recession, poverty levels doubled over 2000-2003. The economic crisis revealed that a fiscal system under stress is barely able to finance social programs sponsored by the public sector, even though measures were introduced to protect a number of key programs from real cuts. It also revealed that the coverage of those programs is uneven and many of them do not well match the current social needs of Uruguay. The fiscal analysis of the Bank shows that social expenditures (which account for 80 percent of all government spending) and the public debt service will not be fiscally sustainable without reform. Policy options for improving living standards for Uruguay's citizens by restructuring social expenditures to enhance their effectiveness both for purposes of fiscal sustainability and greater equity will be another central theme of these Policy Notes.

5. The long-term affordability of essential social services will depend, in large measure, upon the success with which Uruguay is able to increase economic growth. Growth must be at
the center of the government's agenda. Uruguay can no longer be satisfied with the poor performance of the past forty years when per capita income growth averaged little more than one percent a year. Without sustained growth, fiscal consolidation and an overall improvement in the standard of living will not be achievable. The only way in which Uruguay can reconcile its rescheduled debt service obligations with its commitment to a strong social sector agenda is to accelerate economic growth.

6. Economic growth, in turn, will depend upon increasing investment and enhancing competitiveness. This is primarily the role that the private sector should play but in developing a favorable investment climate the government has an important role to play too. In view of pro-cyclical social expenditures and investment needs, fiscal constraints will be very tight for the foreseeable future and, even with an ambitious program of structural reform, the government will have its hands full just to keep up with the growing social needs of a progressively aging population and make the required growth-related investments in education and human capital formation. It will be necessary therefore, to mobilize private capital to the fullest extent possible, including foreign direct investment in agriculture, industry and infrastructure. *The incoming administration has an opportunity to reassess the respective roles of the public and private sectors in setting Uruguay on a higher growth path. This will require creating new opportunities through trade and infrastructure as well as a more enabling environment for private sector development. That will be another recurring theme of these Policy Notes.*
PART I – REDUCING VULNERABILITY

FISCAL MANAGEMENT

7. Fiscal policy is one of the principal instruments available to the government in pursuing the objective of sustained growth with equity – macroeconomic stability is a pre-condition for sustained growth. The new administration will be tightly constrained in managing fiscal policy. In particular, the high level of public debt, which is estimated to stand at about 90 percent of GDP in 2004 (Table 1), will be a major constraint and it remains a serious potential source of macroeconomic vulnerability. Whereas, in many other areas of economic and social policy the government may have an ample choice of options, there can be no room for laxity on the fiscal front.

8. Even after restructuring the public debt in 2003, Uruguay will still need to secure a primary fiscal surplus over the medium-term that is at a level compatible with debt sustainability (para. 20). Projections indicate quite clearly that it will not be possible to meet that target without structural reforms with strong fiscal impact. Under prevailing fiscal structures, the prospective growth in tax revenues will not be sufficient to finance: (i) the additional pensions of an aging population - particularly if pensions continue to be indexed to real wages, (ii) growing infrastructure requirements, and (iii) the contingent liabilities associated with bank restructuring and with guarantees on road and rail concessions.

<table>
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<th>Uruguay: Key Economic Indicators</th>
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<tr>
<td>In percentage, unless otherwise</td>
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<tr>
<td></td>
</tr>
<tr>
<td>2002</td>
</tr>
<tr>
<td>--------</td>
</tr>
<tr>
<td>Real GDP</td>
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<td>Gross Domestic</td>
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<td>CPI</td>
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<tr>
<td>Exports of Goods and</td>
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<td>Imports of Goods and</td>
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<td>Current Account</td>
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<td>Primary</td>
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<td>Overall</td>
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<tr>
<td>Public</td>
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<td>GDP, USD</td>
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Source: Uruguayan Authorities and World Bank estimates.

9. Revenue mobilization. Options for increasing fiscal revenues are few. The new administration has pledged to introduce a personal income tax and that could provide a significant new source of revenue in the longer-run. However, a personal income tax is administratively complex and it will need to be carefully planned and prepared if it is to be applied effectively and equitably. It will take time for procedures and administrative structures
to be put in place. Meanwhile, the government will need to rely upon already established sources of fiscal revenue, including enhanced compliance with social security contributions. In June 2003, the government submitted to Congress a tax reform bill that aimed at increasing revenues by broadening the base of the VAT while, at the same time, eliminating several low-yielding taxes. It proved difficult to assemble a legislative consensus for tax reform because of the approaching elections, but it is recommended that the initiative be revived when the new administration assumes office.

10. Legislative constraints need not hold back reform and modernization of the Tax Administration Department (DGI) which could result in better compliance with the tax code and, hence, increased tax collection. A beginning has already been made to overhaul the organization and procedures of the DGI, improve staff training and increase incentives. The incoming administration would do well to continue with that program and it would be a good idea to proceed expeditiously with the establishment of a special unit for dealing with large tax payers. In addition, the government may consider giving the DGI responsibility for supervising tax free zones and improving coordination with the Customs Office through an integration of their data systems. There are even greater prospects for enhancing revenues from social security contributions which have declined recently from 6.2 percent of GDP in 2000 to 4.1 percent of GDP in 2003. Better coordination between the DGI and the agency which administers the social security system (the BPS) could--aided by the incipient recovery--result in a rebound of revenues from currently low levels.

11. As a general rule, it is not recommended that public enterprises be called upon to increase their contribution to the budget because that is an inefficient way of financing the state. The budget has come to depend upon regular financial support from public enterprises and the system cannot be changed overnight, particularly at a time of tight fiscal constraint. Improved efficiency offers a way to resolve this issue in the medium-term. In the section of these Policy Notes which addresses infrastructure, specific actionable options are discussed for increasing efficiency and reducing costs in public enterprises. Cost reductions would enable public utilities to reduce tariffs to the consumer while, at the same time, sustaining their contribution to the budget. Passing on efficiency gains directly to firms and consumers by lowering tariffs would, over time, encourage higher growth and enhance welfare. Options can also be considered for targeting these welfare gains to the poor.

12. Aside from a few new revenue initiatives and more efficient tax collection, by far the most effective way to increase fiscal revenues would be to accelerate the rate of GDP growth.

13. Public expenditure. Increased efficiency in the public sector and strict expenditure control offer a more assured way for Uruguay to achieve the necessary primary fiscal surpluses that it needs for debt sustainability. The government has already taken measures to reduce over-staffing in both the central government and public enterprises. Public sector employment was reduced by some 10 percent between 1995 and 2002, although public wage expenses did not decline accordingly. There is still room for additional efficiency improvements which could imply inter alia further reduction in public employment over time, in particular through attrition and voluntary retirement schemes. Some of the savings would be offset initially by the need to finance severance payments, but the medium-to long-term fiscal gains would be substantial.
14. Pensions are by far the largest single item of public expenditures in Uruguay and they account for most of the growth in expenditures over the last ten years. Controlling that growth in order that the public finances may reach and sustain the primary surplus target over the medium term will be difficult to achieve under current policies. The present practice of indexing pensions to wages (set under the Constitution), together with a continuing trend towards an aging population will make it difficult to contain costs as the economic recovery progresses unless the system is changed. Similarly, reforms of the military, police and banking special pension regimes are equally critical to contain future contingent liabilities. The specifics of public pension reform are addressed separately in the Policy Notes because of its exceptional importance within the policy framework but the principal recommendations have major fiscal implications. Consideration could be given to increasing the retirement age for pensioners by five years so as to bring it more into line with comparator countries. A first policy option would be to raise the retirement age would both increase contributions and reduce pension expenditures significantly, thereby enabling the system to cope better with a further aging of the population structure. A second important option would be to change the indexation of pensions. At present, pensions are tied to the index of wages which tends to rise much more rapidly than prices in general, particularly during a cyclical recovery. Shifting from pure wage indexation to an index based on a mixture of prices and wages would provide additional much needed financial relief to the public finances while, at the same time, safeguarding the real value of pensions. Some countries have gone even further and have indexed pensions directly to prices alone. That is another option for the government to consider which would create additional fiscal space while being able to finance additional social programs foreseen.

15. In addition to public pensions, Uruguay has a wide range of social protection programs that need to be rationalized and more accurately targeted in order to better serve the needs of the population at large. In many cases, social protection instruments do not adequately cover the most vulnerable groups which include the self-employed and workers in informal employment. Since those groups do not subscribe to pay-roll taxes they have no access to formal programs of social protection while other individuals with a history of contributions may have multiple eligibilities. Specific options for the better targeting of the social assistance safety net as part of a medium-term program are detailed elsewhere in the Policy Notes. While these proposals may not directly improve the overall fiscal balance, they would greatly increase the effectiveness of public expenditures.

16. Apart from regularly budgeted expenditures, the public finances of Uruguay have come under pressure during the 2002 crisis as a result of an almost 100 percent depreciation of the peso and contingent liabilities emanating from the financial sector. About US$2 billion of public debt was contracted (primarily with multilateral institutions) to cover the non-performing loans of publicly owned commercial banks and to finance their recapitalization. The government was also obliged to support some private commercial banks before they were liquidated or restructured. Most of those losses have already materialized but the risk of additional losses from contingent liabilities – while smaller - is still present. Those risks could be greatly reduced by pressing forward with a number of measures as follows:

- Enforce more strictly governance regulations as they apply to financial sector institutions, especially those in the public sector.

6
• As governance improves, separate the development bank functions of BROU from its commercial banking function and eventually place the bank under commercial law.
• Speed up the planned divestment of Nuevo Banco Comercial.
• Bring to a rapid conclusion the sale or disposal of assets from liquidated commercial banks and from the corresponding trust funds of BROU and BHU.

17. **Fiscal management strategy.** Although, in the near-term, fiscal policy will need to focus principally upon the primary balance, other broader issues of fiscal management also merit consideration. A long-standing shortcoming of fiscal behavior in Uruguay is that it has been pro-cyclical. Public expenditures have followed the trend of public revenues, rising in times of economic expansion and contracting in times of recession. Both sound macroeconomic management and a concern for the welfare of the poor would indicate that the public finances should be managed counter-cyclically. That is to say, public expenditures and, in particular, poverty related social expenditures should be sustained in times of economic recession and restrained in times of economic expansion. Strategic options for attaining that goal are discussed in the Bank report “Uruguay - Sources of Growth” where it is shown that introduction of such a fiscal rule can be made consistent with debt sustainability.

18. As far as the next one or two years are concerned, the implications are clear. As the economic recovery continues to gain strength, public revenues are likely to rise and the government should ensure that not all of the increase is absorbed by public expenditures. Instead it should make use of the opportunity to ensure the achievement of primary surplus objectives and consolidate debt sustainability. Experience in other countries shows that a low ratio of debt to GDP greatly reduces the sovereign risk premium and, hence, interest rates on the public debt. Uruguay may wish to target a further reduction in its debt to GDP ratio to the 50 percent level that prevailed before the recent crisis. A lower debt will greatly increase the ability of the government to proactively manage macroeconomic policy and achieve growth with equity. It is noteworthy that Chile has been able to sustain strong growth while bringing down debt to relatively low levels during the 1990s (it currently stands at 13 percent of GDP without central bank debt). This has helped Chile to effectively pursue counter-cyclical fiscal policies since 2000.

**DEBT MANAGEMENT**

19. Debt sustainability does not only depend on generating a primary fiscal surplus sufficient to service the debt, it also depends on managing the debt proactively to ensure that its size, its term-structure and its currency composition correspond to the needs and to the repayment capacity of Uruguay.

20. At the present juncture the size of the debt in Uruguay remains a source of vulnerability. Although the 2003 debt renegotiation has provided short- and medium-term relief on contractual obligations with private bondholders, the ratio of debt to GDP was estimated to stand at approximately 90 percent at end-2004. Simulation exercises in the “Uruguay - Sources of Growth” report show that, provided Uruguay can sustain a primary fiscal surplus at the 2004 level of 3.7 percent or somewhat higher and grow at a sustained annual rate of 3.8 percent (3 percent as from 2008), the debt ratio could be reduced to around 55 percent of GDP within ten
years. Public debt would still remain quite high in the medium-term and thereby continue to contribute to the vulnerability of Uruguay to external shocks.

21. The term-structure of Uruguay's public debt was greatly improved by the debt renegotiation of 2003. The outcome has, in particular, provided relief from liquidity pressures in the bond market (which accounts for about half of all sovereign debt) over the short- and medium-term. However, heavy amortization due on other obligations in the period 2005-06 and amounting to some US$3.3 billion still constitute a potential threat to liquidity. Most of those obligations are due to multilateral financial institutions and Uruguay will need to rely upon continued support from those institutions. That underscores the need to plan ahead with new operations and programs that will ensure continuity of the relationship with multilateral financial institutions supplemented by other selective borrowing from the capital markets as necessary.

22. The currency composition of Uruguay's public debt has also become a major focus of attention ever since the 2002 economic crisis revealed how readily a debt denominated in foreign currency can expose the economy to exchange rate fluctuations. A public debt denominated in foreign currency restricts the maneuverability of the central bank to manage monetary policy and an insufficiency of peso denominated instruments may also stifle the development of the domestic capital market by making it more vulnerable to the exchange rate. For all those reasons the prevailing sentiment in Uruguay favors issuing more peso denominated debt in both domestic and international markets (in particular, indexed peso debt), rather than debt denominated in foreign exchange. The recent placement of 2-year peso denominated bonds on the international markets in an amount of 5.6 billion pesos (later increased by a further 2.6 billion pesos) received an encouraging reception. If capital markets continue to respond well and the interest rate premium required for peso bonds is not too much higher than for dollar denominated bonds, the government could advance the program progressively, targeting both the international market and the domestic market.

23. A strong foreign exchange reserve position is another important aspect of debt management which can provide a cushion such that the government may better manage the rollover of debt as it falls due. The international reserves of Uruguay are currently equivalent to 9 months of imports and they covered some 85 percent of public debt service falling due in the final quarter of 2004. From a payments point of view that may be considered satisfactory coverage. However, foreign exchange reserves amount to barely one quarter of the total stock of foreign currency liabilities in the financial system which suggests a possible source of vulnerability. To further strengthen its liquidity cushion, Uruguay could require financial institutions to carry liquidity reserves on foreign currency deposits that are higher for non-residents and inversely related to the maturity of the deposit. Another policy option would be for Uruguay to explore the possibility of contracting international liquidity insurance with foreign commercial banks.

24. De-dollarization. The desire to issue more peso denominated debt is closely related to the broader and longer-term goal of de-dollarization. It is widely perceived in Uruguay that the widespread use of the dollar for financial transactions has been a source of instability. That instability is all the more acute because there is a currency mismatch between the assets and the

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1 The debt ratio could even decline below 50 percent if real peso appreciation would top 21 percent on average over the medium term with respect to the 2004 level (instead of the 14 percent appreciation assumed in the base case).
liabilities of many financial institutions and the foreign currency obligations of many households and firms are not covered by secure sources of foreign exchange income. De-dollarization appears to offer a way out of those problems but that can only be achieved by reversing the policies that gave rise to dollarization in the first place.

25. The fundamental reason why the dollar has been so widely used for financial transactions in Uruguay is that the citizens lack confidence in the value of the peso. A successful program of de-dollarization will depend, therefore, upon building up confidence in the peso as a dependable store of value. An important policy option to support this would be a monetary policy based upon inflation targeting which in turn requires greater independence for the central bank. Internationally, this is becoming the predominant monetary policy framework under floating exchange rate regimes. At the same time, tight fiscal and sound macroeconomic policies would need to be pursued consistently over time so that inflationary expectations and, hence, peso interest rates, can be kept low. In addition, there are a number of other specific measures that could be taken to foster the adoption of peso-denominated financial instruments and reduce the hazards associated with dollarization. The market may very well be receptive to peso-denominated bonds or certificates of deposit if they were inflation-indexed and if bondholders could be assured that the indexation is fair, transparently administered and strictly honored. As described in the following sections, prudential regulations on financial intermediation may also turn out to be a legitimate complement of a de-dollarization strategy. The government may want to act gradually in the introduction of prudential regulations to encourage de-dollarization, with the pace determined by the rate of increase in confidence in the peso. An overly rapid introduction could lead to capital flight as depositors shift their savings abroad.

FINANCIAL SECTOR REFORMS

26. The 2002 crisis was a devastating experience for the banking sector in Uruguay. Many private commercial banks collapsed, leaving the sector even more dominated by publicly owned banks than was the case before the crisis. The two long-established public banks (BROU and BHU) have now been joined by a third, the Nuevo Banco Comercial (NBC), which was established with assets salvaged from several private commercial banks that were driven into bankruptcy by the crisis. As a result, publicly-owned banks now account for 60 percent of all banking sector assets.

27. The crisis revealed deep structural and managerial weaknesses in BROU and BHU. The government has extended emergency assistance to both banks which are undergoing structural reform with support from the IMF and from the IBRD. BROU is in the midst of a major restructuring to improve efficiency, reduce costs and improve corporate governance. BHU has already transferred all its foreign currency deposits to BROU and is no longer allowed to take such deposits. BHU is also restructuring with the aim of becoming a mortgage institution funded in capital markets. In the course of that restructuring it is shedding unnecessary staff, strengthening loan collection and transferring its loss-making Cartera Social to the Housing Ministry. It is important that these restructuring efforts continue to be diligently pursued and speedily concluded. The government may wish to distinguish more clearly between the commercial and developmental roles that BROU has traditionally played--and including in the budget any subsidy that development lending may entail--and may consider eventually placing
the bank under commercial law. That would help establish a level playing field for the banking sector and, by fostering competition, facilitate the economic recovery.

28. The recently established NBC complicates the picture because, with branches throughout the country, it competes directly with the BROU. While competition – the key incentive for efficiency – is to be encouraged it is not clear how effective that competition will be so long as both banks remain in the public sector. As part of a broader business plan, the NBC (which operates under commercial law) is currently seeking a potential foreign strategic investor. However, it would better serve the long-term interests of the banking sector if the NBC were to be privatized.

29. What remains of the private banking system after the 2002 crisis is a small network of foreign-owned banks and a few domestic banks offering short-maturity dollar-based products. The financial position of these banks is solid and many of them can draw upon support from large parent-banks abroad. During and after the crisis they were the principal beneficiaries of a "flight to quality". Today, they serve only a small part of the market, almost exclusively confined to the Montevideo area and dealing in dollar-denominated products. They are, however, well placed to take advantage of the vacuum left by liquidated domestic banks. In particular, there is scope for engaging more actively in the capital markets and for extending value-added services.

30. The principal challenge for the banking sector in Uruguay today is to reestablish a stable and efficient system of financial intermediation between depositors and borrowers that can channel capital to productive investments within the real economy. The problem is not a lack of deposits. Deposits by residents have already surpassed the level of July 2002 when the bank moratorium was imposed. Non-financial resident deposits in the banking system rose 22 percent over the last year to September 2004. Deposits by non-residents have only recovered modestly but banks, both public and private, are nevertheless extremely liquid because lending policies are restrictive. There are a number of reasons for that:

- The vast majority of deposits in the system today are sight deposits which could be withdrawn at the slightest sign of trouble and banks must prepare themselves for that possibility by maintaining high levels of liquidity.
- Risk aversion and liquidity considerations encourage banks to lend predominantly within the financial sector so that 61 percent of the total loan portfolio is between financial institutions. Loans to the non-financial sector have decreased by almost 60 percent since December 2001; since early 2003, the stock of outstanding private credit was basically unchanged although the share of non-performing loans declined.
- Most deposits (92 percent as of end-June 2004) are foreign currency denominated and, as a result of the crisis, banks are acutely aware of the danger of extending foreign currency loans to borrowers whose income is exclusively peso-denominated. Hence lending is concentrated on the export sector and in short maturities.

31. The problems confronted by the banking sector stem, in part, from a lack of confidence but also from structural shortcomings. The lack of a significant market for peso-denominated financial products has greatly increased the vulnerability of the financial system to external shocks. The government may wish to encourage the development of peso-based financial
services and the recent introduction of inflation-indexed (UI) deposits was an important step in that direction. Measures could be considered to strengthen that initiative by introducing preferential reserve requirements for peso and UI deposits, by requiring a differential risk weighting for peso and UI loans, by encouraging domestic pension funds and insurance companies to invest a proportion of their portfolio in peso and UI instruments (thereby reducing potential asset-liability currency mismatches) and by introducing other such guidelines. The government has already taken some steps in that direction (e.g., raising provisions on foreign currency loans) but needs to pursue them further. At the same time, the supervision authorities should ensure that exchange risks are fully internalized by financial institutions through prudential regulations.

32. The recently introduced deposit insurance program still remains un-funded. If the scheme is funded and implemented selectively to peso and UI deposits in the first instance, this would increase confidence in the banking system as a whole and help foster a gradual "pesification" of the entire financial sector. In implementing the new system, it will be important that the treatment of BROU deposit with 100 percent state guarantee be addressed with caution.

33. Financial sector regulation and supervision will play an important role in the recovery and improved performance of financial sector institutions. If it is to discharge its function well, the regulatory and supervisory authority should be professionally well-equipped and independent. The independence of a central bank from government is now accepted internationally as best practice and it is a goal that Uruguay may also seek to attain. Short of that, the authorities could take measures towards the full technical independence of financial sector supervisory and regulatory activities within the Central Bank.

34. Off-shore banking is an issue that merits special attention from the regulatory point of view. At present, banks in Uruguay can hold both on- and off-shore deposits and other operations that are, in general, regulated in an aggregated manner. Given the very distinct risks embedded by on- and off-shore activities, and their sensitivities to different parameters, many countries separate them, both in terms of the institutions permitted to offer those services and their regulation. This is a complex subject that may have an important impact on bank stability in Uruguay, particularly if non-resident deposits in the system recover to their pre-crisis level. The government may want to consider options to separate on- and off-shore banking activities in line with international experience.

CAPITAL MARKETS DEVELOPMENT

35. A major shortcoming of the financial system in Uruguay continues to be the relative backwardness of the non-banking financial sector. The absence of strong financial institutions other than banks has not only made the banking sector more complacent, but has also stifled the corporate sector for lack of readily available equity and non-bank debt financing. The recently introduction of legislation regarding Fiduciary Trusts ("Ley de Fideicomiso") was clearly an important initiative in creating alternative capital markets, but a number of fiscal and legal technical details are still conspiring to block the way. It is important for the authorities to nurture the goal of capital market development.
The capital markets merit special attention at the present juncture because, in a well functioning and efficient economy, they play a key intermediation role between savers and investors and thereby help to increase growth and employment. Capital markets usually permit longer term financing (since they are not so constrained by asset-liability mismatches). They also allow financial instruments to be priced flexibly according to market forces as illustrated by the recent sale of loans from liquidated banks. At the present juncture, however, the capital markets in Uruguay fall far short of that goal. They deal principally in sovereign debt while corporate debt and equity accounts for only a very small part of the market (capitalization is barely 1 percent of GDP).

At the same time, there is an increasing demand for financial investments fueled by the growth of pension funds. The share of savings channeled through pension funds amounted to some 13 percent of GDP in 2003. As these institutions develop further they will need to diversify their portfolios beyond sovereign debt. There is, therefore, a need for the capital markets to expand and diversify, both to accommodate an increasing demand for financial instruments on the part of savers, and to satisfy an increasing need for loan and equity capital from investors. The government may consider issuing shares for the large state-owned enterprises. This could both foster capital market development and create external incentives to improve corporate governance in public corporations. A prior requirement, however, would be to place public corporations under commercial law.

In part, the small size of the domestic market for corporate bonds and equity in Uruguay is due to institutional and regulatory weaknesses which impair transparency and erode investor confidence. The government could do much to enhance confidence by improving regulation and supervision and, in that context, the incoming administration could consider taking action on a number of fronts.

Internationally recognized best practice calls for capital market regulators to be independent of the government. In Uruguay, they are subordinate to the central bank which, in turn, is not independent from the executive branch. That arrangement can lead to conflicts of interest because the state itself is a major provider of financial services. Greater independence for capital market regulators, together with greater powers for the regulators to enforce the regulatory framework, would serve the interest of capital market development.

With regard to the market for securities, Uruguay initially leaned towards a self-regulated system. Recent securities legislation contemplates regulating the conduct of brokers. Nevertheless, there is a regulatory void in such important areas as manipulation, insider trading and unfair practices. There are also concerns regarding the quality and reliability of audits. Action to redress those shortcomings would do much to improve the securities markets. Similarly, improving corporate governance will require increased disclosure and transparency; this would also help to protect small shareholders.

The policy framework and regulation of pension funds is of special importance because of their growing prominence within the capital markets. An autonomous regulator for pension funds would help avoid possible conflicts with macroeconomic policy. The current restrictions on portfolio investments by pension funds merit reexamination to see whether or not they hinder risk diversification or limit earnings. To strengthen competition, the government may wish to consider options such as separating the functions of account management, where economies of
scale are usually important, and investment management, where stronger competition is both feasible and desirable. Another area of concern for competition is with the minimum return guarantee offered by pension funds. This gives rise to an information asymmetry since the public pension fund – AFAP República – carries - in the perception of the average investor - an implicit state guarantee.

42. In insurance, the monopolistic privileges of the National Insurance Bank (BSE) and the supervisory indulgence it enjoys need to be remedied in order to establish a level playing field on which a more competitive market may evolve with private participation. There are potential complementarities with banking that may lead to promising opportunities for business development. The present structure of capital markets in Uruguay is unduly compartmentalized, particularly taking into account the small size of the economy. Insurance companies could, for example, offer loans to individuals, and banks could sell insurance products. If these artificial barriers were to be reduced, it would enhance competition and foster innovation in the financial sector. This would be a good--though not the only--reason for shifting towards consolidated supervision.

43. New prudential regulations for insurance and pension funds could place greater emphasis on the currency match between assets and liabilities. This may help foster the market for inflation-indexed instruments and reduce the preference for foreign currency-denominated assets. In particular, pension funds may be eager to diversify their portfolios by absorbing inflation-indexed mortgage bonds which the National Mortgage Bank is in the process of issuing.

44. Since trust funds could become a widely-used vehicle for financing new projects, the recently approved Trust Funds Law needs to be well regulated, taking into account tax legislation. New products like warrants may also constitute an attractive proposal for domestic and foreign investors.
PART II – SUSTAINING GROWTH

TRADE POLICIES

45. For a small country like Uruguay, foreign trade is of utmost importance. Uruguay has a strong comparative advantage in agricultural, agro-industrial and forestry products that is still far from fully developed. Fulfillment of that export potential has been constrained by protectionism, especially from OECD countries, in the form of tariffs and non-tariff barriers. Recent analysis undertaken by the Bank in the context of the “Uruguay - Sources of Growth” report indicate that Uruguay stands to gain enormously from a fundamental reform of agricultural world trade. Progress so far under the Doha Round falls a long way short of that objective. In matters of agricultural trade, the interests of Uruguay are consistent with those of other efficient agricultural producers and, in future Doha Rounds, Uruguay may want to consider joining with them to strengthen the lobby for more liberal trade in agricultural products.

46. MERCOSUR has been the most important vehicle of trade policy for Uruguay for many years past. The recent economic crisis has revealed weaknesses in the structure and the share of Uruguay’s merchandise exports to its MERCOSUR partners fell from 55 percent in 1998 to an estimated 24 percent in 2004. The decline was exacerbated by the imposition of significant non-tariff barriers by Argentina and Brazil in an effort to protect their own domestic producers.

47. MERCOSUR can harness its potential for trade expansion by providing a context for member countries to join forces and gain more leverage in trade negotiations with industrial countries which favor high agricultural protection. If progress with future Doha Rounds is slow, then MERCOSUR could actively pursue more limited trade agreements on a regional or individual country basis. A free trade agreement with the USA, and by extension the proposed FTAA, could bring substantial gains for Uruguay and other MERCOSUR countries. The gains can be measured in terms of greater market access for agricultural and agro-processed products, but also in terms of better integrated and more stable policies and regulations as well as modernized institutions. Similar gains could come from a free trade agreement with the European Union. Agreements with the USA and/or European Union can be beneficial even if they fall short of an ideal arrangement which dismantles all programs of domestic assistance and export subsidies. Hitherto, MERCOSUR has adopted a position of principal on domestic assistance and export subsidies. The cost of limited progress has been borne by MERCOSUR’s agricultural exporters with the result that its share of total world exports has declined from 2.3 percent to 1.5 percent.

48. MERCOSUR could further strengthen its internal trade structures and better prepare itself for negotiations with other trade blocs by lowering its common external tariff and harmonizing its broader commercial policies including reduction of MFN (most favored nation) tariffs. This would entail such measures as adopting common health and sanitary standards, developing common safety regulations and establishing a common framework with respect to subsidies and dumping. The standardization of everyday commercial procedures and policies is likely to do more to advance the effectiveness of MERCOSUR as a trading bloc, than the pursuit of more visionary ambitions such as a common currency for which the group is not yet prepared.
49. While striving to mobilize MERCOSUR to the fullest extent possible, Uruguay may also want to consider bilateral trade agreements with other countries wherever these hold a potential for trade gains. Because Uruguay has a more specialized economy than Argentina or Brazil, bilateral agreements can be more narrowly focused. The bilateral agreement concluded with Mexico has led to an acceleration of trade and it illustrates very well how such agreements can be advantageous for Uruguay. Closer commercial ties with India and China would be attractive for Uruguay, either within the MERCOSUR framework or bilaterally. The sheer size of those markets together with their weak comparative advantage in temperate agriculture could make them potentially important markets for Uruguay.

50. The negotiating agenda for trade agreements is becoming progressively more complex. There already exists a large and growing body of international commercial law with which negotiators must be fully knowledgeable. The issues at stake are increasingly numerous and diverse including rules of origin, health and safely regulations, intellectual property rights, government procurement, the foreign investment regime and much more. It is important that Uruguay field a team of well-trained and experienced negotiators in order not to be disadvantaged at the negotiating table. A strong negotiating team will want to rely on technical studies which help to understand and quantify the pros and cons of non-trade issues discussed in trade negotiations. The negotiating team can also benefit from effective inter-agency linkages as well as links with the private sector in order to arrive at a negotiating strategy that will truly serve the interests of Uruguay.

PRIVATE SECTOR DEVELOPMENT AND INNOVATION

51. Sustained growth relies on a dynamic private sector that can invest, generate jobs, foster productivity and create value. Several factors contribute to the development of the private sector ranging from a stable macroeconomic and financial framework, to regulations, programs and institutions that contribute to the efficient markets. Laws, business regulations, and the quality of public institutions that enforce them, directly affect the incentive structure for private businesses, new investment and innovation. Secure property and creditor rights, and predictable laws help to link effort and reward by assuring market participants that they will be able to reap the benefits of their investments. Sound regulations can alleviate information asymmetries and can help to create a level playing field between SMEs and larger firms. Also, specific support for programs targeted at SMEs, can foster the diffusion of knowledge and innovation. Quality improvements among SMEs are fundamental to export promotion, of particular importance to Uruguay are phyto-sanitary improvements critical to increased agricultural exports.

52. Business climate. A comparative evaluation of the business climate in Uruguay and other countries reveals the challenges posed to Uruguayan businesses by the current institutional setup (Figure 1). Based on such comparisons, a number of policy options could be considered by the government to strengthen the enabling legal and regulatory environment for private sector development. These include:

- Simplification of procedures and regulations for starting a business, both at the national and departmental levels. As a pilot initiative, a one-stop window at the departmental level could be used in the design of a more ambitious plan at the national level. In this context, e-government could play an important role.
• Reducing enforcement costs is another challenge. More effective bankruptcy or restructuring procedures for economically viable companies would help to reallocate capital efficiently. That would include a unification of bankruptcy proceedings and setting the right incentives for use of the acuerdos preventivos. Passage of the bill currently in Congress will help establish a better legal framework for business development, especially if accompanied by capacity building and infrastructure support for the Judiciary, particularly the Bankruptcy Courts.

• Both the wealthy and the poor lack efficient access to justice in Uruguay. For the business community delays result from cumbersome procedures and a lack of understanding by judicial authorities of complex business matters such as intellectual property, antitrust and bankruptcy. The poor lack knowledge of their rights, they may be unable to pay legal fees and they may be unaware of alternative mediation mechanisms. Modernization of the justice system, as the guarantor of individual rights and property rights in particular, would encourage private investment. The agenda would include actions to improve case management, expand the use of hearings, simplify the notification process, and streamline appeals. The judicial branch is seeking to establish an additional labor court, and two courts for economic crimes which would strengthen the enabling environment for private sector development. Specialized training and continuing legal education programs for judges would help them to deal with complex economic cases.

53. Perhaps the most effective way to advance a pro-business agenda would be to establish a special unit or commission, at the Office of the President, with the mandate, authority and accountability to deregulate and simplify business procedures and improve the business climate.

54. Institutional framework for SME development and innovation. Despite recent advancements, SME development and innovation policy continues to be weak. Uruguay shares some characteristic features of Latin American public institutions, such as political appointments to top level positions, scarce budget resources, fragmentation and limited coordination. As to specific innovation and SME support programs, there is in Uruguay a lack of strategic vision and poor coordination among the different implementing institutions. This results in fragmentation, a lack of coordination and duplication of efforts and resources in some areas while other problem areas remain unattended. Recently some actions have begun to take shape, with encouraging initial results. Examples are the establishment of the Red ProPymes (SME network); MIF (the IDB funded Multilateral Investment Fund) programs with different business chambers and other institutions; associated initiatives by the UdelaR promoting agreements with companies and private institutions; and the business incubators program promoted by the UdelaR itself, UN Program Empretec, LATU/ORT, and Zonamérica. These measures provide greater strategic and operational consistency to the National Innovation Strategy and they help the planning, funding and execution of programs. They also promote linkages between research and business and, more generally, between the public and the private sector.
Figure 1: Business Climate Comparisons

The index varies between 0 and 7, with higher values indicating more disclosure.

* Other countries that offer the most disclosure globally are Israel and the United Kingdom.

Several initiatives can be suggested to generate a dynamic and competitive production framework of SMEs with appropriate links to large national and foreign enterprises. This framework would need to be complemented by a network of institutions to advance the collective learning process. Policy options include:

a) To strengthen the managerial base

- An Entrepreneur Development Program of projects submitted through institutions such as UdelaR, ORT, LATU, EMPRETEC, etc., for training and for developing technical, commercial and financial networks, and other key activities for start-up companies.
- A Quality Program aimed at strengthening existing enterprises, by improving their access to consultancy and specialized training. This could be achieved by strengthening existing institutions, such as Red ProPymes.
- An information technology diffusion program among SMEs.

b) To promote innovation and the development of value chains

- A supply chain development program, to improve access to knowledge, markets and quality standards. Benefits may also include shared training and consultancy services. Good examples are programs recently developed in Argentina, such as Repsol-YPF suppliers’ program or Techint’s client development program.
- A program for the development of clusters, a network of enterprises and institutions which interact in a determined physical space via cooperative and competitive relations, and for which pertaining to the network is an important element for their individual competitiveness. The main challenge is to stimulate inter-linkages among the different actors, such as researchers from technical schools or universities and enterprises or different business associations. Good examples are SEBRAE’s initiative denominated “Arranjos Produtivos Locais,” which is having an important impact in different regions and sectors of Brazil, and the IDB FOMIN MIF programs in Latin America, including support to the wine producers in Uruguay.
- Assigning scarce innovation and R&D funds strategically and favoring consortia of universities and private sector firms, and large-scale firms with SMEs. An important objective would be to strengthen relations between R&D institutes and agricultural producers and agro-industries that can help shift the emphasis from primary production to agro-processing.

c) Internationalization of SMEs

- Program for SME export promotion. In coordination with the Foreign Office, the program could consider market diversification, the promotion of new exports and the conformation and consolidation of consortia and export groups.

Program designers would be advised to take into consideration a number of core principles including:
• **Coordinating technical assistance programs with financing programs.** Technical assistance services have a limited reach when they cannot be complemented with the funds necessary for carrying out investments or developing corresponding projects.

• **Targeting assistance to value chains and groups of enterprises.** Although it is important for individual companies to be able to access available instruments, incentives to benefit groups of companies in which collective projects with regional/sectoral impact is present, could have greater impact.

• **Evaluation of program cost and impact.** Including criteria for the evaluation of program costs and impact serves an important control function which helps increase transparency in the use of resources, as well as for institutional learning. It also helps to upscale, downscale or reformulate programs or projects that do or do not provide the expected results.

• **Institutional strengthening.** The success of programs will ultimately depend on the quality of the institutions that apply them. It is a good idea to allocate a percentage of allotted resources for institutional strengthening of the local institutional base. Likewise, benefits can be derived from an inter-institutional linking program aimed at strengthening networking, the exchange of experiences, learning and innovation within the system. In this sense, experiences such as the Red ProPymes are worthwhile supporting.

**Agriculture**

57. Agriculture has been a major source of growth for Uruguay in the past and the sector possesses considerable potential for further growth. The agriculture and agro-industry sectors represent approximately 23 percent of Uruguay’s GDP; over half of agricultural output is exported and accounts for more than 70 percent of Uruguay’s total export earnings. Strengthening of the outward orientation of the agriculture sector would help Uruguay to take fuller advantage of its off-season potential in northern hemisphere markets and its aptitude for organic and “green” produce. The recent currency devaluation has increased the competitiveness of Uruguayan agriculture in world markets. This is a temporary boost, however, and longer-term competitiveness will hinge on fundamental structural changes. A stronger, more competitive agriculture can be built on three main pillars: (i) the development and dissemination of new technologies, (ii) improved product quality based upon good production and processing practices and food safety and (iii) the establishment of a new institutional structure to enhance competitiveness.

58. Notwithstanding a generally good quality of agricultural research and development, Uruguay lacks a satisfactory framework of public policy to manage R&D priorities as they relate to agricultural technologies. About 1.5 percent of the agriculture sector GDP is spent on R&D in Uruguay. Hence the problem is not so much a lack of resources but a lack of coordination with respect to strategic sector objectives. One good option that merits consideration by the incoming administration would be to establish a National Agricultural and Agro-Industrial Innovation system to define national policy with respect to the development and adoption of new technologies, evaluate the impact of publicly funded programs and strengthen relationships between R&D institutes, primary producers and agro-industries along the whole supply chain.

59. Food safety is a major concern for the agricultural sector. It is estimated that losses from the recent foot and mouth disease epidemic amounted to US$730 million during 2001-03, or
almost 2 percent of GDP. To avert a repetition of the crisis, concrete measures can be developed at a regional level to guarantee food safety in livestock production. The agencies in charge of sanitary and phyto-sanitary services for Uruguay could benefit from increased funding. The recently introduced program for Good Agricultural Practices (GAP) has shown concrete results for fruit and horticultural production and could be intensified. In particular, small-scale producers stand to benefit from training, product registry systems, and the upgraded productive systems fostered by GAP.

60. To contend with an increasingly diverse agricultural sector, public initiatives are most effective when they are selective and specifically targeted. Previous government attempts to enhance competitiveness have not always been effective. The government could consider building upon the positive experience from coordination groups (mesas) to better understand the concerns and priorities of producers and others in the production chain. Another related option would be to mobilize the “Competitiveness Forum” as a medium of dialogue between representatives of government, private business and workers to develop a shared plan of action for increasing competitiveness. Individual sub-sectors such as beef, dairy, forestry and horticulture could each have their own forum. Public initiatives to strengthen professional skills in agriculture related areas is an option to consider which would help ensure that Uruguay is strongly represented in trade negotiations.

61. The longer-term success of agriculture in Uruguay will depend critically upon conserving the natural resource endowment. Advances already made in stemming erosion, soil degradation and the cultivation of vulnerable land should continue to be pursued. In particular, increased livestock production will depend upon the improved management of natural pastures.

62. Water resource deserve special attention because of their key importance for agriculture. Supplementary irrigation projects have been well received by farmers but efficient irrigation requires the use of sound soil and crop management technologies. A soil and water management plan has been developed by PRENADER but enforcement is difficult because no public funding is available for project implementation. As demand for scarce water resources increases, the role of an improved policy and regulatory framework and an integrated strategy for water resource management will increase commensurately.

63. The great potential for forestry development in Uruguay is now widely acknowledged. New forest plantations have been located in “priority areas” which are unsuitable for other agriculture. As these activities expand, it will be important to assess further the environmental sustainability of commercial forestry, especially with respect to surface water, soils and biodiversity. Sustainable industrial processing of forestry products calls for careful environmental assessment of proposed new investments.

INFRASTRUCTURE

64. Overview. In terms of coverage and quality, the provision of infrastructure and public services in Uruguay is quite good when compared with other Latin American countries and middle-income countries in other regions. Access to electric power is almost universal. Potable water through household connections is available to 91 percent of the population and the proportion served rises to 98 percent if, consistent with standards adopted by WHO and UNICEF
in the context of the MDGs, public standpipes and improved point sources are taken into account. The coverage of basic telephone services is the highest in the region with a ratio of 28.1 lines per 100 inhabitants in 2001. Uruguay is also well served with transport infrastructure. The road and rail network is among the most extensive in Latin America providing access to virtually all parts of the country (although the state and level of utilization of railways is deficient). The sole exception to a satisfactory overall picture is sanitation where only 48 percent of the population is served with household connections. However, if adequate sanitation is defined more broadly in accordance with MDG criteria, the numbers served rise to 94 percent.

65. The relatively broad availability of infrastructure and public services in Uruguay does not justify complacency. In most services there are serious shortcomings with respect to efficiency and, as a consequence, some services are highly priced relative to other countries in the region (Table 2). An inefficient and high cost infrastructure impairs the competitive position of Uruguay, as well as welfare, and makes it difficult for the economy to move onto a higher growth path.

### Table 2 - Ex-refinery Prices (November 2004)

<table>
<thead>
<tr>
<th>Product</th>
<th>Estimated Import Parity price (US$/m³)</th>
<th>ANCAP Ex-refinery price (US$/m³)</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gasoline 95</td>
<td>425</td>
<td>495</td>
<td>16%</td>
</tr>
<tr>
<td>Diesel</td>
<td>465</td>
<td>486</td>
<td>5%</td>
</tr>
<tr>
<td>Kerosene</td>
<td>457</td>
<td>539</td>
<td>18%</td>
</tr>
<tr>
<td>Fuel oil</td>
<td>282</td>
<td>213</td>
<td>-24%</td>
</tr>
<tr>
<td>LPG (US$/tn)</td>
<td>634</td>
<td>506</td>
<td>-20%</td>
</tr>
</tbody>
</table>

*Source: URSEA, December 2004.*

66. There are great differences among infrastructure and public service sectors in matters of efficiency, the quality of service delivered, and pricing. International comparisons have become more complicated as a result of the recent currency devaluation. Electricity tariffs to industrial and commercial establishments are now among the lowest in Latin America. Nevertheless, the latest available data from 2001 indicates that transmission and distribution losses are higher than for other countries in the region except for Brazil and Colombia. In water supply and sanitation, the relatively high number of employees in OSE points to an important source of inefficiency (Figure 2). Similarly, the relatively high price of petroleum products in Uruguay suggests that ANCAP is less efficient than potential external suppliers. In telecommunications the situation is more complex. Costs have been reduced as a result of sector reforms and, since 2002, the price of local and long distance calls has started to decline and converge to regional standards. Internet services, however, remain more expensive than in comparator countries. Overall, issues of efficiency, service delivery and pricing continue to be a major challenge for utilities in Uruguay.
Transport infrastructure constitutes an exception to the overall picture with better standards of efficiency and quality of service. The primary road network is in better condition than in any other country of the region, in large part due to policies that give priority to maintenance. Port services have improved greatly as a result of reforms dating from 1992 with the result that container traffic has increased by 160 percent since 1993. The cost of moving containers is comparable to other ports under concession in Latin America and only slightly above the average for southeast Asia. Railway services have also improved as a result of sector reforms but cargo traffic is low and the sector has a long way to go before it can provide a competitive service.

The increasing efficiency of transport services in Uruguay, roads and ports in particular, is directly linked to sector reform and it provides a good example of what could be done in other infrastructure and public service sectors if a similar approach were to be adopted. Transport sector reform sought to modernize and improve service delivery, increase investment and harness new sources of finance. It placed policy formulation, planning and regulatory oversight securely in the hands of the government while, at the same time, fostering private participation and public-private partnerships in operations and service delivery. Although the ministry has not abandoned all of its operational activities, they are now secondary to its policy and regulatory functions. The reformed institutional framework has proved to be a very effective way of enhancing efficiency and improving the competitive position of Uruguay.

The experience of the transport sector in Uruguay demonstrates how private participation can play a positive role in infrastructure and public services. There is ample scope to expand that experience because private sector participation in Uruguay is much less than in other comparable
countries. According to World Bank data, private investment in infrastructure averaged on 0.5 percent of GDP between 1990 and 2003, as opposed to 1-3 percent in a number of comparator countries (Figure 3). Most of that investment was undertaken within the context of concessions or "green-field" projects. While popular sentiment seems satisfied with current arrangements, it is important that competition and private sector participation continue to be part of the public policy debate. The downside of inadequately managed privatization processes in the context of weak regulatory frameworks or corrupt practices is well documented internationally. At the same time, it is useful to recall the benefits that these policies can bring, if properly managed including: (i) infusion of cash to upgrade essential social services retire public debt, (ii) new technologies and management expertise, (iii) strong efficiency gains if private companies operate within a competitive framework, (iv) resources to expand infrastructure and public services without burdening the public debt, and (v) allowing government to focus more clearly on its regulatory function without conflict of interest as a service provider.

Figure 3: Private Investment in Infrastructure

![Private Investment in Infrastructure Graph](image)

*Source:* World Bank.

70. **Role of the State in infrastructure and public service provision.** In the circumstances that prevail today in Uruguay, with infrastructure and public services largely in the hands of public sector agencies, an effective way to improve efficiency is to distinguish clearly between the three separate functions of policy definition, regulation and operations. In the past these three functions have been merged in the sector agencies themselves. Recent efforts to establish a more disciplined structure have made some headway, but there is still a long way to go.

71. **Policy definition is the weakest function in Uruguay.** According to the law, tariffs are to be set by the government based on proposals from the regulators. In practice, the utilities continue to play a central role in defining tariffs which are then confirmed by the government on the basis of fiscal rather than efficiency criteria. The responsible ministries lack strong policymaking units and there is an absence of publicly available analysis to support key
government decisions. As a result, commercial and financial objectives are not clearly distinguished from social or fiscal objectives in the provision of public services. Subsidy policies are not explicitly articulated and documented and universal service obligations are not clearly defined, particularly as they affect public and private service providers respectively. In the absence of strong policy leadership at the Ministry level, public utility operators have frequently taken upon themselves policy issues by default. Initiatives to redesign and strengthen the policy function at the ministry level would be complemented by efforts to ensure proper organization and staffing, as well as the establishment of appropriate procedures.

72. The second pillar for the provision of infrastructure and public services is a well-structured regulatory framework. Given the small size of the domestic market and the strength of the public utilities, a multi-sector regulatory body offers advantages in ensuring sufficient technical expertise and institutional independence to design and enforce the regulatory framework. The recent establishment of URSEA to regulate power, natural gas, petroleum and water and sanitation services and the establishment of URSEC to regulate the communications sector were important steps forward. However, those regulatory institutions are not yet sufficiently well staffed and equipped and, in some cases, their mandate is not yet sufficiently well defined for them to discharge their functions properly. The legal framework governing URSEA and URSEC has a weakness in that it grants to the Executive the authority to bypass the regulators on specific issues as it deems necessary. In particular, it is the Executive rather the regulators which sets tariffs. The prospect of Executive intervention introduces an element of insecurity and instability into a system where clear and transparent rules of the game are all-important. The autonomy of the regulatory function is further weakened by a provision in the law which permits directors of the regulatory agency to be removed at the discretion of the government. An option would be to ensure a framework whereby directors could only be removed on grounds of incompetence, omission or criminal conviction.

73. Efficiency depends upon adequate performance information on which to base tariff decisions and informed consumer decisions about the services they purchase. Good information on the performance of both public and private operators provides the ability to choose between providers or the ability to hold monopoly providers accountable with respect to quality and price. Regulatory authorities can specify a format for the periodic publication of service quality and performance indicators for water and sanitation, power and communications utilities. Performance indicators and international benchmarks can then be disseminated in the media. URSEA and URSEC face challenges in effectively establishing reliable information on public and private utilities, and overseeing the semiannual publication of service quality and performance indicators.

74. A clear regulatory accounting system is a pre-requisite for transparency. Such a system helps prevent private and public utilities from manipulating accounting data to present a picture that is favorable to their interest. Uniform regulatory accounting standards for all utilities in each regulated sector would: (i) allow for the vertical and horizontal separation of accounts, (ii) reduce the ability of a dominant operator to exclude new entrants, and (iii) provide an effective tool to regulate privately owned and managed infrastructure. The analytic background work for regulatory accounting has already been completed for some sectors such as water supply and power and will soon be completed for other sectors such as gas and communications. With
appropriate support from the incoming administration, a system of regulatory accounting can be fully operational by the end of 2005.

75. The provision, regulation and governance of infrastructure and public services is a complex matter that involves many different government institutions. A desirable way to define the respective roles of sector institutions, their field of competence and their relationships is through the enactment of sector laws. At the present juncture, sector laws exist in Uruguay only for power and communications. Sector laws for natural gas and for water supply and sanitation have been submitted to Congress but have yet to be approved. The need for a comprehensive sector law is especially pressing in the case of water supply and sanitation where the institutional framework is particularly complex. A recent Executive decree, dated September 2004, clarified institutional responsibilities in the sector, but a decree is a weaker legal instrument and is unlikely to prove as effective as a sector law. In the case of petroleum products, a sector law was enacted but subsequently annulled following a referendum, leaving a legislative void to be filled. At issue in the referendum was the ability of ANCAP to enter into partnerships with the private sector. As a result of the annulment, many other important sector issues are now in limbo including opening the sector to imported refined petroleum products, capping ex-refinery prices at import parities, and regulating price margins throughout the supply chain. Early action to complete the legal frameworks in key sectors would set the stage for further improvements in efficiency and in service quality.

76. Better and more efficient corporate governance is a priority in the infrastructure and public services sectors. The Constitution requires Board Directors of public companies to be selected strictly on the basis of their personal and technical competence and this provision would be worthwhile enforcing. Consideration could be given to a number of specific rules governing Directors' activities and functions which have proven effective in other countries including: (i) provisions against political activity both while in office and for a period thereafter and limits on day-to-day management responsibilities, (ii) compensation commensurate with responsibilities to define, review and update the medium-term vision, objectives and goals of public utilities and the strategy to achieve them, (iii) decision-making with respect to the functioning of the company, and supervision and reporting of results. While there are good reasons to limit grounds for dismissal, e.g., for professional failure or criminal conviction, removal of public company directors needs to be a credible option.

77. **Sectoral issues in infrastructure.** In addition to issues which cut-across all sectors of infrastructure and public services, there are sector specific issues that merit attention. Some of the more important sector issues are discussed below.

78. **Electric power** is entirely in the hands of a single public utility, UTE, which has a monopoly of generation, transmission and distribution. International best practice does not favor a vertically-integrated single provider model because the lack of competition generally results in a high cost service. As a first step towards the greater separation of generation, transmission and distribution the government recently established a wholesale market for electric power (*Administrador del Mercado Eléctrico*, ADME) with a mandate to introduce spot trading. However, implementation of the initiative has met with resistance from UTE. Amongst the options to be considered is to make ADME fully operational. Another measure that merits consideration is to permit large consumers to purchase their power directly from the Argentine wholesale market. In addition, if the planned new TCC generation facility were to be built and
operated by a public company separate from UTE, it would foster competition and better prepare the way for greater private sector participation in the power sector.

79. Beyond regulatory and institutional changes, the government may wish to consider actions to: (i) increase energy efficiency, (ii) reduce losses and (iii) diversify sources of supply. Issues and policy options to address them include the following:

- **Electricity consumption could be reduced substantially by encouraging greater energy efficiency.** The potential gains exceed the expected annual increase in demand for electric power. Greater energy efficiency could reduce energy imports and the need to invest in new supply. Consideration could be given to introducing incentives for the acquisition and installation of energy efficient products and adapting the regulatory framework to support energy efficiency.

- **As a result of the economic crisis, electricity losses have increased substantially in Uruguay.** One way of reducing those losses would be to further improve distribution facilities and enforce legal connections. This would be particularly effective if combined with measures to encourage efficient energy use.

- **The recent energy crisis revealed weaknesses in prevailing arrangements for the regional energy market.** Uruguay would greatly gain from more secure arrangements for the supply of power both in normal times and in times of emergency. The negotiation of long term agreements to expand interconnections with Argentina and Brazil is a policy option that merits serious consideration. However, from an economic standpoint, the preferred option would be to expand local electricity generation using natural gas imported from Argentina, with petroleum as a backup in emergencies when natural gas may not be available.

80. **Hydrocarbons** are another area where policy issues linger. The import of crude oil and refined products, the refining of crude petroleum, and the transport, storage and sale of petroleum products are all a monopoly of ANCAP. Private companies participate only in distribution. Ex-refinery prices are significantly higher than import parity costs for most petroleum products. This provides protection for ANCAP but undermines competitiveness for the economy as a whole. The subsidization of LPG puts natural gas at a competitive disadvantage. The structure of taxation of gasoline, diesel and fuel oil distorts the market and results in high diesel consumption. As a result, unnecessary refining costs are incurred to meet the demand for diesel. Policy options include: (i) reducing pricing distortions; (ii) increasing efficiency of ANCAP; and (iii) increasing the use of natural gas.

- **Discriminatory taxes result in high prices for most petroleum products except diesel and LPG.** As a result, there is no incentive for the market to seek out the most cost-effective energy sources. Import parity pricing for petroleum products would encourage ANCAP to improve its efficiency while leading to lower prices for gasoline, diesel and kerosene.

- The efficiency of ANCAP would benefit from the vertical separation of its different businesses and the application of regulatory accounting. This could be complemented with open access to port and storage facilities as well as the sale of loss-making businesses.

- The industrial and residential gas market would also benefit from the removal of subsidies on fuel oil and LPG. In addition, switching costs for residential customers and
to a lesser extent industrial customers are excessive and should be reduced. There is also a need for a natural gas law and by-laws as well as a regulatory framework governing tariffs, the respective mandates of private and public operators, and right-of-way issues.

81. **Telecommunications** pose special problems of policy oversight and regulation because sector technologies and hence the scope and content of services are expanding at bewildering speed. The Ministry of Defense is not well suited to provide policy oversight for these increasingly complex and diverse services. Consideration could be given to establishing a Secretary of Communications with rank of Ministry within the Presidency or another Ministry. Transparency would be enhanced if the accounts of ANTEL were separate from those of ANCEL, its subsidiary for cellular telephones. Furthermore, contracts between ANTEL and other public sector institutions could be subject to competitive bidding with the participation of private sector providers.

82. Regarding **ports**, Uruguay has been shifting progressively away from a model in which ANP is both owner and operator, towards a landlord model in which ANP owns the basic port infrastructure (quays, docks and storage yards) while private concessionaires build superstructure facilities such as office buildings, furnish equipment such as cranes and operate the port facilities themselves. Under the landlord model, ANP has become a regulator and its regulatory function could be further strengthened by divesting it of its few remaining operating activities. Consideration could also be given to fostering competition for container cargo between ports and between terminals.

83. **Railway** reform of 2002 put an end to the vertical integration of the Uruguayan railway by splitting infrastructure management and operations. The reform called for the State Railway Administration (AFE) to act as a commercial company, funding itself through revenues from traffic and a gradually declining state subsidy; and assigned infrastructure management and regulation to the Ministry of Transport and Public Works. The new framework includes modalities for private sector participation, including the figure of railway operators and the rules governing the acquisition of operating licenses, but so far no operators have shown interest. In order to complete the reform process, the government still needs to strengthen regulation and improve rail operating rules to avoid conflicts between AFE and potential new entrants. It is also critical to make sure that DNV maintains technical objectiveness in controlling access to the network and circulation. In the near future the rail system may be called upon to transport a much greater volume of forest products. There may be a need to redefine the role of railway operations and track maintenance to accommodate the increased traffic more effectively. Significant improvements in the present system will be needed to attract new traffic which implies additional investment in some key links of the network.

84. **Roads** are critical to enhance regional integration and export competitiveness. The success of a policy that gives priority to maintenance was clearly demonstrated during the crisis. This policy should continue to be the cornerstone of any road sector strategy. However, experience shows the importance of maintenance and rehabilitation. Additional new investments could aim at enhance regional physical integration and export competitiveness without sacrificing road maintenance. A major success of the road sector reform has been to ensure that road user charges are used to finance road sector investments. Private sector participation has helped achieve that goal. However, the private sector has not yet been a significant additional
source of investment in the sector. The new administration will face the continuing challenge of attracting resources from the private sector. The Megaconcession is one possible way of attracting additional private resources for the sector in the short-term. The improvement of road asset management at Departmental level is an area for attention. One option is to assemble all available financing for departmental roads, including DNV transfers (Departmental Road Program), the OPP managed funds (cuenca programs), and portions of the Fondo de Desarrollo del Interior that are destined for departmental roads, to finance an expanded program under the direction of DNV.

85. **Water supply and sewerage** are characterized by very unequal levels of service and water tariffs are very high by regional standards. Access to potable water is almost universal and that, together with a relatively high standard of service, has projected for OSE an image of efficiency and an understanding of social needs that does not fully reflect the reality of the situation. Provision of sewerage services is far below needs. Water and sewerage tariffs in Uruguay cover operation and maintenance costs, ensure medium term profitability, and support borrowing on commercial terms for a substantial investment program. However, the cost of providing service is very high and frequently constrains the investment program. A key policy option is to ensure that tariff policies are clear, transparent and consistent with an explicitly articulated social policy. This would require firm policy guidance. A related action would be to improve OSE's governance, involving a clearer delineation of institutional responsibilities within the sector and a more effective regulatory function. Achievement of these objectives would be facilitated by the enactment of a sector law.

86. Decentralization is one of the most promising ways to help increase the efficiency and efficacy of Uruguay's infrastructure sectors and, in that context, there are many options that the government may consider. The provision of water supply and sewerage services in Montevideo could be merged into a separate company with OSE serving the interior. Experience has shown that the area currently served by URAGUA as a separate operator independent of any other utility is a viable arrangement from a technical, financial, economic and social viewpoint. This is healthy arrangement from an institutional viewpoint since it promotes competition and provides a national benchmark and a yardstick for competition. In that respect the experience of the road sector with both public and private participation is particularly relevant. Concessions and road maintenance, carried out both by the ministry and the private sector, have improved productivity as a result of competition based on performance-based evaluation.

87. International experience shows that programs to reduce unaccounted-for water are rarely sustainable unless physical investments are accompanied by institutional improvements to ensure that operations and maintenance are fully incorporated into the company's culture. Institutional measures to improve governance and management of OSE could be consolidated and expanded. The hiring of a private firm to reduce unaccounted for water in Montevideo in exchange for a portion of the incremental billings that result from reduction in water losses is another measure to consider. This would be a good way to access new capital for sewerage investments and bring greater efficiency to operations in the capital city and elsewhere.
MODERNIZING THE STATE

88. The capacity to design and implement increasingly sophisticated policies and reforms--as required by the agenda of global integration, increased competition and private sector development--is closely linked to the professionalism and incentives of its civil service. The capacity to decide strategically in turn depends – among other things – on the integration of the budgetary process with strategic objectives and results. Important state reforms have streamlined budgetary procedures, reduced public employment and introduced incentives in remuneration scales. However, Uruguay is far from having an efficient, streamlined and motivated civil service and results-based budgeting, which could improve strategic planning and results monitoring, is far from producing the expected results.

89. Among the policies needed to increase the professionalism of its civil service, the government could consider linking performance evaluation, bonus and promotion to the achievements of the targets of the executive units; to be effective, targets of the performance evaluation system may need to be defined by the relevant units. The government could also consider introducing procedural reforms to the timetable for evaluating budgetary goals and results. Approval of the budget is given (or denied) months after the planning and submission of the budget have been completed and execution has begun. Deepening civil service reform and results-based budget management initiatives will be conducive simultaneously to a more agile and efficient state as well as to potentially important fiscal savings over the medium and long term.

90. Further progress in government procurement modernization can have a similarly large payoff. Procurement is not just a key instrument to lower public expenditure - in spite of already sizable gains, there is still scope for substantial additional gains. It can also become an important instrument to promote competition and innovation. Through procurement, SMEs may improve access to government purchases on a purely competitive basis. Technical standards required by the government may also contribute to improve the quality of goods or the processes through which they are produced.

91. The government could consider full implementation of the project for Modernization of State purchasing. For example, the SICE (Integrated State Purchasing and Contracts System) could be brought into a more general use among the executive units, or at least those within the Central Administration. This would facilitate the standardization of procurement procedures and compliance with the country’s legal framework. Bringing SICE into general use would provide a guarantee of compliance with procedural rules, such as the obligation to publish on the website and ensure payments by the State are recognized for purchasing. It would also allow for a more wide-ranging control of the calls for bids and the “extension” of such calls, an aspect that is currently difficult to control in Uruguay. Generalized implementation of the system would also be useful for keeping suppliers up to date with their tax payments.
PART III – IMPROVING LIVING STANDARDS

SOCIAL SECTOR OVERVIEW

92. Uruguay dedicates a generous portion of its income to the social sectors. Measured by public spending as a portion of GDP, Uruguay is comparable to the United Kingdom, Spain and New Zealand. However, the bulk of social expenditures in Uruguay are concentrated in two areas – public pensions for the elderly and health services. Since health service expenditures are also heavily skewed towards the elderly, it is clear that overall social expenditures are driven by the demographics of an aging population.

93. Apart from public pensions and health, the level of public expenditure in other social services is similar to, or even less than, the norm for Latin America. Education, in particular, receives far fewer fiscal resources than in neighboring countries. Notwithstanding the relatively low level of sector expenditures, education outcomes compare favorably with those of other Latin American countries. Literacy is virtually universal and basic education is available to all, including the poor. However, the achievements of the education system fall far short of what Uruguay needs if it is to break free from years of economic stagnation and move forward with a knowledge-based economy towards a higher growth path. In particular, measures need to be taken to improve secondary education and reduce the drop-out rate which currently stands at a high 50 percent of all secondary school entrants. That will require more investment in full time education and better financial incentives and training to improve the quality of teaching.

94. Only by increasing the rate of economic growth will Uruguay be able to provide for an increasingly aging population and, at the same time, finance its other obligations, including a heavy debt burden. The distribution of social expenditures in Uruguay today does not favor growth and leads to an underinvestment in human capital formation. That, in turn, could forestall growth and lock the productive economy into a stationary state wherein the increasing financial burden of an aging population becomes unsustainable. The cost of state pensions and health care has been escalating rapidly in recent years and it must be brought under control in order to free resources for human capital formation and other essential growth-related investments including a more equitable safety net. The following sections of these Policy Notes put forward options how this may be done while, at the same time, preserving and enhancing the social safety net.

POVERTY PROFILE

95. The recession and 2002 crisis had a deteriorating effect on poverty and other social indicators, although most of them continue to be better than in the majority of Latin American countries. Unemployment began to increase in 1998, when it was below 10 percent, and reached almost 20 percent at the end of 2002; by late 2004, it declined to 12.5 percent. At the same time, the proportion of self-employed and informal workers also grew between 1998 and 2002 and was accompanied by a reduction in real wages in the private sector. Poor performance of the labor market in terms of job creation and wage behavior impacted negatively on household income. As a result, and aggravated by the 2002 crisis, poverty increased between 2000 and 2003 - from 17 percent to 31 percent of the population according to INE and from 2.6 percent to 5.3 percent
on the standard measure based on US$2 per day adjusted for PPP. Extreme poverty also doubled to 2.8 percent according to INE.

96. Vulnerable groups were the most affected by the crisis. These vulnerable groups are composed, in general, by households in which the head is unemployed, employed in the informal sector or self-employed; crowded households; households headed by construction sector workers, by individuals with low educational attainment or by young persons. There are also some “new poor”, notably individuals living in households with intermediately educated heads. Poverty is heavily concentrated among the young. Official estimates show that, in 2003, 52 percent of the population up to 15 years was living under the poverty line, whereas only 10 percent of people over 65 were living under poverty conditions. This is partly linked to Uruguay’s social protection system.

97. It is important, in terms of vulnerability, to highlight the following. First, households in which the head is unemployed or employed in the informal sector have a substantially higher risk of poverty than the average household. Households in which the head does not participate in the labor market are much better off than any other group, and this effect became more pronounced throughout the period. This result is related to the increasing coverage and value of pensions since the 1989 reform. Pensions became then an even more effective insurance against poverty. Second, and consistent with the findings for most Latin American countries, the risk of being poor is lower for households headed by older individuals, by women or by workers of high paying industries (banking, utilities and transportation). Third, high school education consistently lost part of its value as an effective insurance against poverty during the period. That is, having a head with some post-secondary education is becoming increasingly important for households. Fourth, the young are over represented among the poor, and this situation worsened during the recession. In 2002, the average number of persons was 4.8 in poor households and only 2.8 in non-poor ones, and poor households had four times the number of children under 14 than a non-poor family. Fifth, the welfare gap between the urban poor and urban non-poor widened over the 1990s.

98. Additional important points regarding vulnerability include the following: (i) having self-employed individuals in the household increases the probability of being poor relative to households with only wage earners, or with only inactive members. Furthermore, a household with an informal (i.e. not having social security benefits) or self-employed head is more likely to be poor than a household with an unemployed head, especially during the recession. (ii) being a public employee is an effective insurance against poverty; (iii) being a home owner also provides effective protection against poverty; (iv) households consisting of a couple and children have a higher probability of being poor than households without children or single person households; and (v) once household characteristics are controlled for, the likelihood of being poor in Montevideo is higher than in any other region, except for Maldonado.

99. Although small in absolute numbers—about 130,000 people living in settlements of less than 5,000 persons and 57,000 in dispersed rural areas--rural poverty rates exceed those of urban poverty. In 2000, the poverty headcount was 25.0 for small settlements of 900-5000 inhabitants, 28.2 percent for villages with less than 900 inhabitants, and 19.5 percent for dispersed rural areas; while the urban poverty headcount was 17.2 percent. Rural dwellers living in small and medium-sized towns are highly dependent on wage labor and have lower average income levels than those living in dispersed rural areas. About half of the rural poor work in agriculture and
livestock, albeit those living in dispersed rural areas depend mainly on self-employment activities and family work. Poverty is higher among those working in agriculture—as agricultural wages are significantly below the wage average in Uruguay—than among those working in the non-farm sector (mainly in the government and transport sectors). As in urban areas, poverty in rural Uruguay particularly affects children—up to 61 percent of children aged 15 or younger in the smaller settlements of 900-5000 inhabitants. There is no information on how the crisis affected the rural poor because periodic statistics are not collected in the rural areas. Development of reliable information on living and working conditions in the rural areas would greatly assist informed policy decisions on rural poverty and rural development.

SOCIAL PROTECTION

100. While total spending on social protection in Uruguay is high compared to the Region and even the OECD countries (Figure 4), the system is dominated by public pensions which have absorbed the equivalent of 18 percent of GDP on average during the past 5 years. There is ample evidence that the high cost of public pensions has crowded-out public expenditures on other much needed programs of social protection such as unemployment benefits and transfers in kind and in cash to the poor. As a result, the coverage of these other programs is uneven and many urgent social needs remain unattended.

Figure 4: Spending on Social Protection (Social Insurance and Welfare) as a Percentage of GDP (1998)

Source: World Bank (SIMA) and OECD.
101. **Social safety net.** The recent economic crisis revealed serious shortcomings in the provision of unemployment benefit which is currently available only to workers who have contributed insurance premiums to the *Banco de Prevision Social* (BPS) during the 12 month period prior to job loss. Many workers do not contribute to the BPS so that, at the height of the crisis in 1999, unemployment benefits were provided to only 17 percent of the unemployed. The serious poverty impact of the crisis points to the need for a more effective structure of income protection for the unemployed. The government could examine ways to extend the contributory system of unemployment benefits to currently uncovered sectors like domestic workers and the self employed. In part to finance the extended coverage, benefits would be best structured on a declining basis to provide initial protection but include built-in incentives for active job search thereafter. However, even if the system is extended in this way, experience in other countries suggests that many workers will still remain outside the system. Unprotected workers should therefore be able to turn to a basic non-contributory cash transfer or to direct employment “work-fare” programs in the event of job loss. In May 2003, Uruguay launched an experimental work-fare program (*Programa de Actividades Comunitarias*) and the results have been promising.

102. The government administers a program of family allowances for low income households but benefits are quite small and it appears that many low income households with children that may be eligible are not receiving it. The family allowance program is well designed to ensure that beneficiaries send their children to school and participate in preventative health care programs. However, the program would benefit from a reassessment because the cash transfers are too small to effectively alleviate poverty and administrative “red tape” may deter many poorer households that would benefit the most.

103. The incoming administration has indicated that an immediate policy priority for building an ‘Uruguay Social’ will be to introduce an emergency program of help to the poor and especially poor children. The emergency program would build on institutions such as *asignaciones familiares* and the existing workfare scheme. Income support would be extended to poor households under specific conditions relating to temporary work and the attendance of minors in school and health care programs. Such an emergency program—built on existing institutions—would help to rebalance the overall social protection system in the medium run. An extension of the safety net, centered around a sustained national work-fare program and conditional cash transfers to protect the poorest in times of economic hardship, would be an important contribution to a reformed social protection system. It would be important that these measures incorporate specific mechanisms to reach the rural poor who, due to their location away from urban centers, face additional difficulties of access to social protection programs.

104. Uruguay operates a number of food transfer programs which have been called upon to expand their activities by as much as one third in the wake of the economic crisis. While it appears that these programs are well targeted towards the poor, it is not clear whether they are as effective as cash transfer programs in combating poverty. It would appear, however, that greater consolidation and better coordination between the country’s many food programs could significantly enhance their effectiveness as could closer ties with a more substantial program of family allowances.

105. It is difficult to ignore Uruguay’s need to expand non-contributory cash and work-fare assistance to protect households from job losses and to better combat poverty and foster equity. It is equally difficult to see how that can be done unless the disproportionate burden of public
Pensions can be brought under control. The Banco de Prevision Social is in deficit and requires large transfers from the budget to cover its obligations. It will not be able to extend further the system of social protection so long as its present financial imbalance persists. In 1996, Uruguay launched a funded pension pillar covering about a quarter of beneficiaries. However, in itself, this reform will not resolve the financial imbalance of the BPS, in fact it initially caused transitional costs which are expected to be reversed over the next decades.

106. Public pensions. Two key measures can help bring the escalating cost of public pensions under control. First, there could be a closer link between the retirement age and increases in longevity. Consideration could be given to raising the retirement age as is being done in several OECD and emerging market countries. For example, an increase by five years, from 60 to 65 for women and men, would bring the retirement age more into line with other countries (Figure 5). A possible increase in the retirement age should be implemented gradually, with due consideration for workers currently close to retirement, as has been done in many other countries. Second, and much more important as a potential source of near-term financial savings, consideration should be given to switching the indexing of public pensions from a wage-based index to an inflation-based index or to a combination of the two. Indexing reform could be introduced in an incremental manner and could go hand in hand with the expanded safety net contemplated by the incoming administration. That also would bring the system more into line with most other middle income countries which have moved away from wage-indexing, in many cases to straight price indexation, for reasons of fiscal sustainability. An added advantage of inflation-indexing or a mixture of wage- and inflation-indexing would be to make the value of pensions less volatile and less vulnerable in times of recession. During the recent crisis, for example, pensioners would have preserved the value of their pensions better if they had been linked to inflation rather than to wages.

Figure 5: International Comparison of Retirement Age

![Image of Figure 5: International Comparison of Retirement Age](source: World Bank)
107. By generating fiscal savings, these pension reform options would free up resources to fund new social assistance initiatives and to consider possible reductions in pay-roll taxes which would encourage job creation in the formal sector. At 40.5 percent, Uruguay's payroll tax wedge greatly exceeds the Latin American average (27.1 percent) and even surpasses the average in OECD countries (38.8 percent). The shift to mixed wage-price indexation is estimated to generate 0.3 percent of GDP in annual savings, effective almost immediately. A five year increase in the retirement age could generate annual savings of as much as 0.4 percent of GDP, but these savings would materialize only over the medium term. Pension reform, therefore, would promote economic efficiency and faster growth, while permitting the system of social protection to better serve the objectives of equity and poverty reduction. A key priority which the incoming administration may consider is the establishment of a commission to evaluate policy options (including changes to key parameters) to improve inter-generational equity and fiscal sustainability of the pensions system.

**EDUCATION**

108. Uruguay's education system produces good results by Latin American standards. By 2003, virtually all children were enrolled in preschool at age five and remain in school to complete the full primary cycle of six grades. Enrolment in secondary and tertiary education is also increasing, albeit at a slower rate. According to results from a 2003 Program for International Student Assessment (PISA), Uruguay performed better than the other participating countries in Latin America, although significantly below OECD standards (Table 3).

109. Uruguay may wish to look beyond its neighbors in Latin America and more towards the standards of OECD countries where its development aspirations should be directed. Within that frame of reference Uruguay falls far short of its potential and far short of the education outcomes that must be achieved if the country is to move forward with a knowledge-based economy that will propel it to a higher rate of growth and to a higher standard of living. An acceleration of the growth rate will depend critically upon the effectiveness with which Uruguay can improve its educational outcomes, particularly at the secondary and tertiary levels.

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<td>United States</td>
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<td>Portugal</td>
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<td>Greece</td>
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<td>Turkey</td>
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<td><strong>Uruguay</strong></td>
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<td>Thailand</td>
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<td>Mexico</td>
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<td>Brazil</td>
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</table>

*Source: OECD.*

110. Public expenditure on education in Uruguay amounts to 3.6 percent of GDP which is considerably lower than the Latin American average of 4.5 percent and even lower still when compared with the average of 5.3 percent in high income countries. Investment in education will have to increase if Uruguay is to establish a high quality of education for all its children and its youth. However, additional resources alone will not produce the desired improvements in educational access, equity and quality. Improvements in education service delivery, including a
strengthening of the organizational and institutional structure of the education system are needed to ensure that additional resources be used effectively.

111. The administration of public education in Uruguay is in the hands of ANEP, an autonomous institution. Within ANEP, primary, secondary, and technical education are separately governed, each by an independent council composed of political appointees. The three councils are coordinated by a five-member National Directive Council (CODICEN) which is appointed by the legislature. The organization of the governance structure into three separate governing councils results in a compartmentalization of the education system which impairs overall planning and erodes the effectiveness of ANEP. A review of the administration of education in Uruguay could usefully focus on simplifying ANEP’s structure, thus enabling it to better plan for and manage the educational process as a continuum from preschool to secondary school graduation. One option would be to strengthen the role of the director of ANEP vis-à-vis the governing councils.

112. The most pressing problem facing education in Uruguay is the high dropout rate from secondary education. Whereas 90 percent of primary school graduates enter secondary school, only 50 percent of the entrants successfully graduate from secondary school. The dropout rate is even higher for students from low-income households. There is a general perception that poverty may be an important cause for the high dropout rates of 14-17 year olds. Additionally, research indicates that many students drop out in the fifth year because they are unable to meet examination standards. That points to the need for developing more effective teaching methods and school strategies targeted at retaining 14-17 year olds in school. Thus, the new administration may consider introducing conditional cash transfers to low-income families, together with school programs tailored to retain youth in school. In addition, a specific strategy to improve secondary education enrollment and drop-out rates in the rural areas, where educational indicators are worse, could prove to have positive outcomes not only in the education system, but also in the labor market and in terms of poverty reduction.

113. Evidence suggests that teacher selection, their assignment to schools, and their remuneration may result in both low quality and inequality in the delivery of educational services. In particular, inadequate incentives in the teaching profession result in high rates of absenteeism and low teacher performance, especially in schools serving disadvantaged populations. One possible way to reduce these problems would be to reform the teacher career path and introduce several promotion tracks, where promotion would be based on a systematic performance evaluation and upon the assumption of new responsibilities such as mentoring new teachers. Consideration should be given to preparing reforms early on in the administration, and to bringing teachers fully into the process to improve the prospects for success.

114. The assignment of teachers between schools is also an important issue from the viewpoint of both efficiency and equity. Under the present system teachers select the school of their choice on the basis of seniority. As a result, new teachers and those with lower levels of education end up in the “least desirable” schools which, in many cases, are schools serving the most vulnerable populations. Those same schools typically also have a higher rate of teacher turnover. One policy option to attract better qualified teachers to schools serving disadvantaged populations would be to offer a financial bonus in recognition of the additional challenges faced by teachers in those schools. In addition, if teacher school assignments were extended to a two or
three year period, it would provide more stability and continuity between teacher and student as well as between teacher and principal.

115. In 1998 the government, with support from the Bank, introduced a full-time school program (FTS) targeted at students from low-income households. The program offers a longer school day and introduces a different pedagogic approach with special training for teachers. Although no impact evaluation of the program has been carried out to date, the available data indicate that students in the FTS program outperform those from similar socio-economic backgrounds who attend regular schools. In addition, there is widespread support in Uruguay for an expansion of the program. However, since the recurrent cost per student in the FTS program is 78 percent higher than for regular urban schools, any expansion of the program will need to be carefully planned within the limits of budget constraints.

116. Technical education is especially problematic in Uruguay because the general perception is that it constitutes a lower track education for poor performers. Currently, around 80 percent of primary school graduates enter the traditional secondary school system and 20 percent choose a technical/vocational secondary school. While technical school graduates are more likely to be employed than secondary school graduates, they earn lower average wages than do graduates from traditional secondary schools. Also, most students who go on to the university have a traditional secondary school background and not a technical one. One option for technical school reform would be to eliminate the first cycle of technical education and replace it with the regular secondary education curriculum. It has been difficult to make progress with that proposal, in part because of the administrative structure of ANEP whereby technical education is the responsibility of a separate council which makes it difficult to bridge the gap between technical and regular secondary education. Furthermore, the relationship between technical education and the labor market should be strengthened to improve the quality and relevance of technical schools.

117. Access to tertiary education is much more limited than either primary or secondary education and the greatest numbers of university students come from high income households. That raises serious questions of equity because public resources channeled to tertiary education effectively benefit households in the highest income brackets. To redress problems of inequity, besides the above mentioned policies to improve access to the second cycle of secondary school and graduation of students from low income households, consideration could be given to an expanded scholarship scheme for children from lower income families. At the same time, public university students take much longer to complete their degrees than is expected or stipulated in the programs. To improve both educational effectiveness and cost-efficiency, the possibility of introducing incentives to encourage students to complete a minimum number of courses per year and, therefore, to complete the university degree within a reasonable time frame, could be considered. Further, a student loan program could be established, analogous to that in the United Kingdom, whereby graduates would pay back a portion of their earnings once employed (and earning above a threshold income level).

HEALTH

118. Uruguay has good health indicators and access to health care is almost universal. The country has also made significant improvements in the performance of its health services over
the past years. Both the Ministry of Health and the Fondo Nacional de Recursos (FNR) have upgraded their effectiveness and efficiency. The Ministry has extended its coverage of low income households, substantially reduced the number of unnecessary hospitalizations and consultations and reformed its procedures for the procurement of medical supplies. Similarly, FNR has gone from deficit to surplus by reducing unnecessary care and costs. The incoming administration may seek to consolidate those gains by making sure that they are institutionalized.

119. Notwithstanding recent improvements, Uruguay faces serious challenges in the health sector. The heavy financial burden of health care continues to increase year by year and could become unsustainable. Uruguay spends close to 11 percent of its GDP on health care, one of the highest ratios in the world, although the “high cost” as share of GDP does not translate so much into a “high cost” on a per capita basis, which averaged US$550 in the late 1990s (before the macroeconomic crisis), compares favorably with the U.S., Europe and other countries with comparable health indicators. The high cost of health services is driven by an aging population, but it also reflects an unduly complex institutional structure with overlapping responsibilities and a system that is not well matched to the health needs of the population. The fragmentation of the system results in high costs and undermines the standard of service. Primary and secondary health prevention is marginalized within the health care system, thereby increasing the cost of complex treatment at the tertiary level. Only 7 percent of the budget of the Ministry is dedicated to public health programs. Significant inequities persist in the distribution of fiscal subsidies for health care which encompass direct fiscal subsidies paid to the health insurance of the social security institute and substantial indirect subsidies paid to the mutualistas (IAMCs).

120. The financial problems of the health sector are most clearly manifested in the operation of the IAMCs. Notwithstanding a sharp increase in monthly premiums over the past ten years, most IAMCs have steadily increased their long-term debt and seven have gone bankrupt since 1999. Nearly one quarter of IAMCs had operating deficits in 2003 equivalent to 25 percent or more of their revenues and many are becoming increasingly indebted. The recent economic crisis added to the financial woes of the IAMCs but it was not the cause of their problems. Those problems reflect much deeper weaknesses of management together with a regulatory framework that has served to protect the least efficient IAMCs rather than rewarding those that perform better.

121. The incoming government has indicated a preference for a harmonized system that will ensure a more equitable access to services, an improved quality of care and increased financial protection, while at the same time reducing the financial burden of the system. In that context, the incentive framework can be improved for all actors in the system (consumers, health service providers, ASSE, IAMCs). Policy options can be formulated for reducing fragmentation and increasing the effectiveness of financial and regulatory incentives. The government has yet to choose a specific strategy to ensure harmonization. There are a number of choices in that respect:

- The current organization of the system could be retained with key improvements in the framework of regulation and incentives.
- A “virtual” single pool model could be adopted. The present system of multiple insurers would be retained but all of them would be subject to a standard set of rules with respect
to the package of benefits, portability of benefits, and access to public and private providers.

- A single insurer (or single pool) system could be adopted analogous, for example, to the British or French National Health Service system.

122. Many countries in the region have faced similar options and their choices have been based on historical and cultural preferences, as well as fiscal constraints. Regardless of the specific strategic approach chosen, a transitional phase could help in facilitating the shift to a more effective incentive framework. There are at least five key areas of transitional reform that the government may want to consider:

- The balance between insurance and prevention can be improved. Uruguay appears to place insufficient emphasis on prevention for a country with significant challenges in the area of chronic non-transmissible diseases.
- The regulatory framework for the IAMCs can be simplified and enforcement strengthened. Some of the key features of an improved regulatory framework might include (i) more effective consumer protection, (ii) a payment system from BPS to IAMCs to provide greater incentives for efficiency and to reduce risk selection (iii) improved procedures for procuring health services from providers, (iv) guaranteed access to key health services, and (v) measures to ensure that health events do not push IAMC affiliates into poverty.
- The scope and coverage of health benefit entitlements for all recipients of public subsidies can be more clearly defined. Fiscal subsidies in the absence of an explicit coverage contribute to inequities and inefficiency.
- The current fiscal subsidy policy is inequitable and inefficient. Subsidies to any insurer (public or private) ought to be targeted to those participants in greatest need. There are many ways of designing and introducing a re-targeted system.
- Reforms within the Ministry of Health can be deepened, including reform of the provider payment mechanism in ASSE to link financing with the actual provision of services to Ministry of Health beneficiaries.

123. Uruguayan policy-makers face difficult decisions about the physician labor market—one of the most complex in the world. Current labor market legislation severely impairs the many different institutions within the system to manage their costs more effectively. The organization of the medical profession in Uruguay is also in need of reform. There are more than 13,000 physicians in Uruguay—one for every 259 citizens. A powerful union strictly regulates placements, leading to a proliferation of part-time employment with physicians holding an average of 3.5 different positions. The proliferation of multiple part-time positions lowers the quality of health care to patients.

GENDER ISSUES

124. Notwithstanding Uruguay’s well founded reputation as a socially progressive society, women continue to suffer from discrimination within the labor market and elsewhere. The male-female wage gap and labor participation gap closed significantly between 1990 and 2000 but no further progress has been registered since then. Recent research shows that the wage gap rises in line with income and education so that it is particularly wide for the highly educated. Indeed, the
data shows that women, on average, outperform men in terms of educational attainment. Among the possible measures to reduce gender wage gaps are: proactive labor market policies to reduce the segregation of women in low-paying occupations, intermediation services to foster a non-discriminatory labor market and anti-discrimination legislation empowering women to sue employers who offer unequal pay for equal work.

125. Domestic violence is a serious issue in Uruguay as in many other countries. A recent IDB survey found that more than 46 percent of women married or living with their partner suffered some kind of domestic violence in the previous year. Domestic violence has serious consequences for women's health, well-being and productivity. It also negatively affects the health and educational attainment of their children. Considerable progress has been made in terms of legislation and policies to address domestic violence, including the preparation of a National Plan against domestic violence and a law creating family courts with specialized jurisdiction over domestic violence cases. More broadly in terms of access to justice, the government envisages the creation and scaling up of mediation centers serving the country's most vulnerable populations and the appointment of more public defenders. Additional resources would be needed to successfully implement these initiatives.

126. The government could consider developing a comprehensive national strategy for gender equality, drawing upon public and civil society to identify a roadmap for the advancement of women's rights. The national strategy would articulate a clear set of policy goals and identify the indicators of progress. It would allocate responsibilities between the many institutions, both public and private, that have a role to play. Finally, it would establish monitoring mechanisms to measure the pace of progress towards established goals and it would evaluate the instruments for advancing women's rights with a view to restructuring them where necessary to ensure effectiveness. The institution charged with designing and executing national policies related to women and the family, the Institute for the Family and Women, has limited capacity. Its annual budget of approximately US$30,000 is insufficient to fully implement the National Plan against domestic violence or to develop a national strategy to promote gender equality. The government might wish to give consideration to strengthening the Institute.
CONCLUSION

127. The recent social and economic crisis in Uruguay has focused attention sharply on the vulnerability of a small open economy to shocks emanating from outside. It will not be possible to insulate Uruguay completely from external shocks in the future. The challenge for an incoming administration will be to develop more effective protective mechanisms that can cushion the impact of adverse external events and protect essential social and economic structures to the maximum extent possible. Strong and diversified economic and social structures will be able to handle the task much more effectively. The key to a strong economic fabric is growth and a central task of the new administration should be to break with the poor growth performance of the past. Only with sustained growth will the government be able to assemble the resources needed to improve the welfare and the security of the Uruguayan population.

128. The policy options proposed in this report would be challenging to implement, not least because they would call for fresh thinking. The issue before the new administration is not only to revitalize the economy, but to do so in a way that will avert the prospect of another crisis down the road. With that in mind, the options suggested here focused not only on issues of economic management but also on social inclusion and poverty reduction so that no section of society will be left behind. A matrix of principal policy options (below) summarizes the key issues. In putting forward those options, the World Bank makes no claim to privileged insight. It simply seeks to contribute to a broader policy discussion that will engage the incoming administration, civil society and other interested parties who share the same goal of helping Uruguay resolve its current difficulties and setting itself once more on a forward path.
# Matrix of Principal Policy Issues and Options

## Part I - Reducing Vulnerability

<table>
<thead>
<tr>
<th>Policy/Program</th>
<th>Policy Issues</th>
<th>Policy Options</th>
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<tbody>
<tr>
<td><strong>Macroeconomic Policy</strong></td>
<td>• Stabilize macroeconomic environment</td>
<td>i. Implementation of a reform program to ensure medium-term fiscal sustainability.</td>
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<td>ii. Maintenance of a floating exchange rate regime and a credible anti-inflation stance conceding greater autonomy to the Central Bank.</td>
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<tr>
<td><strong>Fiscal Policy</strong></td>
<td>• Ensure debt sustainability</td>
<td>i. Achieve and maintain over the medium term primary surpluses that are consistent with debt sustainability and estimated at or above the level achieved in 2004.</td>
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<tr>
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<td>• Improve tax collection</td>
<td>ii. Deepen tax administration reforms; increase social security contribution compliance.</td>
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<td>• Control growth of public expenditure</td>
<td>iii. Pass on efficiency increases in public enterprises to consumers through lower tariffs.</td>
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<td>• Improve fiscal management</td>
<td>iv. Proceed with pension reform including special regimes for police, military and banking.</td>
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<td>v. Limit contingent liabilities by deepening financial sector reforms.</td>
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<td></td>
<td>vi. Consider implementation of counter-cyclical fiscal rule.</td>
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<tr>
<td><strong>Debt Management</strong></td>
<td>• Reduce debt to GDP ratio over time</td>
<td>i. Develop programs with multilateral institutions to help smooth large amortizations with such institutions over 2005-07.</td>
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<td></td>
<td>• Reduce foreign currency exposure</td>
<td>ii. Issue more peso-denominated debt (including inflation-indexed debt) and establish consistent regulatory and tax framework to enhance the credibility of new instruments.</td>
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<td>iii. Gradual introduction of prudential regulations to encourage de-dollarization.</td>
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<tr>
<td><strong>Financial Sector</strong></td>
<td>• Recover fully from banking collapse of 2002</td>
<td>i. Complete restructuring BROU and BHU.</td>
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<td>• Create level playing field for private competitors</td>
<td>ii. Sell equity in the NBC.</td>
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<td>• Develop capital markets</td>
<td>iii. Encourage the introduction of inflation-indexed peso instruments.</td>
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<td>iv. Funding and cautious implementation of the deposit insurance scheme.</td>
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<td>v. Improve financial sector regulation and supervision – autonomy of regulator.</td>
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<td>vi. Internalize currency and country risk.</td>
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<td>vii. Strengthen legal and regulatory framework for security trading.</td>
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<td>viii. Eliminate regulatory asymmetries in insurance and pension fund markets on banking institutions.</td>
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<tr>
<td>Policy/Program</td>
<td>Policy Issues</td>
<td>Policy Options</td>
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</table>
| Private Retirement Savings Accounts | • Investment portfolios skewed to public debt instruments augment political risk  
                             | • Lack of private securities (debt and equity) for optimal diversification | i. Gradually lower “ceilings” on AFAP portfolio holdings of government debt. |
|                             | • Prohibition on international investment augments country risk of pensioners | ii. Financial sector strengthening to increase supply of tradable securities and new instruments in general (corporate bonds, warrants, leasing). |
|                             |                                                                              | iii. Gradual and controlled aperture of investment of AFAP portfolios in rated foreign securities. |
### Part II - Sustaining Growth

<table>
<thead>
<tr>
<th>Policy/Program</th>
<th>Policy Issues</th>
<th>Policy Options</th>
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<tbody>
<tr>
<td>Trade Policies</td>
<td>• Diversify export markets</td>
<td>i. Seek agreements between MERCOSUR and the USA, FTAA and the European Union.</td>
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<td>ii. Explore bilateral or regional trade agreements independently from MERCOSUR.</td>
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<td>iii. Deepen intra-MERCOSUR trade linkages (lowering the common external tariff and adopting common sanitary standards).</td>
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<td>iv. Strengthen institutional capacities.</td>
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<tr>
<td>Agriculture</td>
<td>• Improve coordination in the Generation and Innovation of Agriculture Technology</td>
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<tr>
<td></td>
<td>• Adequately fund sanitary and phyto-sanitary activities</td>
<td>i. Establish a system to define and orient a national policy for R&amp;D and to evaluate impact of R&amp;D expenditures.</td>
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<tr>
<td></td>
<td>• Ensure quality of agricultural production</td>
<td>ii. Increase amount and efficiency of spending on sanitary/phyto-sanitary activities together with reforms leading to improved management and efficiency.</td>
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<td>• Strengthen institutional framework for inward integration and overall competitiveness</td>
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<tr>
<td>Infrastructure</td>
<td>• Improve governance structure</td>
<td>iii. Continue to seek consensus at the regional level for a common sanitary policy.</td>
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<td>• Create effective competition framework</td>
<td>iv. Improve agro-industrial sector linkages with R&amp;D and promote differentiation of products through development of protocols and certification of products that specify the labor and processes and provide value-added and improved access to markets.</td>
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<tr>
<td></td>
<td>• Lower costs</td>
<td>v. Promote competitiveness for agro-industrial chains, raise overall competitiveness and enhance outward integration.</td>
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<td>vi. Separate clearly the function of policy definition, regulation and operations.</td>
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<td>ii. Strengthen autonomy of regulators.</td>
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<td>iii. Complete and consolidate public information systems.</td>
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<td>iv. Board directors appointed based on technical merits rather than political criteria.</td>
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<td>v. Vertical disintegration of public monopolies, and increased transparency in interconnections.</td>
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<td>vi. Promote private sector participation.</td>
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<td>vii. Enact sector laws.</td>
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<td>viii. Strengthen competition authority of URSEA and URSEC.</td>
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<td>ix. Introduce regulatory accounting.</td>
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### PART II - Sustaining Growth (con't.)

<table>
<thead>
<tr>
<th>Policy/Program</th>
<th>Policy Issues</th>
<th>Policy Options</th>
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</table>
| Infrastructure sub-sectors          | • High prices in water, fuels and energy  
• Incomplete regulatory framework in gas, petroleum products and water                                                                                                                                   | i. Adopt import parity prices for fuels.  
ii. Adopt a national energy policy.  
iii. Yardstick competition in water and energy.  
iv. Programs for reducing energy and water losses.  
v. Universalize sewerage services.  
vi. Promote energy interconnections with Argentina and Brazil and tap their wholesale markets through long-term supply contracts.  
vii. Operationalize the wholesale energy market (ADME).  
viii. Consider separating the TCC plant from UTE. |
| Enabling environment for private sector | • Over-regulation of firm entry, high cost of contract enforcement  
• Ineffective bankruptcy procedures  
• Lack of level playing field between SMEs and larger firms  
• Unfocused SME programs  
• Lack of professional civil service  
• Strategic budget planning ineffective | i. Simplify procedures and capital needs to start a firm.  
ii. Passage of Bankruptcy Law in Congress and enactment of accompanying regulations.  
iii. Capacity building in the specialized bankruptcy courts.  
iv. Deepen procurement as a means to facilitate SME's quality and innovation as well as fiscal savings.  
v. Target clusters/networks rather than individual firms.  
vi. Strengthen managerial base and promote entrepreneurship.  
vii. Systematic monitoring and evaluation to refine innovation programs.  
viii. Civil service reforms.  
ix. Results-based budgeting. |
### PART III – Improving Living Standards

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<tr>
<th>Policy/Program</th>
<th>Policy Issues</th>
<th>Policy Options</th>
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</table>
| **Old Age, Survivor and Disability Public Pensions** | • Indexing benefits to (lagged) wage growth is unnecessarily costly, and inefficient due to its cyclic nature  
  • Minimum/average retirement age too low with respect to average longevity | i. Establish a commission to evaluate policy options (including changes to key parameters) to improve inter-generational equity and fiscal sustainability of the pensions system.  
  ii. Gradually switch benefit indexation to prices or combination of wages and prices.  
  iii. Link retirement age to increases in longevity. |
| **“Non-Contributory” Public Pensions** | • Benefit levels are too similar to “contributory” benefits, contributing to evasion and gaming  
  • Incomplete coverage of elderly poor | i. Clearly differentiate non-contributory benefit from contributory minimum benefit (possibly using savings from measures above to raise contributory minimum).  
  ii. Proactive measures to ensure complete coverage of elderly poor. |
| **Unemployment Insurance** | • Low coverage among work force, and low incidence among unemployed  
  • Constant benefit levels encourage dependence  
  • Predictable employment “suspensions” covered with risk pooling mechanism  
  • Discretionary/arbitrary extensions of benefit periods | i. Establish self targeting, non-contributory benefit for unemployed, expanding existing work-fare program.  
  ii. Extend legal eligibility for unemployment insurance to all workers who meet employment and contribution criteria.  
  iii. Introduce declining benefits in unemployment insurance program.  
  iv. Phase out coverage of “suspensions”, and introduce individual savings mechanism to cover seasonal industries.  
  v. Eliminate discretionary extensions of benefit period. |
| **Job Security and Severance Regulation** | • Inefficient firm-level risk-pooling, due to small size of pool  
  • May increase average duration of unemployment  
  • May lead to employment discrimination against young and women | i. Consider reducing severance costs and compensating with extended unemployment insurance and saving instrument (like Chile). |
| **Family Allowances** | • Small program size constrains impact  
  • Education and health conditions go un-enforced hindering program efficiency | i. Expand to cover at least all poor households with children under 18.  
  ii. Enforce education and health conditions (particularly as school desertion is rising). |
### PART III – Improving Living Standards (con’t.)

<table>
<thead>
<tr>
<th><strong>Policy/Program</strong></th>
<th><strong>Policy Issues</strong></th>
<th><strong>Policy Options</strong></th>
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</table>
| **In-Kind Food Assistance** | • Decentralized, uncoordinated administration of at least 10 programs (probably more), leads to multiplicity of programs, over-lap, duplication and waste  
• Small program size constrains impact  
• No program encouraging breast feeding  
• Seeking to meet redistribution/poverty objectives with in-kind transfers, limits effectiveness  
• Some programs lack both clear nutritional and distribution/poverty objectives (community kitchens; food basket for pensioners)  
• Programs are not evaluated | i. Consolidate programs with nutritional objectives under one government agency.  
ii. Consolidate and expand nutritional programs targeting children.  
iii. Add program that encourages breast feeding (information campaign).  
iv. Replace programs with clear redistribution/poverty prevention objectives, with cash transfers, consolidating with and strengthening Family Allowances and/or Non-Contributory Pension programs.  
v. Gradually phase out programs that have neither a clear nutritional nor redistribution objective.  
vi. Conduct regular program evaluation. |
| **Education** | • Adequately fund education  
• Integrate education programs from pre-school through secondary school  
• Reduce high secondary school drop-out rate  
• Reduce gap between technical education stream and general secondary education  
• Enhance equity of access to tertiary education | i. Increase public expenditure on education above the present 3.6 percent of GDP.  
ii. Simplify structure of ANEP.  
iii. Strengthen director of ANEP vis à vis the governing councils.  
iv. Improve secondary school teaching methods.  
v. Introduce cash transfer program for low-income families.  
vi. Introduce special programs for rural secondary schools.  
vii. Reform teacher career path to reward good performance  
viii. Offer financial incentives to teachers who work in schools serving disadvantaged communities.  
ix. Expand full-time school programs.  
x. Replace first cycle of technical education with regular secondary school curriculum.  
xi. Strengthen link between technical education program and labor market requirements.  
 xii. Expand scholarships for students from low-income households.  
 xiii. Enhance incentives for completing tertiary courses within reasonable timeframe.  
 xiv. Introduce student loan program. |
### PART III – Improving Living Standards (con’t.)

<table>
<thead>
<tr>
<th>Policy/Program</th>
<th>Policy Issues</th>
<th>Policy Options</th>
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</table>
| **Health**     | • Harmonize present system and reduce fragmentation  
                 • Control costs of health care | i. Retain current system structure with selective reforms in incentives and regulatory framework; or  
ii. Adopt a single insurer (or single pool) system; or  
iii. Adopt a “virtual” single pool model where multiple insurers are subject to standardized rules.  
iv. Improve management of IAMCs within stronger regulatory framework.  
v. Strengthen system of primary health care.  
vi. Address challenges in physician labor market. |
| **Gender Equality** | • Reduce male-female wage gap  
                       • Advance women’s rights | i. Enact anti-discrimination legislation.  
ii. Fully fund and implement the national plan for reducing domestic violence.  
iii. Strengthen Institute for the Family and Women.  
iv. Develop a comprehensive national strategy for gender equality. |