Statement by Todd Crawford  
Date of Meeting: June 6, 2000

URUGUAY - Country Assistance Strategy and Loan to the Administracion de las Obras Sanitarias del Estado

Overview

1. We appreciate the opportunity to discuss this concise yet comprehensive Country Assistance Strategy (CAS). We wish to express our appreciation also for the thoughtful Country Assistance Evaluation (CAE), which highlights the highly satisfactory outcome of CAS 97 and provides good background for today's discussion.

2. As the CAS and CAE both note, Uruguay has a per capita GNP of $6,180 ($9,480 in purchasing power parity terms), strong social indicators, and one of the most equitable income distributions in Latin America. It has made commendable gains in broad-based educational achievement, health services coverage and overall human development. Notwithstanding recent signs of some possible increases in social stratification, poverty is modest compared with many other countries in the region. Uruguay has also made progress in achieving macroeconomic stability and implemented important structural reforms including trade liberalization and streamlining the public sector. Recently, with its request to the IMF for a precautionary stand-by arrangement, which was approved on May 31, the Government expressed its renewed commitment to strengthen macroeconomic policies and proceed with structural reforms to put public finances on a sounder footing and help build the economy's regional and global competitiveness. Access to international capital markets should improve as Uruguay implements these policies and in line with the investment grade rating on its sovereign debt.

Greater Selectivity Leading to Graduation

3. In light of these factors, we agree with the overall thrust of the proposed Country Assistance Strategy. It is appropriate to become more selective, focusing on targeted social sector operations to address the needs of vulnerable groups, on activities with important
environmental dimensions to preserve Uruguay's natural resource base, and on operations that will reduce the *costo Uruguayo* so as to make the private sector more competitive.

4. We also agree that it is appropriate, against the backdrop of Uruguay's economic and social achievements and within this framework of greater selectivity, to begin phasing down the volume of the Bank's assistance to Uruguay. Graduation by the end of this five-year CAS period, based on achievement of the target development values in Table 5, should be the objective. While there are numerous references throughout the CAS to eventual consideration of graduation, we would have welcomed greater explicitness on this point.

5. We generally concur with the proposed composition and volume of the base case lending program. We are concerned, however, that the triggers lack specificity. Uruguay's compliance with the performance criteria of its IMF stand-by arrangement can serve as a proxy for an acceptable macroeconomic framework. However, what objectively verifiable indicators will staff use, for example, to judge unsatisfactory progress on financial sector reforms? The low case trigger of 30 percent or more problem projects is excessively lenient given Uruguay's demonstrated institutional capacities and the commendable performance of its project portfolio. Does this trigger reflect staff's expectation of a significant deterioration in project performance due to fiscal adjustments required under Uruguay's IMF stand-by arrangement? We would also appreciate clarification of the lending staff would expect in the low case.

6. Within the framework of this graduation strategy, we could envision a potential high case lending program if the Government were able to build a consensus in favor of a bolder approach to privatization and structural reform, particularly in the financial sector. As noted in both the CAE and the CAS, reforms in this sector are incomplete and the role of state-owned banks remains large. Privatization could make a big contribution to creating the conditions for more competitive private enterprise. We are not in a position to second guess the Government's judgment as to how far and how fast it can go in reducing the role of the state in key productive sectors and creating scope for a more vibrant, competitive private sector. However, we are concerned that the chosen strategy of trying to make public sector entities more efficient may not be sufficient to achieve the desired reduction in the *costo Uruguayo*.

**Diagnostics**

7. We note the CEA's emphasis on good diagnosis of economic, social, and political issues as a key ingredient in the success of CAS 97. We are pleased to see, once again, sound diagnosis as the basis for the present CAS. We appreciate the detailed yet concise information regarding the socio-economic context for the proposed Bank assistance program. We commend the Bank and the authorities for having included NGOs in the assessment of the causes of poverty and social exclusion in the recent Poverty Assessment. The information about the demographic characteristics and size of vulnerable groups -- such as young people, female-headed households, and the Afro-American population -- should aid the Government and the Bank to target social programs more effectively. We note, however, that the recent Poverty Assessment did not cover rural areas. Although rural inhabitants account for only 10 percent of Uruguay's population, we hope that this information gap will be filled either by other donors, such as the IDB, or in the second phase of the Poverty Assessment, which is under way.
8. We are pleased to note that a Country Procurement Assessment Review (CPAR), issued in July 1999, highlights the strengths and weaknesses of public procurement and makes recommendations to improve it. Given that weaknesses in the procurement process have contributed to delays in project implementation, we concur that lack of progress in strengthening public procurement should be a trigger for moving to the low case lending scenario. How do staff assess progress to date and what benchmarks will they use moving forward?

9. We welcome the proposed Social Expenditure Review. Despite significant spending on health and education, performance indicators in these sectors have deteriorated in recent years. Inefficiencies in health care delivery have eaten up the higher spending. Significant quality issues in education are reflected in high repetition rates, particularly in poor areas. These results underscore the need for a clear accounting of government expenditures to ensure maximum effectiveness of the government's social sector spending as well as Bank lending.

10. We would urge that the Bank and the Government also collaborate on a macro-level Public Expenditure Review (PER). This is especially important given concerns expressed in the CAS regarding governance and transparency of government expenditures. Such a PER could help the Government to clarify the opportunity costs of continued large-scale public sector involvement in the economy and could possibly build support for more ambitious privatization. If a consensus in favor of such privatization were to develop, a PER could also help the Government to make expenditure choices optimizing the use of privatization proceeds. We would in any case regard a PER as a prerequisite for any future adjustment lending under the high case scenario.

**Relations with Key Lending Partners**

11. The CAS notes that the Inter-American Development Bank (IDB) is expected to continue to be the major source of external development finance for Uruguay, providing some five times the volume of World Bank lending envisioned during the CAS period. Do staff believe that this volume of lending will undercut the World Bank's ability to promote important structural reforms? We welcome the reference in the CAS to close collaboration between the Bank and the Fund, most intensively in the area of financial sector reforms, which are central to the new IMF stand-by arrangement.

**OSE Modernization & Systems Rehabilitation Loan**

12. We agree that the adaptable program loan to the Administracion de las Obras Sanitarias del Estado (OSE) for its modernization and systems rehabilitation is consistent with the CAS. We support its objectives of enhancing OSE's operational efficiency, establishing an independent regulator that is separate from the suppliers of water and sewerage services, and promoting private sector concessions for the provision of such services. We appreciate the benefits that should accrue to low-income populations. We concur with the emphasis on efficiency gains, rather than on capacity expansion. With physical and commercial water losses equal to 45 percent of water production, there is clearly a lot of room for gains from rehabilitation and greater efficiency. We welcome the attention that will be given to strengthening OSE's
environmental planning and management capacity. In this regard, we would encourage preparation of full Environmental Impact Assessments for the Salto and Paysandu sewage treatment plants. These plants will discharge effluent into important water resources shared with Argentina and caution is justified.

13. While we note the CAE's finding that the Bank's lending to Uruguay has achieved substantial institutional development, we have some concerns about the incentives to encourage OSE to improve its performance. This project, as currently envisioned, may not take the reform agenda far enough. We would appreciate further staff comment on the incentives, which appear to be of three types:

- The first of these is competition from private sector providers, but this competition will be modest. The coverage of private sector providers by the end of the program in 2009 will be only 67,000 households, which is not a significant share of Uruguay's 3.3 million population. Thus, the risk of continued monopolistic, inefficient behavior will persist. Without accompanying measures such as rate caps and a prohibition on subsidies from the general budget, this degree of competition appears unlikely to stimulate improved performance.

- The second kind of incentive is to be provided by the new system of performance targets to be established during the first phase. The PAD is not clear, however, on what sanctions will apply to OSE personnel for failure to meet the targets. Without sanctions, accountability will be weak at best.

- The third incentive for improved performance is that the regions will be able to retain 20 percent of the savings accruing from reduced volumes of unaccounted for water, rather than having to remit those savings to OSE's main treasury. This may be the most effective incentive for improved performance. Could staff comment on the feasibility of increasing the share of savings that the regional offices can retain over time? Further, the best way to ensure accountability and local demand driven investment might be to establish the regional offices as independent entities. In many countries, water and sewerage utilities are local institutions that operate under national, or even local, regulation and supervision. We would encourage staff and the authorities to consider full decentralization of OSE (i.e., dividing it into independent regional units) as a policy goal to pursue during subsequent phases of the loan.

14. Finally, we note that the specifics of reform in later stages of this APL are yet to be agreed. This is understandable. The course of future reform will depend on the lessons learned from Uruguay's experience with concessioning and with establishing performance benchmarks for OSE. However, precisely because of this uncertainty, we would have preferred a lending instrument other than an APL. It is difficult for the Board even to discuss subsequent phases of APLs and, therefore, it will have little opportunity to influence the subsequent stages of reform. A series of investment loans would give the Board such an opportunity, while still affording the same flexibility with respect to design of operations and timing that OED's Country Assistance Evaluation found was the key to explaining the highly satisfactory outcome of CAS 97.