SIMULTANEOUS DISCLOSURE

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

URUGUAY

PROGRAM FOR STRATEGIC INTERNATIONAL POSITIONING

(UR-L1076)

LOAN PROPOSAL

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CONTENTS

Annexes	
Annex I	Development Effectiveness Matrix (DEM) – Summary
Annex II	Policy Matrix

Electronic links

Required

1. Matrix of Conditions and Means of Verification
   http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=37306552
2. Results Matrix
   http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=37297531
3. Policy Letter
   http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=37532030

Optional

1. Monitoring and Evaluation Plan
   http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=37307199
2. Economic evaluation
   http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=37300061
3. Macroeconomic analysis of investment flows and growth
   http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=37294654
4. Investment promotion mechanisms: analysis, international evidence, and suggestions
   http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=37297569
5. Using Synthetic Controls to Evaluate an International Strategic Positioning Program in Uruguay
   http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=37312864
6. Bibliography
   http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=37309934

ABBREVIATIONS

ANII	National Research and Innovation Agency
BIPPA	Bilateral Investment Promotion and Protection Agreement
BIT	Bilateral investment treaty
bps	Basis points
CIACEX	Interministerial Commission for External Trade Affairs
CND	National Development Corporation
DTT	Double taxation treaty
DUA	Single Customs Document
FDI	Foreign direct investment
FFF	Flexible Financing Facility
GDP	Gross domestic product
MEF	Ministry of Economy and Finance
MERCOSUR	Southern Common Market
NFPS	Nonfinancial public sector
NPV	Net present value
PENCTI	National Strategic Plan for Science, Technology and Innovation
PPP	Public-private partnership
R&D	Research and development
UNASEP	Private Sector Support Unit
Uruguay XXI	Institute for the Promotion of Investment and Exports of Goods and Services
VUCE	Ventanilla Única de Comercio Exterior [“single foreign trade window”]

PROJECT SUMMARY

URUGUAY
PROGRAM FOR STRATEGIC INTERNATIONAL POSITIONING
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Financial Terms and Conditions[i]				
Borrower: Eastern Republic of Uruguay			**FFF**	**FFF/RP**[ii]
		Amortization period:	20	11.5
Executing agency: Ministry of Economy and Finance (MEF)		Drawdown period:[iii]	3 years	3 years
		Grace period:	[iv]	1 year [v]
Source	**Amount**	Weighted average life (in years)	max. 12.75	max. 7.75
IDB: Ordinary Capital	US$183,750,000	Front-end fee:	50 bps	50 bps
		Commitment fee:	25 bps [vi]	25 bps [vi]
IDB: Ordinary Capital - Reallocation Program (RP)	US$366,250,000	Inspection and supervision fee:	[vi]	[vi]
		Interest rate:	LIBOR-based	LIBOR-based
Total	US$550,000,000	Currency of approval:	US$	US$

Project at a Glance

Project objectives/description: The general objective of the program is to help consolidate the international positioning of Uruguay by strengthening the legal and institutional framework for attracting investment, promoting and facilitating trade, and maximizing the local impact of that positioning.

Components: (i) Macroeconomic framework; (ii) Investment promotion; (iii) Trade promotion and facilitation, and (iv) Enhancing innovation capacities.

This operation is structured as a programmatic policy-based loan with a deferred drawdown option, and is consistent with the IDB country strategy with Uruguay (2010-2015) (document GN-2626), as it seeks to improve the country's international positioning through the attraction of more foreign direct investment, and will contribute to achieving the strategic objectives established in the Report on the Ninth General Increase in the Resources of the Inter-American Development Bank (document AB-2764) such as: (i) support development of small and vulnerable countries; and (ii) competitive regional and global integration.

Special contractual conditions: Funds will be disbursed as the targets agreed upon and listed in the Policy Matrix are achieved (see Annex II).

Exceptions to Bank policies: None

Project qualifies as: SEQ [ ] PTI [ ] Sector [ ] Geographic [ ] Headcount [ ]

(i) The financing will come from Ordinary Capital resources under the country's regular allocation for 2013 and the Ordinary Capital resources paid in advance by the country and reallocated under the Bank's Reallocation Program (document FN-672-1).

(ii) The portion of the loan under the Reallocation Program will benefit from the options offered by the Flexible Financing Facility (FFF) (currency and interest rate conversions), except for the flexibility to change amortization schedules. The amortization schedule applicable to this portion of the loan will be the payment of consecutive, semiannual installments, in equal amounts to the extent possible, upon completion of the grace period.

(iii) The program will use the procedure for policy-based loans with a deferred drawdown option (document GN-2667-2), which establishes an original drawdown period of three years from the date of eligibility for disbursement, with the option of a single renewal for another three years. In this specific case, the renewal option will be available only for the portion of the financing using resources from the country's regular allocation for 2013. For the portion of the financing using resources paid in advance by the country and reallocated under the Bank's Reallocation Program, the borrower has declared that it will waive the option of renewing the drawdown period for an additional three years.

(iv) For the portion of the financing using resources from the country's regular allocation for 2013, the grace period will depend on the amortization schedule agreed upon between the borrower and the Bank when the disbursement request is formalized during the drawdown period.

(v) Counted as of the first loan disbursement within the drawdown period.

(vi) The commitment fee and inspection and supervision fee will be established periodically by the Board of Executive Directors as part of its review of the Bank's lending charges, in accordance with the applicable provisions of the Bank's policy on lending rate methodology for Ordinary Capital loans.

I. DESCRIPTION AND RESULTS MONITORING

A. Background, problem addressed, and rationale

1. Macroeconomic context

1.1 Emerging from the deep financial crisis of 2001-2002, the Uruguayan economy entered a strongly expansionary cycle. The annual growth rate, which had averaged barely 2.2% during the second half of the twentieth century, accelerated to an average of 5.9% during the period 2004-2011. This faster growth was accompanied by an appreciable reduction in volatility, which had been a characteristic feature of the Uruguayan economy during previous decades.

1.2 In a country with moderate demographic growth, this change translated into a sharp increase in per capita output, the purchasing power of which, measured in terms of a comparable international shopping basket, more than doubled from the trough reached during the crisis at the beginning of the century. The sustained economic recovery and the increase in average incomes resulted in significant welfare gains for a population that had been hard hit by the crisis.

1.3 On the fiscal front, the sound economic performance led to an improvement in the public accounts. The fiscal deficit dropped from 2.6% of GDP in 2003 to 0.9% of GDP in 2011. Over that same period, public debt declined from 93% of GDP to 43%.[1]

1.4 The economic growth observed since the 2002 crisis can be explained in part by higher levels of investment. While total investment represented 15% of GDP on average over the years 2000-2005, that proportion rose to 20% during 2005-2011. The increase in investment was driven by foreign direct investment (FDI), which after averaging 1.9% of GDP between 2000 and 2005 jumped to 5.8% of GDP in the second half of the decade. Yet despite this substantial growth, the investment rate is still far from the 25% that the government has set as its long-term objective.

1.5 Although FDI performed strongly in 2010-2011, the current international environment and the effects that the latest international financial crisis has had on Uruguay add a note of caution regarding the future behavior of the economy. The global economic recession of 2008 may have caused less collateral damage than in other countries of the region, but it led to a marked slowing of growth. The greatest impact of the international financial crisis was its effect on the country's access to financing and on its balance of payments. The country risk index (Emerging Markets Bond Index) for Uruguay, after averaging 300 basis points in the first half of 2008, jumped to 900 basis points after the collapse of Lehman Brothers. Given the high costs of financing in the capital markets, multilateral credit agencies became the main source of financing for the central government in 2009, contributing more than US$1.1 billion. These disbursements served to cover 80%

[1] This reduction in debt was accompanied by an improvement in its currency composition and an extension of its maturity limits. In light of these improvements, the two leading risk rating agencies granted investor grade status to Uruguayan debt.

of amortization and interest on the debt that year. As to the balance of payments, the surplus on the capital account fell from 15.2% of GDP in 2008 to 4.8% in 2009, and FDI shrank by more than 25% in that year.

1.6 If the international environment should deteriorate, the Uruguayan economy would experience a phase of slower growth, which would result in lower tax revenues and would place pressure on public finances. The financing needs for the nonfinancial public sector (NFPS) under a base scenario similar to that used by the Ministry of Economy and Finance (MEF) for preparation of the public accounts would average US$1.9 billion per year between 2013 and 2015. These financing needs would increase under alternative, less favorable scenarios such as the one proposed by Borensztein et al. (2012), according to which average financing needs during 2013-2015 would rise to US$2.2 billion, and would be even greater in a scenario of a stronger impact from the international financial crisis.

2. Growth, investment and productivity: determinants and interrelationships

1.7 Thanks to the buoyant economy, Uruguay is currently in a situation close to full employment. Growth in recent years has in fact exceeded the economy's potential growth rate, and this is now producing underlying inflationary pressures. There was no sign of such pressures following the 2002 crisis, when growth was to a large extent based on making better use of idle factors of production. Today, that source is close to being exhausted.

1.8 In this economic context, the main challenge facing the country from the structural viewpoint is to increase the potential growth rate of the economy. A detailed analysis of the growth accounts (see optional electronic link 3) indicates that if Uruguay is to achieve a sustainable growth path and thereby consolidate its growth record to date it will need, at the same time, to expand and improve its endowment of both physical and human capital and to promote innovation as an effective way of boosting productivity and addressing the constraints and shortages that could potentially jeopardize the country's sustained economic growth.

1.9 An estimate of the income gap between the United States and Uruguay suggests that there has been a change in the factors underlying Uruguay's relative performance. Back in the mid-1980s the productivity gap accounted for 75% of the income differential between the two countries; today, the relative importance of productivity has declined to the point where it explains just over 50% of the gap. The trend in the income gap is explained primarily by the lower relative factor intensity of the Uruguayan economy. The bulk of the difference in factor accumulation is explained by the relative decline in the capital-output ratio compared to that in the US economy.

1.10 To reverse this trend, the country must address the challenge of consolidating a sustained investment process. The additional investment effort (compared to the historic trend) needed to achieve the long-term equilibrium rate within five years is

3.6%, which is in line with the government's objective of raising the investment rate to around 25% of GDP (see optional electronic link 3).

1.11 In turn, these higher investment levels would help to close part of the productivity gap. The economic literature shows that productivity improvements are dependent on investment in physical and human capital (Aghion and Howitt, 2009). Although it is possible to imagine specific circumstances in which a given resource endowment could be used more efficiently (one arguable case in the region is the period of macroeconomic disequilibrium that prevailed during the 1980s), there is abundant empirical evidence to show that technological improvements and significant innovations will come about only when firms make a consistent effort at research and development.[2]

1.12 Moreover, the process of technological improvement has been driven in many cases by the knowledge embodied in machinery and in imported capital goods (recognizing that the effective incorporation of knowledge will in many circumstances require additional adaptive efforts); or it has been generated through inflows of FDI. It is clear that productivity trends and capital accumulation tend to be complementary and to move in tandem (Arnold & Javorcik, 2009). According to Bank estimates, the Uruguayan economy still exhibits an appreciable gap in terms of its relative capital endowment, and consequently still requires a significant investment effort to put the country on a long-term growth path.

1.13 **Determinants of investment.** Numerous studies have examined the importance of both economic and political factors in explaining why FDI is attracted to specific countries. On the political front, evidence indicates that stability and institutional quality are determining factors for attracting FDI, and Uruguay compares well in both areas.[3] Among the most relevant economic factors, the domestic market has traditionally been considered the predominant one, along with the availability of factors of production.[4] More recently, growing importance has been attached to so-called "cluster economies" as an important consideration in firms' decisions on locating their activities, both at home and abroad. In this sense, in addition to the importance of such factors as communications infrastructure and business networks, special value is attached to the technological and innovative capacities and skills of the local setting.[5]

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2 See IDB (2011), Crespi, G. and Zuñiga, P. (2010) and López, A. et al. (2010) for examples from Latin America.

3 See Campos and Kinoshita (2003); Kahai (2004); Bénassy-Quéré et al. (2005; 2007); Busse and Hefeker (2007); Daude and Stein (2007); Naudé and Krugell (2007); Ali et al. (2010); Biglaiser and Staats (2010).

4 Wheeler and Mody (1992); Hanson (2001); Campos and Kinoshita (2003) find empirical evidence of the importance of the domestic market as well as labor availability, while Owen (1982); Clark *et al.* (1989); Shatz and Venables (2000) also demonstrate the significance of the factor endowment. The review by Holland et al. (2000) also attaches prime importance to the size of the market and its growth potential, while factor costs are second in importance.

5 See Head et al.(1995); Barrell and Pain (1999); Campos and Kinoshita (2002; 2003); Nonnemberg and M. J. Cardoso de Mendonça (2004); and Li and Park (2006).

1.14 For their part, governments have negotiated a series of bilateral investment treaties (BIT) and double taxation treaties (DTT) intended to send investors a clear signal that they will enjoy the protection of international law in the event of disputes and to mitigate the risk of double taxation for foreign entities. Such agreements have proven to be significant factors in explaining FDI flows, as they create predictable, transparent rules for the treatment of investments.[6] At the same time, a series of studies has analyzed the influence of policy variables, such as tax rates or the granting of incentives. On the first point, evidence points to a negative link between the level of taxes and the inflow of investment.[7] As to the second, evidence suggests that incentives play a secondary role in investment location decisions, as the potential host regions have already been "filtered out" (in firms' decision-making processes) by means of other fundamental variables (resources, market, strategic assets, etc.).[8]

1.15 Lastly, special attention should be paid to the proliferation of public-private partnerships (PPP) as a mechanism for promoting investment, especially in infrastructure. Generally speaking, a PPP can be defined as a cooperative agreement between the public and private sectors where responsibilities, risks, resources, and rewards are shared and divided with a view to achieving joint objectives. Contracts of this type, if structured efficiently, could address both government shortcomings and market failures while at the same time incorporating the relative strengths of the public and private sectors (Kwak et al, 2009). In practice, arrangements for joint participation in infrastructure projects are very frequent in developing countries. According to the United Nations Conference on Trade and Development (UNCTAD) (2011), more than 60% of FDI-financed infrastructure projects undertaken in developing countries over the period 1996-2006 involved PPP concessions and agreements.

3. Policies and institutions for deepening strategic international integration

1.16 In this context, the strategy for positioning Uruguay internationally has paid special attention to the role of FDI. The country has received significant amounts of FDI in recent years (reaching a historic high of US$2.614 billion in 2011), driven not only by promising growth prospects at the local and regional levels but also by an active policy for attracting investment and the perceived stability of Uruguayan institutions and the "rules of the game." In fact, much of the FDI arriving in

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[6] For a survey of evidence on this topic, see Sauvant and Sachs (2009). Studies showing that DTTs and/or BITs promote greater levels of FDI include Banga (2003); Neumayer and Spess (2005); Neumayer (2007); Siegmann (2008); Desbordes and Vicard (2009); Barthel et al. (2010).

[7] See Root and Ahmed (1978); Grubert and Mutti (1991); Loree and Guisinger (1995); Hanson (2001); Bénassy-Quéré et al. (2001a; 2001b); Demekas et al. (2007); Coelho (2010); Feld and Heckemeyer (2011).

[8] According to a recent survey by Ginevičius and Šimelytė (2011), the literature seems to support the idea that the main incentives affecting FDI are more likely to involve fiscal tools of promotion (particularly tax exemptions) than financial benefits. Studies claiming a positive link between tax incentives and foreign investment include Goolsbee (1998); Buettner and Ruf (2007); Miyagiwa and Ohno (2009); Havranek and Irsova (2010).

Uruguay is geared to supplying the markets of the larger MERCOSUR members from a base in Uruguay, selected precisely for these reasons (López, 2011).

1.17 Uruguay has historically welcomed FDI, and the policies applied to foreign capital in recent decades have reflected the growing interest in attracting such flows (Bittencourt, et. al., 2009). The government's policy for attracting investment has been to encourage all forms of investment, without distinction between domestic and foreign sources. The general regime of incentives does not discriminate between foreign and local investors from the tax viewpoint, and no prior authorization is required for foreign investment. Persons and corporations can set up business in Uruguay without having to meet any preconditions or to obtain special government permits (for a detailed analysis of the treatment of investment in Uruguay see optional electronic link 4).

1.18 The government body responsible for defining policy with respect to commercial integration, international negotiation, trade promotion and investment, as well as incentive mechanisms, is the Interministerial Commission for External Trade Affairs (CIACEX). At the operating level there are two agencies: the Institute for the Promotion of Investment and Exports of Goods and Services (Uruguay XXI) and the Private Sector Support Unit (UNASEP), although neither of these has FDI promotion as its exclusive objective. The policy for attracting investment has two facets: on one end, Uruguay XXI seeks to recruit investors abroad and assist them in their endeavors (active policy). On the other hand, once investors have shown an interest (passive policy), the UNASEP provides them with more specific information about the promotion regimes and helps them decide which system of benefits is most appropriate to their case (Román, 2010).

1.19 The government has launched a series of reforms in recent years intended to consolidate a long-term process of sustained investment. The current government has undertaken to promote a number of policy reforms, notably to: (i) update the investment promotion regime to optimize its impact and make it more transparent; (ii) meet international standards for the sharing of financial and fiscal information, to ensure that the country continues to move forward through the various phases of the peer review process in the OECD Global Forum on Transparency and Exchange of Information for Tax Purposes; (iii) create a regulatory framework that allows risks to be shared between the public and private sectors in large infrastructure projects, using PPP for specific projects; (iv) take steps to modernize trade facilitation and to update customs regulations; and (v) implement policies on technological innovation so as to deepen the development impact of FDI.

4. Problems and challenges

1.20 Although Uruguay has succeeded in improving its international positioning through a policy of economic openness that has attracted a growing volume of investment, it still faces the challenge of overcoming a series of obstacles that stand in its way.

1.21 **Diversification of investment targets.** Uruguay needs a greater presence of investment in sectors that offer high value added. Over the period 2007-2010 the primary sector and construction (including hotels and restaurants) represented 54% of total investment, while industry accounted for only 13%. During this time there has been a further concentration of FDI in the primary sectors and in natural resource-intensive industries, a trend first noted in the 1990s (Bittencourt et. al., 2009). In addition, although directed to various sectors, the most significant amounts of investment are still excessively concentrated in a few large-scale paper and forestry projects. The concentration of investment can be seen in the sharp growth of the construction sector's share of total FDI since 2006: that share rose from 11% in 2001-2005 to 27% over the years 2006-2010. This situation reflects the construction and installation of cellulose plants as well as the boom in real estate investment in Punta del Este. The sector concentration of FDI is compounded by the concentration of investment sources: MERCOSUR represented an average of 34.7% of FDI in 2008-2010, with Argentina alone accounting for 26.4% over that time.

1.22 **International perception.** Although Uruguay has succeeded in attracting significant investment in recent years, it is still not regarded as a prime location for investment. According to the most widely used international indicators, such as the Global Competitiveness Index published by the World Economic Forum, Uruguay ranks seventy-fourth among 144 countries, and in fact experienced one of the sharpest drops (11 places) in its ranking over the last year. Something similar has happened with the ranking by the World Bank's Doing Business report, where Uruguay lost two places, falling from 87 to 89 out of 185 countries. The main problems cited in these rankings relate to excessive bureaucracy, inefficient foreign trade procedures, labor market rigidities, the failure of the education system to turn out the skills needed for industry, and the low capacity for business innovation. In short, the variables of time, cost, and complexity of the business climate in Uruguay offer a window of opportunity for promoting public policies that will facilitate the development of FDI and foster its sustainable growth.

1.23 **Improving the standards of trade facilitation.** The country is gradually attempting to establish itself as a regional logistics hub and platform. Its privileged location as a gateway to MERCOSUR, together with its promotional regimes, offer a favorable climate for attracting investments targeting the regional market. However, the country needs to de-bureaucratize its customs procedures and reduce processing times for export, import, and transit operations. In the 2012 "logistic performance indicator" Uruguay ranks fifty-sixth out of 155 countries, behind the two largest MERCOSUR countries: Brazil (45) and Argentina (49). The standards of trade facilitation are in turn affected by the pressing need to improve infrastructure, particularly the highway system. Capurro et al. (2010) estimate the cumulative gap in road infrastructure during the period 2000-2010 at US$1.152 billion, and they project highway investment needs for the next 10 years at US$4.440 billion.

1.24 **Weak capacities for business innovation.** Although investment in R&D has increased in recent years, there is still a gap vis-à-vis the rest of the region and more advanced countries (Sánchez et al., 2012). In 2010, the country invested 0.4% of GDP in R&D, while the average for the region was 0.75%, and in many OECD countries this ratio exceeds 2%. The low investment in R&D is explained in part by the low participation of businesses, which account for just over 40% of the total, while in the more advanced countries businesses contribute over 60%. According to the latest national survey of innovation in industry, conducted by the National Research and Innovation Agency (ANII), while firms have increased their innovation effort (from 2.43% of sales in 2003 to 3.18% in 2009), they are still devoting very few resources to research and development (only 0.16% of sales, compared to 0.64% in Brazil and 0.2% in Argentina). This limited investment in R&D is also associated with a human resource problem, as reflected in the 2012-2013 Global Competitiveness Report of the World Economic Forum, which shows that Uruguay is lagging behind in the teaching of mathematics and science, the availability of scientists and engineers, and the capacity of businesses to absorb technology.

1.25 To these structural problems must be added the challenge inherent in the international context. The slow recovery of economic activity in developed countries has reduced the growth rate of global activity.[9] This has adversely impacted growth in Uruguay and in the region's economies, which experienced a sharp economic slowdown during 2011.[10] As a result of growing uncertainty in international markets, the growth prospects for the world and the regional economies have systematically diminished.[11] These lower growth prospects and heightened uncertainty pose a challenge to the sustainability of current investment levels.

5. Program strategy

1.26 Over the last decade Uruguay has developed a strategy for international positioning in which raising investment levels is one of the key priorities. This is reflected in a series of initiatives (see paragraph 1.19) that this program seeks to consolidate.

1.27 In a country with a small domestic market, a structurally limited productive base, and the predominance of short value chains, the potential to attract investment depends heavily on the outlook for penetrating external markets and on the consistency between policies for attracting investments, sector incentives, and

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[9] According to the 2012 World Economic Outlook, the advanced economies grew by 1.6% in 2011, and 1.3% in 2012, well below the average of 2.7% observed over the five years preceding the crisis. The growth rate of the global economy dropped in 2011 to 3.8% compared to 5.1% in 2010, and preliminary data for 2012 indicate growth of 3.3%.

[10] According to the Center for Economic Research (2011), 43% of the Uruguayan economy's growth can be attributed to growth in Argentina, and a further 35% to growth in Brazil. As a result of slower global activity, the Argentine and Brazilian economies saw their growth rates fall from 9.2% and 7.5%, respectively, in 2010 to 8.9% and 2.7% in 2011. This slowdown persisted in 2012, with the IMF forecasting growth rates of 2.6% and 1.5%, respectively

[11] Between April and October 2012 the IMF cut its 2013 growth projections for the world economy from 4.1% to 3.6%, and those for Latin America and the Caribbean from 4.1% to 3.9%.

export promotion and facilitation. In turn, to maximize the impact of investment the country will have to establish the conditions for promoting the dissemination of knowledge, skills, and innovation as an integral part of broader strategies for productive and industrial development.

1.28 In this context, and with due regard for the problems mentioned above, the program strategy is to act simultaneously on a set of crosscutting factors that affect the country's attractiveness for investment in the broad sense and at the same time, bearing in mind the reduced size of the domestic market, move forward with a series of actions to improve trade facilitation and promotion standards so as to ensure that foreign investors setting up in the country will have maximum access to third markets. This will be complemented with specific actions to improve business capacities for innovation and technology absorption as an effective mechanism for attracting investment and maximizing its impact within the economy.[12]

1.29 The program proposes a series of reforms to support the government's policy of attracting investment by strengthening the general framework and optimizing the specific instruments available to the country for this task. The reforms covered by the program include the signing of BITs with a group of important countries so as to provide legal coverage and predictability to investments. The program also includes the signing of DTTs and treaties for sharing tax information as mechanisms for making the tax treatment of investments more efficient and transparent and thereby strengthening Uruguay's attractiveness as a destination for FDI. This last measure will be supplemented with the adoption of the rules needed for identifying the owners of corporations and for the efficient sharing of tax information with foreign tax authorities. Effective implementation of these last measures should, taken together, allow Uruguay to complete phase II of the OECD Global Forum on Transparency and Exchange of Information for Tax Purposes.[13] These measures will be supplemented with the approval of rules that will allow the country to implement an efficient PPP system so as to optimize the investment promotion regime and generate specific instruments for trade and investment promotion.

1.30 The program will also support the government's efforts to consolidate an "expanded market" by strengthening Uruguay's position as a regional logistics hub. Lastly, as a complement to the measures relating to investment promotion and trade facilitation, the program will seek to strengthen the regulatory and financial

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[12] All the measures described below were assessed in a study conducted during program preparation, evaluating the impact of such measures in various countries that have implemented them (see optional electronic link 4).

[13] In October 2011 the Global Forum on Transparency and Exchange of Information for Tax Purposes published its evaluation of the legal and regulatory framework in Uruguay that was in effect until July 2011. That evaluation was unable to go beyond phase I, primarily because of the following substantive findings: (i) lack of rules to ensure the identification of the holders of bearer shares and of nonresident entities with substantial economic links to Uruguay, and (ii) lack of information sharing agreements with countries considered relevant (Argentina and Brazil).

framework for implementing the National Strategic Plan for Science, Technology, and Innovation (PENCTI), it will support measures to improve synergies between the academic sector, local industry, and FDI, and it will reinforce the regulatory framework for building technological capacities.

1.31 This program of reforms is a central element of a comprehensive dialogue that the Bank has been conducting with Uruguay in the area of investment promotion and trade facilitation, covering technical assistance, financial and nonfinancial support and synergies with other Bank initiatives, such as the Program to Support Global Export Services (loan 2590/OC-UR), Program to Support the Uruguayan Customs Bureau (loan 1894/OC-UR), Technology Development Program II (loan 2004/OC-UR), Program to Support Future Entrepreneurs (loan 2775/OC-UR); Foreign Trade Management Support Program (loan 1971/OC-UR), and the Plan to Promote Public-Private Partnerships (ATN/ME-12386-UR). This has yielded a thorough understanding of the kind of reforms to be included in the program.

6. Country and Bank strategies

1.32 The program is consistent with the IDB country strategy with Uruguay (2010-2015) (document GN-2626), as it seeks to improve the country's international positioning through the attraction of more FDI, including investment in sectors that export high value-added goods. In turn, the country strategy with Uruguay gives priority to infrastructure through support for PPPs, which represent one of the key reforms under this program. Lastly, the program will contribute to achieving the strategic objectives established in the Report on the Ninth General Increase in the Resources of the Inter-American Development Bank (document AB-2764) such as: (i) support development of small and vulnerable countries; and (ii) competitive regional and global integration.

B. Objectives, components, and cost

1.33 The general objective of the program is to help consolidate the international positioning of Uruguay by strengthening the legal and institutional framework for attracting investment, promoting and facilitating trade, and maximizing the local impact of that positioning. The specific objectives are: (i) to boost the ability to attract investment to high value-added sectors; (ii) to improve trade promotion and facilitation standards; and (iii) to develop local capacities for innovation and technology absorption.

1.34 **Component I. Macroeconomic framework.** The objective of this component is to ensure a macroeconomic context consistent with the program's objectives and with the guidelines established in the sector policy letter.

1.35 **Component II. Investment promotion.** The objective of this component is to support the government's efforts to consolidate a set of wide-ranging sector reforms that will strengthen the overall policy framework for attracting investment. The policy reforms supported by this component include: (i) the signing of bilateral treaties for avoiding double taxation and for improving the tax treatment of investment so as to comply with global standards for the international exchange of information; (ii) the signing of bilateral investment promotion and protection agreements as a means to ensure international levels of protection and nondiscrimination for investors from third countries; (iii) issuance of rules and regulations needed to identify the owners of companies and to exchange tax information with foreign tax authorities so as to improve international tax transparency; (iv) amendments to the investment promotion regime designed to attract investment projects that will generate high-quality jobs through changes in the methodology for evaluating the investment projects to be promoted; and (v) creation of a specific legal framework to facilitate the pursuit of large-scale investment projects in infrastructure through PPP arrangements.

1.36 **Component III. Trade promotion and facilitation.** This component will help to consolidate the government's trade promotion and facilitation policy by strengthening the country's capacities for export promotion and trade facilitation. This will be achieved through the following public policy reforms: (i) adoption of a new Customs Code in line with international best practices, with improvements to the penalties regime and the customs brokerage regime, and the harmonization of customs treatment with MERCOSUR rules; (ii) issuance of the regulations needed to extend use of the electronic Single Customs Document, to extend use of the electronic seal, to implement a new system of merchandise inspection for risk management and to expand the use of the electronic filing system in all customs stations; (iii) approval of the legislation needed to create the status of "Authorized Economic Operator"; (iv) approval of specific legislation for institutionalizing trade promotion posts abroad; (v) approval of guidelines to create a post-investment "after care" unit and to establish a Single External Trade Window (Ventanilla Única de Comercio Exterior, VUCE).

1.37 **Component IV. Enhancing innovation capacities.** The objective of this component is to help strengthen local capacities for innovation and technology absorption. In particular, planned measures will stimulate investment by Uruguayan firms in R&D, by creating promotional instruments as well as new institutions for specialized human resource training. To achieve these objectives, the following policy reforms will be implemented: (i) regulatory and financial strengthening for development of the PENCTI, establishing management commitments between the ANII and the Executive Branch for effective implementation and creating new promotional instruments that will more effectively meet the needs of businesses interested in innovating; (ii) creation of two specific funds to promote research and innovation projects to address the needs and opportunities in priority sectors of the PENCTI; and (iii) creation of new specialized training institutions, involving the establishment of the National Technological University and the fulfillment of management commitments between the Executive Branch and the Basic Sciences Development Program (PEDECIBA), for training in the basic sciences at the master's and doctorate level.

1.38 **Economic analysis.** The project team performed an economic analysis of the program's costs and benefits. That analysis focused on estimating the impact that the program would have on average wages in the economy and the labor productivity gains induced by greater investment flows. The analysis was based on an economic growth model calibrated specifically for Uruguay, estimating different scenarios of capital accumulation. The key elements in the calculation included: (i) a calculation horizon of 25 years; (ii) an annual discount rate of 8%; and (iii) an average annual interest rate of 1.1% (see Economic Evaluation).

1.39 According to the analysis, the net present value (NPV) of the benefits under the base scenario is estimated at US$949 million. Nine alternative scenarios were then analyzed to examine the robustness of the estimates and in all the cases studied the NPV of the benefits is positive and varies between US$350 million and US$2.001 billion, from the most pessimistic to the most optimistic scenarios. It should be noted that other economic benefits were not quantified, leaving room to suppose that the results of the evaluation could be even more robust.

C. Key results indicators

1.40 To measure the effectiveness of the reform measures over the medium term a results matrix was prepared, indicating the impacts, outcomes, and outputs expected from the program (see Results Matrix). The impact indicators considered are the growth in the investment rate and the increase in exports. The principal outcome indicators include improvement in the overall business competitiveness indicator, reduced times and costs involved in exporting and importing, and increased investment in R&D.

II. FINANCING STRUCTURE AND MAIN RISKS

A. Financing instruments, amount, and currency

2.1 This operation is structured as a programmatic policy-based loan with a deferred drawdown option. The program follows the guidelines and directives established in the New Lending Framework (document GN-2200-13); Policy-Based Loans: Guidelines for preparation and implementation (document CS-3633); Proposal to Establish a Set of Contingent Lending Instruments of the IDB (document GN-2667-2); and the Proposal for the Establishment of a Reallocation Program (document FN-672-1). This operation represents an amount of up to US$550 million. It is the first of two consecutive operations that will be independently financed but technically interrelated. A subsequent operation is planned for an amount that is yet to be determined but is initially estimated at US$150 million, subject to the country's external financing needs, the availability of Bank resources for Uruguay, the priorities of the Bank's country strategy with Uruguay, and progress under the policy matrix. The policy matrix details indicative commitments for a second operation which, in general terms, entail the consolidation and implementation of the reforms included in this program under each area of activity.

B. Environmental and social safeguards

2.2 The potential environmental impacts of the operation were evaluated in accordance with Directive B.13 of the Bank's environment policy, applicable to policy-based loans. Given its characteristics, the program will not generate any adverse impacts, directly or indirectly.

C. Fiduciary risks

2.3 The operation does not present any risks with regard to its financial execution, as the technical conditions for disbursement will have been substantially fulfilled before submission to the Bank's Board of Executive Directors.

D. Other considerations and risks

2.4 There are three categories of risk associated with the proposed structural changes and the targets for this programmatic operation, and they were evaluated by the project team on the basis of the probability and impact of their occurrence: (i) macroeconomic and fiscal sustainability risks; (ii) public management and governance risks; and (iii) sustainability risks.

2.5 Under the first category, the team identified the macroeconomic instability that might be induced by external factors such as the current slowdown of the major world economies. This risk is mitigated by the government's prudent fiscal policy and its precautionary financing policy (of which this program is an integral part).

2.6 As for the risks identified under the second and third categories, there is the possibility of opposition from certain sectors that consider themselves affected by the reforms, particularly in the area of trade facilitation, as the reforms to be implemented in this area will make the system more efficient and are bound to affect certain links in the logistics chain. The government is paying special attention to publicizing the measures, their timetable, and their impact so that those potentially affected can adapt to the changes. Lastly, there is the latent risk associated with the broad interagency coordination needed for effective implementation of the reforms considered under the program. To address that risk, the program calls for strengthening the work of the CIACEX, which is responsible for coordinating export promotion and investment policies.

2.7 **Policy letter.** The Bank has agreed with the government that the policy letter will: (i) spell out the national government's commitment to the objectives and activities considered under this program; and (ii) stress consistency of the policies to be supported through the program with the country's international positioning strategy.

III. IMPLEMENTATION AND MANAGEMENT PLAN

A. Execution arrangements

3.1 The borrower will be the Government of the Eastern Republic of Uruguay and the executing agency will be the MEF. The executing agency will have the following responsibilities: (i) coordinating the activities of the various institutions responsible for the adoption of measures or the technical implementation of activities; (ii) monitoring the activities called for in this operation; (iii) maintaining official communication with the Bank; (iv) preparing the necessary reports within the established timeframes agreed upon with the Bank; and (v) mitigating risks and resolving problems that may arise during program execution.

B. Arrangements for monitoring results

3.2 Program monitoring will consist of verifying the policy measures agreed as conditions. The MEF will provide the information needed to verify compliance with the progress indicators that will serve as triggers for the subsequent phase of the program. The regulatory and institutional reforms called for in the program will constitute a policy intervention at the national level, and consequently will affect the economy as a whole. In order to evaluate the aggregate impact of that intervention on attracting investment and on the country's international trade, the "synthetic control" method will be used (see for example Abadie et al., 2010). This method involves using a combination of countries unaffected by similar reforms to constitute the control group for comparative purposes. The effects of the reforms are identified by comparing the actual performance of the economy subject to intervention in the areas of interest against the counterfactual given by the performance of the synthetic control group. There will also be a specific evaluation to examine the program's impact on foreign trade using the difference-in-differences method (see Monitoring and Evaluation).

Development Effectiveness Matrix			
Summary			
I. Strategic Alignment			
1. IDB Strategic Development Objectives	**Aligned**		
Lending Program	**The intervention contributes to the lending program for (i) small and vulnerable countries, (ii) poverty reduction and equity enhancement, and (iii) support regional cooperation and integration.**		
Regional Development Goals	**The intervention contributes to (i) Share of formal employment in total employment, (ii) Trade openness (trade as percent of GDP), (iii) Intraregional trade in LAC as percent of total merchandise trade, and (iv) Foreign Direct investment net inflows as percent of GDP.**		
Bank Output Contribution (as defined in Results Framework of IDB-9)	**The intervention contributes to Bank outputs: (i) Individuals (all, men, women, youth) benefited from programs to promote higher labor market productivity, (ii) Number of jobs added to formal sector, (iii) Regional and sub-regional integration agreements and cooperation initiatives supported, and (iv) Number of cross border and transnational projects supported (infrastructure and customs, etc.).**		
2. Country Strategy Development Objectives	**Aligned**		
Country Strategy Results Matrix	**GN-2626**	**The operation contributes to increase services exports, to improve public administration and to increase company investment in R&D.**	
Country Program Results Matrix	**GN-2696**	**The project is included in 2013 Country Program Document.**	
Relevance of this project to country development challenges (If not aligned to country strategy or country program)			
II. Development Outcomes - Evaluability	**Highly Evaluable**	**Weight**	**Maximum Score**
	9.0		**10**
3. Evidence-based Assessment & Solution	**8.4**	**33.33%**	**10**
4. Ex ante Economic Analysis	**10.0**	**33.33%**	**10**
5. Monitoring and Evaluation	**8.6**	**33.33%**	**10**
III. Risks & Mitigation Monitoring Matrix			
Overall risks rate = magnitude of risks*likelihood	**Low**		
Identified risks have been rated for magnitude and likelihood	**Yes**		
Mitigation measures have been identified for major risks	**Yes**		
Mitigation measures have indicators for tracking their implementation	**Yes**		
Environmental & social risk classification	**C**		
IV. IDB´s Role - Additionality			
The project relies on the use of country systems (VPC/PDP criteria)			
The project uses another country system different from the ones above for implementing the program			
The IDB's involvement promotes improvements of the intended beneficiaries and/or public sector entity in the following dimensions:			
Gender Equality			
Labor	**Yes**	**The operation aims to improve the international strategic positioning of Uruguay as a mechanism to endure a process of sustained economic growth. This will result in an improvement in the level and quality of employment, to the extent that the proposed reforms would lead to improved labor productivity (component IV) and quality employment generation (component II).**	
Environment			
Additional (to project preparation) technical assistance was provided to the public sector entity prior to approval to increase the likelihood of success of the project			
The ex-post impact evaluation of the project will produce evidence to close knowledge gaps in the sector that were identified in the project document and/or in the evaluation plan	**Yes**	**The impact evaluation will provide evidence of the impact of "aggregate reforms" on Foreign Direct Investment. Such evidence is new in the literature.**	

The intervention is aligned with three dimensions of the lending program: lending program for small and vulnerable countries, for poverty reduction and equity enhancement, as well as, lending program to support regional cooperation and integration. The intervention contributes to following regional development goals: (i) Share of formal employment in total employment, (ii) Trade openness (trade as percent of GDP), (iii) Intraregional trade in LAC as percent of total merchandise trade, (iv) Foreign Direct investment net inflows as percent of GDP. Moreover, it contributes to the following Bank outputs: (i) Individuals (all, men, women, youth) benefited from programs to promote higher labor market productivity, (ii) Number of jobs added to formal sector, (iii) Regional and sub-regional integration agreements and cooperation initiatives supported, and (iv) Number of cross border and transnational projects supported (infrastructure and customs, etc.). The project is aligned with the country strategy and it is included in the country program document.

The overall program aims to contribute to the consolidation of Uruguay's international positioning by strengthening the policy and institutional framework for attracting investment, promotion and trade facilitation, and maximizing the local impact of such positioning. This operation is structured through a Policy Based Loan with Deferred Drawdown Option.

The results matrix presents the impact, outcome and product indicators related to the objectives and components of the program. Indicators presented in the matrix are SMART. The program includes an economic analysis of the overall program and of each of its components. The project also includes a complete monitoring and evaluation plan. The program evaluation will estimate the effects of aggregate interventions on FDI thus contributing to generate new international evidence on this subject.

The main risks are identified and they include mitigation measures.

POLICY MATRIX

POLICY REFORMS AND OBJECTIVE	OUTPUT OF THE REFORM (PROGRAM I)	COMMITMENTS UNDER PROGRAM I	INDICATIVE COMMITMENTS FOR PROGRAM II
Component I: Macroeconomic Framework			
Stable macroeconomic framework for promoting investment and exports.	Maintain a framework of macroeconomic policies consistent with program objectives.	Maintain a framework of macroeconomic policies consistent with program objectives.	Maintain a framework of macroeconomic policies consistent with program objectives.
Component II: Investment Promotion			
Adapt the investment promotion regime to encourage investments in sectors with high value added.	Adapt the investment promotion regime to encourage projects geared to generating high-quality employment, technological innovation, and the use of clean technologies.	Issue an executive decree amending the investment promotion regime to encourage projects geared to generating high-quality employment, technological innovation, and the use of clean technologies.	
		Issue general regulations for the Investment Law Enforcement Commission (COMAP) specifying scoring criteria for investment projects submitted under the new regime.	
Attract foreign direct investment through the host government's commitment to respect international standards of protection and nondiscrimination vis-à-vis investors from third countries.	Ratification of at least two Bilateral Investment Promotion and Protection Agreements (BIPPAs).	Publication in the Official Gazette of the law ratifying the BIPPA with India.	Entry into force of the agreements with the Republic of India and the Republic of Chile.
		Publication in the Official Gazette of the law ratifying the BIPPA with Chile.	

POLICY REFORMS AND OBJECTIVE	OUTPUT OF THE REFORM (PROGRAM I)	COMMITMENTS UNDER PROGRAM I	INDICATIVE COMMITMENTS FOR PROGRAM II
Pursue the negotiation of double taxation treaties (DTTs) as a mechanism for attracting investment by allowing investors to deduct taxes paid in Uruguay from those owed in their home country, even if the project enjoys tax exemptions in Uruguay under the promotion regime; at the same time, make more transparent the tax system under which the investments are made.	Signature and submission to Parliament of at least four Double Taxation Treaties.[1]	Submission to Parliament of a bill ratifying the Double Taxation Treaty with Argentina.	Entry into force of the treaties with Argentina, Finland, the Republic of Korea, Malta, Portugal, Ecuador, and India.
		Submission to Parliament of a bill ratifying the Double Taxation Treaty with Finland.	
		Submission to Parliament of a bill ratifying the Double Taxation Treaty with the Republic of Korea.	
		Submission to Parliament of a bill ratifying the Double Taxation Treaty with Malta.	
	Ratification of at least three Double Taxation Treaties.[2]	Publication in the Official Gazette of the law ratifying the DTT with Portugal.	
		Publication in the Official Gazette of the law ratifying the DTT with Ecuador.	
		Publication in the Official Gazette of the law ratifying the DTT with India.	
Promote the approval of double taxation treaties to make the tax system more efficient and to improve the overall business climate.	Submission to Parliament of at least five agreements on the exchange of tax information.	Submission to Parliament of a bill ratifying the Agreement for the Exchange of Tax Information with the Federative Republic of Brazil.	Entry into force of the agreements with Brazil, Denmark, Norway, the Faroe Islands, Greenland, Sweden, and Iceland.
		Submission to Parliament of a bill ratifying the Agreement for the Exchange of Tax Information with the Kingdom of Denmark.	
		Submission to Parliament of a bill ratifying the Agreement for the Exchange of Tax Information with the Kingdom of Norway.	

[1] All Double Taxation Treaties contain a clause on the exchange of tax information between signatory countries.

[2] All Double Taxation Treaties contain a clause on the exchange of tax information between signatory countries.

POLICY REFORMS AND OBJECTIVE	OUTPUT OF THE REFORM (PROGRAM I)	COMMITMENTS UNDER PROGRAM I	INDICATIVE COMMITMENTS FOR PROGRAM II
		Submission to Parliament of a bill ratifying the Agreement for the Exchange of Tax Information with the Faroe Islands.	
		Submission to Parliament of a bill ratifying the Agreement for the Exchange of Tax Information with Greenland.	
	Ratification of at least two agreements for the exchange of tax information.	Publication in the Official Gazette of the law ratifying the Agreement on the Exchange of Tax Information with Sweden.	
		Publication in the Official Gazette of the law ratifying the Agreement on the Exchange of Tax Information with Iceland.	
Improve the investment climate by achieving greater international fiscal transparency.	Issue specific regulations for identifying the owners of companies.	Publication in the Official Gazette of the law regulating the identification of holders of bearer shares and requiring them to register with the Central Bank of the Eastern Republic of Uruguay.	
		Issuance of the executive decree regulating the registration of holders of bearer shares and requesting reports from foreign tax authorities.	
		Issuance of the executive decree setting a time limit for registration with the tax administration of all transfers of participations in commercial corporations, except tradable shares.	
	Issue the regulations needed to optimize the exchange of tax information with foreign tax authorities.	Issuance of the executive decree adjusting regulations to practices of the Global Forum on Transparency and Exchange of Information for Tax Purposes.	

POLICY REFORMS AND OBJECTIVE	OUTPUT OF THE REFORM (PROGRAM I)	COMMITMENTS UNDER PROGRAM I	INDICATIVE COMMITMENTS FOR PROGRAM II
Implement a new regulatory framework for promoting investment in the country's physical infrastructure through public-private partnerships.	Establish and regulate a special legal framework governing public-private investments for infrastructure projects.	Issuance of the Executive Decree regulating the law on public-private participation facilitating its implementation and the execution of contracts signed under the regime.	Establish interagency coordination mechanisms between the CND, la PPP unit of the MEF and the Office of Planning and Budget (OPP) to make more efficient the process of evaluating PPP projects.
		Issuance of the Executive Decree regulating private initiative and competitive dialogue with the State on public-private participation projects.	
Component III: Trade Promotion and Facilitation			
Simplify customs processes, procedures and requirements for import, export, and transit of goods.	Approve specific guidelines for implementation of a Single Foreign Trade Window (VUCE) mechanism.	Signature of the act constituting Phase II of the VUCE project by the MEF, the Ministry of Foreign Relations, the National Director of Customs and the Secretary of CIACEX.	VUCE established and operating.
Optimize customs regulations, eliminating regulatory inefficiencies, facilitating intra-zone trade, and fostering greater regional trade integration.	Preparation of a new customs code for Uruguay, adapting it to international best practices, improving the penalties regime, the customs brokerage regime, and harmonizing customs treatment with the new MERCOSUR regulations.	Submission to Parliament of the bill for the new Customs Code of Uruguay.	Implementation of the new customs code following approval of the law.
Modernize customs controls.	Expand use of the electronic DUA.	Issuance of the regulation approving the pilot plan for implementing the digital DUA for transit operations for all customs offices in the country.	Compulsory use of the electronic DUA for all foreign trade operations, wherever feasible.
		Issuance of the regulation extending application of the digital DUA pilot plan for imports, and its operating annex.	
	Approve the operating regulations for customs transit through use of the electronic seal, expanding its scope.	Issuance of the regulation on control of customs transit operations using the electronic seal, expanding its scope to cover transit of containers within the country and extending it to customs brokers, and its operating annex.	Issuance of the general regulation on the electronic seal for transit of goods outside containers.

POLICY REFORMS AND OBJECTIVE	OUTPUT OF THE REFORM (PROGRAM I)	COMMITMENTS UNDER PROGRAM I	INDICATIVE COMMITMENTS FOR PROGRAM II
	Create a new system of risk management verification of goods using data processing techniques and criteria for identifying and assessing risks.	Inclusion of the risk management system in the draft Customs Code, specifying that it must use data processing techniques and be based on criteria for identifying and assessing risks.	Effective implementation of the risk management system.
	Expand use of the electronic filing system in all customs offices in the country.	Issuance of the general regulation requiring that all records processed by customs brokers be initiated through the electronic filing system.	
Streamline customs inspection of goods at the border, in line with international best practices.	Create the status of "Authorized Economic Operator" (OEA).	Include the status of Authorized Economic Operator in the draft Customs Code.	Entry into force of the regulations governing the status of OEA, its functioning, its relationship with customs, and the requirements for certification, recertification, and service.
Generate new and more effective instruments for promoting exports and investments abroad.	Create trade promotion offices abroad, under coordination by Uruguay XXI.	Minutes of the CIACEX ministerial meeting indicating priority for trade promotion offices abroad.	Issuance of the executive decree authorizing trade promotion offices abroad.
Generate specific mechanisms for promoting reinvestment by firms already located in the country.	Create an investment after-care unit in Uruguay XXI.	Minutes of the CIACEX ministerial meeting agreeing to creation of the investment after-care unit in Uruguay XXI.	Issuance of the decision of the Board of Directors of Uruguay XXI creating an investment after-care unit.
Component IV: Enhancing Innovation Capacities			
Boost the impact of FDI on national development.	Regulatory and financial strengthening for implementing the PENCTI.	Memorandum of understanding between the executive branch and ANII, establishing: (a) management targets; (b) resources for implementing the PENCTI; (c) monitoring and evaluation mechanisms.	Continuity of government efforts to stimulate innovation and research in the country.
		ANII approval of the general conditions for creation of the "Fondo Orestes Fiandra" for financing established medium-sized and larger firms with an innovative profile.	

POLICY REFORMS AND OBJECTIVE	OUTPUT OF THE REFORM (PROGRAM I)	COMMITMENTS UNDER PROGRAM I	INDICATIVE COMMITMENTS FOR PROGRAM II
		Preparation of the general conditions for a program of subsidies for the filing of patents by small and medium-sized enterprises in the biotechnology, pharmaceuticals, electrical and electronic, ICT and machine tool sectors.	
Promote synergy between the academic sector, local industry, and FDI.	Develop specific instruments to promote business innovation through academia-business links	ANII approval of at least two sector funds for technological innovation, for business-academia consortia, geared to priority sectors of the PENCTI.	Greater collaboration between public and private stakeholders in the innovation process.
Strengthen the regulatory framework for the generation of technological capacities.	Establish the legal framework needed to expand the training of specialized human resources.	Ratification of the law creating the Universidad Tecnológica del Uruguay.	Startup of at least four technology programs and research and development activities.
		Memorandum of understanding between the Ministry of Education and Culture and PEDECIBA to provide more advanced training.	
		ANII approval of the general conditions for subsidizing technical assistance from foreign experts for local firms.	