

**Document of
The World Bank**

FOR OFFICIAL USE ONLY

Report No 92892-PA

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROGRAM DOCUMENT FOR A PROPOSED LOAN

IN THE AMOUNT OF US\$300 MILLION TO

THE REPUBLIC OF PANAMA

FOR A

FIRST PROGRAMMATIC SHARED PROSPERITY DEVELOPMENT POLICY LOAN

March 5, 2015

Macroeconomic and Fiscal Management Global Practice
Central America Country Management Unit
Latin America and the Caribbean Region

This document is being made publicly available prior to Board consideration. This does not imply a presumed outcome. This document may be updated following Board consideration and the updated document will be made publicly available in accordance with the Bank's policy on Access to Information.

PANAMA GOVERNMENT FISCAL YEAR

January 1 – December 31

CURRENCY EQUIVALENTS

(Exchange Rate Effective as of March 5, 2015)

Currency Unit=Balboas (B/.)

1.00 B/=US\$1.00

ABBREVIATIONS AND ACRONYMS

ACP	Panama Canal Authority (<i>Autoridad del Canal de Panamá</i>)
ASEP	National Authority of Public Services (<i>Autoridad Nacional de Servicios Públicos</i>)
CPF	Country Partnership Framework
DICRE	<i>Dirección de Inversiones, Concesiones y Riesgos del Estado.</i>
DPL	Development Policy Loan
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GRS	Grievance Redress Service
IBRD	International Bank for Reconstruction and Development
IDB	Inter-American Development Bank
IDAAN	National Water Supply and Sanitation Administration (<i>Instituto de Acueductos y Alcantarillados Nacionales</i>)
IFC	International Finance Corporation
IMF	International Monetary Fund
ISTMO	Technological Solutions of the Operational Management Model (<i>Soluciones Tecnológicas del Modelo de Gestión Operativa</i>)
MEF	Ministry of Economy and Finance
MIDES	Ministry of Social Development (<i>Ministerio de Desarrollo Social</i>)
MINSA	Ministry of Health (<i>Ministerio de Salud</i>)
PFM	Public Financial Management
SAP	Systems, Applications and Products in Data Processing
SIASAR	Rural Water and Sanitation Information System (<i>Sistema de Información de Agua y Saneamiento Rural</i>)
UTM	Unit of Transformation and Modernization (<i>Unidad de Transformación y Modernización</i>)
WSS	Water and Sanitation Services

Vice President:	Jorge Familiar
Country Director:	J. Humberto Lopez
Senior Practice Director:	Marcelo Giugale
Practice Manager:	Antonio Nucifora (Acting)
Task Team Leader:	Friederike (Fritzi) Koehler-Geib, and Rong Qian

REPUBLIC OF PANAMA

FIRST PROGRAMMATIC SHARED PROSPERITY DEVELOPMENT POLICY LOAN

TABLE OF CONTENTS

1. INTRODUCTION AND COUNTRY CONTEXT.....	1
2. MACROECONOMIC POLICY FRAMEWORK.....	3
RECENT ECONOMIC DEVELOPMENTS	3
MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY	7
3. THE GOVERNMENT’S PROGRAM.....	10
4. THE PROPOSED OPERATION	10
LINK TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION	10
PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS	11
LINK TO CPF, OTHER BANK OPERATIONS AND THE WBG STRATEGY	24
CONSULTATIONS, COLLABORATION WITH DEVELOPMENT PARTNERS	24
5. OTHER DESIGN AND APPRAISAL ISSUES	25
POVERTY AND SOCIAL IMPACT	25
ENVIRONMENTAL ASPECTS.....	26
PUBLIC FINANCIAL MANAGEMENT, DISBURSEMENT AND AUDITING ASPECTS.....	26
MONITORING AND EVALUATION	27
6. SUMMARY OF RISKS AND MITIGATION	28

ANNEXES

ANNEX 1: POLICY AND RESULTS MATRIX.....	30
ANNEX 2: LETTER OF DEVELOPMENT POLICY	34
ANNEX 3: FUND RELATIONS ANNEX	38

The Development Policy Loan was prepared by an IBRD team consisting of Friederike (Fritzi) Koehler-Geib and Rong Qian (Task Team Leaders), Adriana Cardozo, Anne Brockmeyer, Carmen Rosa Yee-Batista, Charles Delfieux, Concepcion Aisa Otin, Diana Mercedes Lachy, Dianna Pizarro, Edmundo Murrugarra, Eduardo Andres Estrada, Ekaterina Grigoryeva, Francisco Lazzaro, Jennifer Keller, Kinnon Scott, Fernando Javier Anaya, Kimberly Vilar, Luis Felipe Duchicela, Lourdes Consuelo Linares, Maria Virginia Hormazabal, Mark Lambrides, Meilyn Gem, Miguel Angel Saldarriaga, Miguel Vargas-Ramirez, Rocio Malpica, Rodrigo Silveira Cabral, Silvia Gulino, and Svetlana Proskurovska. Peer reviewers are Abha Prasad, Antonio Leonardo Blasco, Gallina Vincelette, and Samuel Freije-Rodriguez. The team gratefully acknowledges the support and guidance provided by J. Humberto Lopez, Antonio Nucifora, Auguste Tano Kouame, Maryanne Sharp, Anabela Abreu, Oscar Calvo-Gonzalez and Fernando Blanco. In addition, the team is thankful for helpful comments and support from Alma Kanani, Cecile Valadier, Desiree Gonzalez, Fang Yang (IMF), Jovana Stojanovic, Luca Ricci (IMF), Maryanne Sharp, and Wei Shi (IMF). Finally, the Bank team would like to express its gratitude for the collaboration of the Government of Panama in the preparation of this Development Policy Loan.

SUMMARY OF PROPOSED LOAN AND PROGRAM
REPUBLIC OF PANAMA

FIRST PROGRAMMATIC SHARED PROSPERITY DEVELOPMENT POLICY LOAN

Borrower	Republic of Panama
Impl. Agency	Ministry of Economy and Finance
Financing Data	<i>IBRD Loan.</i> <i>Terms:</i> Commitment-linked variable spread loan, denominated in US dollar, with level repayments of principal payable in 19 years (including 0.5 year of grace period). The Borrower wishes to maintain all conversion options embedded in the loan. The front end fee is 0.25 percent of the total loan amount, financed from Borrower's own resources. <i>Amount:</i> US\$300 million.
Operation Type	Single tranche DPL (first in a planned series of three programmatic DPLs)
Pillars & Objectives of the Operation	The Program Development Objective of the DPL series is to support the Government of Panama's efforts to (i) expand inclusion and opportunities, (ii) improve service delivery, and (iii) modernize fiscal management.
Result Indicators	<p>(i) Expanding inclusion and opportunities</p> <ul style="list-style-type: none"> • Number of projects prepared in line with the National Development Plan for Indigenous Peoples. (Baseline 2014: 0; target 2017:3) • Culturally differentiated programs in health and education are available for beneficiaries of <i>Red de Oportunidades</i>. (Baseline 2014: standard programs; target 2017: differentiated programs) • Semiannual monitoring and evaluation reports are produced on the performance of <i>Beca Universal</i>. (Baseline 2014: 0; target 2017: 2) • 20 percent of students of technical secondary education have graduated from <i>ProJoven</i>. (Baseline 2014:0; target 2017: 20) • Percent of elderly aged 65 or older without other pension receive benefits from the <i>120 a los 65</i> program. (Baseline 2014: 27 percent; target 2017: 42) • The Government provides <i>Red de Oportunidades</i> transfers through the banking system. (Baseline 2014: 0; target 2017: 60 percent of funds) <p>(ii) Improving service delivery</p> <ul style="list-style-type: none"> • The basic sanitation plan has at least 30,000 households as beneficiaries. (Baseline 2014: 0, target 2017: 30,000) • 50 percent rural water boards are connected to SIASAR. (Baseline 2014: 400, target 2017: 5000) • Average hours of electricity outages/year are reduced. (Baseline 2014: 53; target 2017: 36.7, annual average) <p>(iii) Modernizing fiscal management</p> <ul style="list-style-type: none"> • Share of central government and decentralized entities funds channeled through a Single Treasury Account is increased. (Baseline 2014: 0; target 2017: 100% for Central Government funds and 85% for decentralized Government entities.) • Financial statements for budget execution are automatically generated. (Baseline 2014: no; target 2017: automatic generation) • Availability of contingent financing instruments is increased. (Baseline 2014: 5 instruments and mechanisms; target 2017: 2 additional instruments)
Overall risk rating	Moderate
Operation ID	P151804

IBRD PROGRAM DOCUMENT FOR A PROPOSED LOAN TO THE REPUBLIC OF PANAMA

1. INTRODUCTION AND COUNTRY CONTEXT

1. **Expanding inclusion, improving service delivery, and modernizing fiscal management are critical for further reducing extreme poverty and sharing prosperity in Panama.** This program document proposes a Development Policy Loan (DPL) in the amount of US\$300 million for the Republic of Panama, the first in a series of three Programmatic Shared Prosperity DPLs. Panama's new Government took office in July 2014 and has swiftly begun implementing a reform plan with a focus on human development, sustainable economic growth, and institutional strengthening. The reforms supported by this DPL series are an integral part of the Government's plan for the next five years and address key development challenges in Panama.

2. **Exceptional growth contributed to significant progress on poverty reduction and shared prosperity in recent years.**¹ Panama's real growth averaged 7.2 percent between 2001 and 2013, more than double Latin America and the Caribbean's average, resulting in important achievements in poverty reduction. Between 2007 and 2012, poverty fell from 39.9 percent to 26.2 percent, and extreme poverty declined from 15.6 percent to 11.3 percent. During the same period, income growth of households in the bottom 40 percent of the population increased 8.2 percent. This compares to the average per capita income growth of 6.6 percent. This makes Panama one of the top five performers in the region in terms of increasing shared prosperity.

3. **Despite this remarkable progress, Panama still has an important work to do to build an inclusive society.** The most immediate challenges include: (i) prosperity that has not reached everyone, in particular, the indigenous and the youth; and (ii) the limited coverage and quality of basic services, notably in electricity as well as in water and sanitation.

4. **With respect to the first challenge, poverty and extreme poverty remain high in some rural areas, particularly in the indigenous areas (*comarcas*), and prosperity has not reached them.** Extreme poverty in rural areas averages about 27 percent compared to less than 4 percent in urban areas.² Among rural non-indigenous areas, the poverty rate varies from 22 percent in the *Colon* region to 58 percent in *Bocas del Toro* in 2012. In contrast, in the indigenous areas, poverty reaches as high as 83 percent in *Gnobe Buglé comarca* (Annex 4). Moreover, people in *comarcas* did not benefit from the strong growth as much as in other regions: among the bottom 40 percent, for those who lived in the three main *comarcas*, income growth was only 2.4 percent between 2007 and 2012, significantly lower than the national level of 8.2 percent.

5. **While Panama has been a top performer in creating jobs in recent years, youth and social protection beneficiaries face particular labor market difficulties.** The youth unemployment rate of 8.1 percent in 2012 is close to three times the national average at 3.1 percent. Moreover, Panama's youth are unable to access higher quality employment. In part, higher

¹ Unless otherwise stated, the analysis uses national definitions of poverty and shared prosperity (both poverty lines and the income aggregate). The value of the national poverty line was US\$7.9/day urban and US\$5.8/day rural.

² Using a US\$4 a day poverty line, moderate poverty in Panama declined from 33.5 percent in 2007 to 20.9 percent in 2012 compared to the rate in the Latin America region, which declined from 32.2 percent to 25 percent.

unemployment and lower quality jobs for youth reflect a lack of necessary skills for the labor market. Youth unemployment has not only short term consequences but also affects long term decisions on human capital investment and future earnings of those that are unemployed.³ Key causes are high drop-out rates from secondary education (over 40 percent in 2011) and poor educational quality (stemming in part from outdated curricula).⁴ In addition, beneficiaries of social protection programs, such as *Red de Oportunidades*, are not able to graduate from the program and tend to remain dependent on transfers because they are unable to find employment.⁵

6. **The sustainable delivery of basic services, notably in electricity as well as in water and sanitation is the second challenge in Panama's inclusion agenda.** Partly due to an inefficient institutional set-up, access to potable water and sanitation services remains low in rural areas, particularly in the *comarcas*. While 92.9 percent of Panamanians overall have access to potable water and 65 percent to sanitation services, in rural areas, coverage drops to 78.1 percent and 85.2 percent, respectively. Among rural indigenous populations, coverage plummets to 60 percent and 20 percent, respectively. Similarly, the energy sector has lagged behind rapidly growing demand resulting from fast economic growth. A distortive subsidy scheme has exacerbated the weaknesses and led to underinvestment in power generation, transmission and distribution. As a result, power outages occurred in the beginning of 2014 and required the use of less efficient, costly emergency power stations. This not only jeopardizes the sustainability of energy provision, but, together with the energy subsidies, also leads to high fiscal costs.

7. **The new Government has moved ahead with its reform plan to address these key development challenges.** In terms of inclusion, it has made indigenous development a priority by creating a Ministry of Indigenous Affairs and developing culturally appropriate social protection programs. Moreover, the Government has taken on policies to tackle high drop-out rates from secondary education and low educational quality issues. For instance, the Government has introduced a vocational training program, *ProJoven*, has reformed the education system to foster bilingual education, and has updated the curricula of high school baccalaureates. In terms of service delivery, the Government has launched an ambitious basic sanitation program with the goal to provide potable water to 100 percent of Panamanians and leaving zero latrines. The Government is addressing the institutional weaknesses in the energy sector and tackling the electricity subsidy scheme by adjusting tariffs to lower the fiscal cost.

8. **To support this reform agenda, it is critical to step up fiscal management to ensure an efficient allocation of public resources.** While in general Panama has sound fiscal policies, it lags in terms of the efficiency of fiscal management. For instance, weak fiscal risk management can create fiscal pressures in the event of a natural disaster, which may limit Government's ability to finance planned inclusion and public service expansion programs. These issues are particularly relevant in the case of Panama where fiscal management is important for stability, given that the economy is fully dollarized. The Government is aware of this importance, and fiscal policy is ruled by the Social and Fiscal Responsibility Law. Freeing up resources through improvements in efficiency of fiscal management is critical for greater inclusion and better service delivery. To this

³ Mroz and Savage (2006)

⁴ World Bank (2014) Social Sector Expenditure and Institutional Review.

⁵ A social protection program that provides conditional cash transfers to poor and extreme poor families with co-responsibilities in health and education.

end, the Government is consolidating all accounts of public entities into a single treasury account, and is modernizing the fiscal management of disasters.

9. **The proposed DPL series supports the Government in the reform plan focusing on the areas of inclusion and opportunities, service delivery, and fiscal management.** The inclusion and opportunity pillar of the DPL series supports the Government in (a) tackling extreme poverty by prioritizing culturally appropriate development in indigenous areas; (b) creating opportunities for youth and increasing incentives for secondary school graduation; and (c) expanding the coverage and improving the targeting and quality of social protection programs for the poor. The second pillar supports service delivery in the energy and water and sanitation sectors. These pillars are being pursued in a fiscally sustainable manner. To further ensure fiscal space for such spending, the Government's reforms include a fiscal management component. Thus the third pillar of the DPL supports the modernization of fiscal management through (a) strengthening the financial planning of Government resources; and (b) increasing Government's ability to manage fiscal risks from disasters.

2. MACROECONOMIC POLICY FRAMEWORK

RECENT ECONOMIC DEVELOPMENTS

10. **Over the past decade, Panama has been one of the fastest growing economies worldwide.** With an average annual growth rate of 7.2 percent between 2001 and 2013, Panama has outpaced other Latin American countries and grown significantly faster than most emerging economies. Not only has growth been high, but it has also been accompanied by notable poverty reduction. Furthermore, Panama has been a top performer in terms of creating jobs. The employed labor force in Panama increased from 1.0 million in 2001 to 1.6 million in 2013, representing a 66 percent increase and exceeding Latin America (38 percent) and Central America (44 percent). Panama's exceptional growth performance over the past decade stems from an open, competitive and diversified economy. The country's continuous improvements in infrastructure, resulting in one of the best port and airport networks worldwide, has allowed Panama to consolidate its position as the most competitive economy in Central America and second after Chile in Latin America and the Caribbean, according to the 2014-15 Global Competitiveness Report.

11. **Panama has recovered from the 2008 global financial crisis faster than other countries in the region.** While most countries have not yet been able to return to their pre-crisis growth rates, Panama grew faster after the global crisis than before (9.4 percent on average over 2010-2013, compared to 7.0 percent on average between 2002-2007). Even though the growth rate is estimated to moderate to around 6.2 percent in 2014, this remains one of the highest rates of growth that will be achieved this year. The key drivers of this growth are strong public investment, a parallel increase in Foreign Direct Investment (FDI) and private investment in general, and the continued importance of the Panama Canal and its expansion, which has fed back into other sectors, including transport and logistics as well as the financial sector.

12. **The increased contribution of public investment to growth has been backed by an ambitious public investment program and the Panama Canal expansion.** Public investment increased from 3.1 percent of the Gross Domestic Product (GDP) in 2001 to 9.5 percent in 2013.

In 2010, the Government launched a public infrastructure program comprising more than 100 projects, such as highway upgrades, roads enlargement and upgrade in Panama City, airport infrastructure upgrades in six airports (including *Tocumen* Airport), the Panama Canal expansion, Metro Line 1 in Panama City and a metro bus system, among others. The total investment of the program is estimated at US\$16.7 billion and the execution rate is above 80 percent. The Panama Canal expansion amounts to US\$5.2 billion and is expected to be finalized by the end of 2015.

13. **The strong growth performance has been moderating since 2013, but remains at high levels.** While public investment still contributed significantly in 2013, growth decelerated to 8.4 percent (compared to 10.9 in 2011 and 10.8 in 2012), mainly due to a decline in trade through the Colon Free Zone and reduced Canal traffic. The Colon Free Zone was impacted by controls on foreign exchange payments in Venezuela, and import tariffs imposed by Colombia on textile and shoes. Canal traffic was affected by the decision of a major shipping company to temporarily reroute their vessels away from the Panama Canal, resulting in a decline in cargo volume and Canal fees. The expectation is that business will return to the Panama Canal once the new locks are operational and larger vessels can pass. As of October 2014, economic activity grew by 5.1 percent, compared to 8.1 percent in the same period of the previous year. The deceleration is mainly explained by a slowdown in construction and to a lesser extent decelerations in mining, manufacturing, and contractions in agriculture and the hotel and restaurant sector. The construction sector only grew 16.9 percent in the first nine months of 2014 falling from 34.4 percent in the same period of a year earlier following completion of some large public investment projects.

14. **Panama's current account deficits have been widening in the recent past.** The current account deficit has grown in the last few years, reflecting continuing high imports stemming from public and private investment along with recent export declines. In the last decade, the increase in investment has led to an expansion of imports, mostly of investment goods and raw materials. At the same time, Panama's exports have declined, particularly within the Colon Free Zone. Contributors to that decline were the foreign exchange constraints and the protectionist measures by Venezuela and Colombia, two key export markets. Foreign exchange constraints, for example, resulted in Venezuelan importers owing Panamanian suppliers more than a US\$1 billion. In all, the deterioration of the trade balance has contributed to a worsening of the current account deficit from 10.2 percent of GDP in 2012 to 11.3 percent in 2013.

15. **FDI remains the largest source of external finance to the current account deficit.** Buoyant FDI inflows have financed on average 80 percent of the current account deficit in the last three years. Panama has been successful in attracting FDI inflows from economies all over the world. To date, FDI inflows in Panama are concentrated in the service sectors including construction, the Canal and the Colon Free Zone, and financial services.

16. **As a fully dollarized economy, Panama's monetary policy is driven by United States Federal Reserve decisions.** Interest rates and the money supply respond mainly to developments in the banking system. Inflation has decreased as food inflation eased and oil prices softened in 2014, decelerating from 3.7 percent in 2013 to 2.5 percent in 2014, remaining below the 2009-2012 average of 4.4 percent. By the end of 2014, the food component of inflation (representing 32.3 percent of the consumer price basket) contributed 1.9 percent to headline inflation, led by higher prices for meat, bread and grains, and milk, while prices for fruits, vegetables and sugar

decelerated. Relatively high food price inflation was mitigated by low inflation rates in transportation, housing services, and diverse goods.

Table 1: Panama—Key Economic Indicators 2010-2018

	2010	2011	2012	2013	Estim.		Projected		
					2014	2015	2016	2017	2018
Real GDP	7.5	10.9	10.8	8.4	6.2	6.2	6.4	6.5	6.5
CPI Inflation (eop)	4.9	6.3	4.6	3.7	2.4	2.5	2.7	2.9	2.9
Savings and investment									
Gross national savings	13.3	10.6	17.0	17.2	18.0	17.5	18.8	18.5	18.1
Gross fixed investment	23.9	25.6	27.1	28.5	28.2	27.7	27.4	26.9	26.1
Fiscal accounts									
Central government									
Total revenues (including grants)	17.3	16.7	17.1	16.2	14.6	14.1	14.3	14.6	14.8
Current revenue	16.8	16.6	17.1	15.9	14.5	14.1	14.3	14.6	14.8
Tax revenues	10.7	10.7	11.7	11.4	10.2	10.5	10.5	10.5	10.4
Nontax revenues	6.1	6.0	5.4	4.6	4.4	3.6	3.7	4.2	4.4
<i>o/w Panama Canal fees and dividends</i>	2.8	3.1	2.7	2.3	2.2	2.1	3.1	3.7	4.7
Capital revenue	0.5	0.0	0.0	0.3	0.1	0.0	0.0	0.0	0.0
Total expenditure	19.7	20.1	19.8	20.4	18.8	18.3	17.8	16.8	16.4
Capital expenditure	6.9	7.6	7.8	9.1	7.1	6.3	6.1	5.3	4.8
Primary Balance	0.1	-1.1	-0.8	-2.3	-2.4	-2.1	-1.3	0.0	0.6
Overall Balance	-2.4	-3.3	-2.7	-4.2	-4.2	-4.2	-3.5	-2.2	-1.5
Nonfinancial Public sector									
Overall Balance (excluding ACP)	-1.7	-2.0	-1.4	-2.8	-3.6	-1.9	-1.2	-1.0	-0.5
Overall Balance (including ACP)	-3.3	-4.1	-3.1	-4.7	-4.9	-3.6	-3.0	-2.1	-0.9
External sector									
Current Account Balance	-10.7	-15.0	-10.0	-11.3	-10.2	-10.2	-8.6	-8.4	-8.0
Trade Balance (of goods)	-17.5	-22.5	-18.7	-19.1	-18.6	-18.1	-17.5	-17.0	-16.5
Net exports from Colón Free Zone	1.7	0.8	1.4	3.2	2.0	1.6	1.5	1.5	1.5
Services Balance	12.3	11.8	13.6	11.8	12.3	12.3	13.3	13.4	13.3
Net factor income	-8.8	-5.9	-6.8	-7.3	-5.9	-6.0	-5.8	-6.1	-5.7
Net current transfers	0.5	0.6	0.2	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Foreign direct investment	8.4	8.8	8.3	10.3	8.6	8.4	8.2	7.9	7.0
Total Public Debt*	41.4	41.2	40.3	39.0	39.1	38.6	36.4	34.0	31.3
GDP (in millions of current US\$)	28,814.10	33,270.50	37,956	42,648.1	47,459	52,565	57,941	63,867	70,399

Source: Ministry of Economy and Finance Update as of January 12, 2015, National Institute of Statistics and Census (INEC), International Monetary Fund (IMF) and World Bank staff calculations.

Note: Nominal GDP numbers correspond to a base year of 2007 and are based on latest Government projections. Panama Canal Authority (ACP) = Panama Canal Authority.

* Total Debt of Non-Financial Public Sector including ACP and net of non-governmental assets formerly helped by the Fiduciary Fund.

17. Panama's fiscal position worsened in 2013-2014 period as a consequence of lower revenues as a percentage of GDP vis-à-vis previous years. The fiscal deficit of the nonfinancial public sector, excluding the Panama Canal Authority, closed at 2.8 percent of GDP in 2013, below the legally mandated deficit ceiling of 3.1 percent under the Social and Fiscal Responsibility Law but above the previous three years average of 1.7 percent of GDP. The fiscal deficit of the nonfinancial public sector widened since 2013 driven by both declining total revenue and increasing capital expenditure. For instance, the contribution from the Panama Canal Authority

declined to 2.3 percent of GDP in 2013 from 2.7 percent in 2012 as a result of a temporary slowdown in transit. In 2014, the deficit further widened to 3.6 percent of GDP and the Government had to request a further increase of the deficit ceiling to 4.1 percent of GDP.⁶ The widening of the fiscal deficit in 2014 was driven by the electoral cycle and additional spending on road infrastructure, metro rail subsidies, energy subsidies due to blackouts and energy bills approved by the previous administration before leaving office. Moreover, the overestimation of tax revenues during the budgeting process further exacerbated the slippage.

18. **Panama's tax revenues are low.** Despite the recent tax reform program implemented in 2009 and 2010, tax revenue is still low in Panama. It averaged 11.2 percent of GDP in the last three years, below the average of 13.4 percent in Central America and the world average of 17.3 percent.⁷ Revenues from the Canal are a significant non-tax revenue source for the Central Government representing over 10 percent of total revenues. While dividends and fees from the Canal and other non-tax revenues added another 4.6 percentage points of GDP in 2013 to Central Government's revenues, they remain low by international standards. Higher tax revenue would allow for higher social spending to further reduce poverty and increase shared prosperity.

19. **The banking sector remains sound and healthy.** According to the latest International Monetary Fund (IMF) Article IV Consultation, most local banks have a traditional business model with limited wholesale funding, and are well capitalized, profitable and liquid. In the recent past, overall credit to the private sector has grown in line with nominal GDP. The loan portfolio is balanced, with loans to the real estate and commerce sectors each accounting for about 25 percent of total credit. The banking sector is relatively sound, with all financial institutions exceeding the minimum capital adequacy ratio. Bank deposits remain stable and non-performing loans declined from 1.9 percent in 2010 to 1.4 percent in 2013, as a result of payments and loan growth. Provisions to non-performing loans have increased from 120 percent in 2009 to 171.5 percent in 2013. In addition, authorities are applying risk-based supervision to most banks, and the Superintendence of Banks is working to enhance the countercyclical capacity of the system. Moreover, there are recent efforts to enhance financial and corporate transparency and monitor systemic risks. Yet Panama neither has a lender of last resort facility, nor a deposit insurance scheme, resulting in the need for greater liquidity and more conservative lending practices by the banks and a strict, ready-and-able-to-act-swiftly, supervisory role of the Authorities.

20. **The fiscal deficit led to a marginal increase in the debt to GDP ratio of 0.1 percentage points in 2014 reaching 39.1 percent, halting its previous downward trajectory.** The ratio of public debt to GDP (including external debt contracted for the Panama Canal expansion) fell from about 66 percent in 2005 to 39 percent in 2013. To encourage the development of domestic capital market, the authorities also increased local debt issuance. Its efforts have been rewarded by all credit rating agencies. Panama achieved investment grade in 2010 and the rating further improved in 2012. In April 2013, all three agencies confirmed Panama's BBB rating, one notch above investment grade, on par with Brazil, one notch below Peru and Mexico.

⁶ The 4.1 percent revised ceiling was estimated using the 1996 National Account base year.

⁷ The tax to GDP ratio in Panama decreased due to the update of the GDP base year to 2007.

Table 2: Panama—Summary Fiscal Accounts of the Central Government
(In percent of GDP)

	2010	2011	2012	2013	Estim.	Projected			
					2014	2015	2016	2017	2018
Overall balance	-2.4	-3.3	-2.7	-4.2	-4.2	-4.2	-3.5	-2.2	-1.5
Primary balance	0.1	-1.1	-0.8	-2.3	-2.4	-2.1	-1.3	0.0	0.6
Revenues and grants	17.3	16.7	17.1	16.2	14.6	14.1	14.1	14.6	14.8
Current revenue	16.8	16.6	17.1	15.9	14.5	14.1	14.1	14.6	14.8
Taxes	10.7	10.7	11.7	11.4	10.2	10.5	10.5	10.5	10.4
Direct taxes	5.5	4.9	6.1	6.1	5.2	5.5	5.6	5.6	5.6
Income tax	4.8	4.4	5.5	5.5	4.6	4.9	5.1	5.1	5.1
Of which: Capital gains	0.3	0.3	0.3	0.7	0.3	0.3	0.3	0.3	0.3
Tax on wealth	0.6	0.6	0.6	0.7	0.6	0.6	0.6	0.5	0.5
Indirect taxes	5.3	5.7	5.6	5.2	5.0	4.9	4.9	4.9	4.8
Import tax	1.4	1.2	1.1	0.9	0.8	0.8	0.8	0.7	0.7
ITBMS	2.7	3.1	3.1	3.0	2.8	2.8	2.7	2.7	2.7
Petroleum products	0.3	0.3	0.3	0.3	0.3	0.2	0.2	0.2	0.2
Other tax on domestic transactions	0.9	1.1	1.1	1.0	1.1	1.2	1.2	1.2	1.2
Nontax revenue	6.1	6.0	5.4	4.6	4.4	3.6	3.5	4.2	4.4
Dividends	2.5	2.8	2.4	2.1	1.8	1.7	1.6	1.9	2.0
Of which: Panama Canal Authority	1.6	2.0	1.7	1.4	1.4	1.3	2.0	2.4	2.5
Panama Canal Authority: fees per ton 1/	1.2	1.1	1.0	0.9	0.8	0.8	1.1	1.3	1.5
Transfers from decentralized agencies	1.3	0.9	0.6	0.6	0.5	0.5	0.5	0.4	0.4
Other	1.1	1.2	1.4	1.0	1.2	0.7	0.3	0.5	0.5
Capital revenue	0.5	0.0	0.0	0.3	0.1	0.0	0.0	0.0	0.0
Grants	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total Expenditure	19.7	20.1	19.8	20.4	18.8	18.3	17.6	16.8	16.4
Current expenditure	12.8	12.5	12.0	11.3	11.7	12.0	11.6	11.5	11.5
Of which:									
Goods and services	1.1	1.2	1.4	1.2	1.3	1.3	1.2	1.2	1.2
Personal services	4.4	4.2	4.2	4.1	4.2	4.3	4.2	4.1	4.1
Transfers	4.4	4.5	4.2	3.6	4.0	4.0	3.8	3.9	3.8
Capital expenditure	6.9	7.6	7.8	9.1	7.1	6.3	5.9	5.3	4.8

Source: Ministry of Economy and Finance Update as of January 12, 2015 and World Bank staff calculations.

MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

21. **Panama's economic growth is expected to slow and converge to its long term potential during the period from 2014 to 2018.** Annual real GDP growth is expected to moderate to an average of 6.4 percent a year during this period as the broad public investment program comes to an envisaged end. Particularly high public investment and the Canal expansion contributed to the exceptional growth rates in the period from 2011 to 2013. In addition, difficulties in the Colon Free Zone continue diminishing trade contribution, and construction decelerates. Yet growth is projected to remain healthy, driven mainly by private investment. In addition, a new public investment program of US\$3 billion is expected to be implemented under the current administration. Unemployment is expected to remain at 3.5 percent, as job creation is supported by the growing economy. Inflation is projected to ease and remain below 3.0 percent for the next three years due to low oil prices throughout 2015 and food prices. The current account deficit is projected to fall from 11.3 percent in 2013 to an average of 9.1 percent during 2014 to 2018,

reflecting an improved services balance supported by Canal services and tourism.

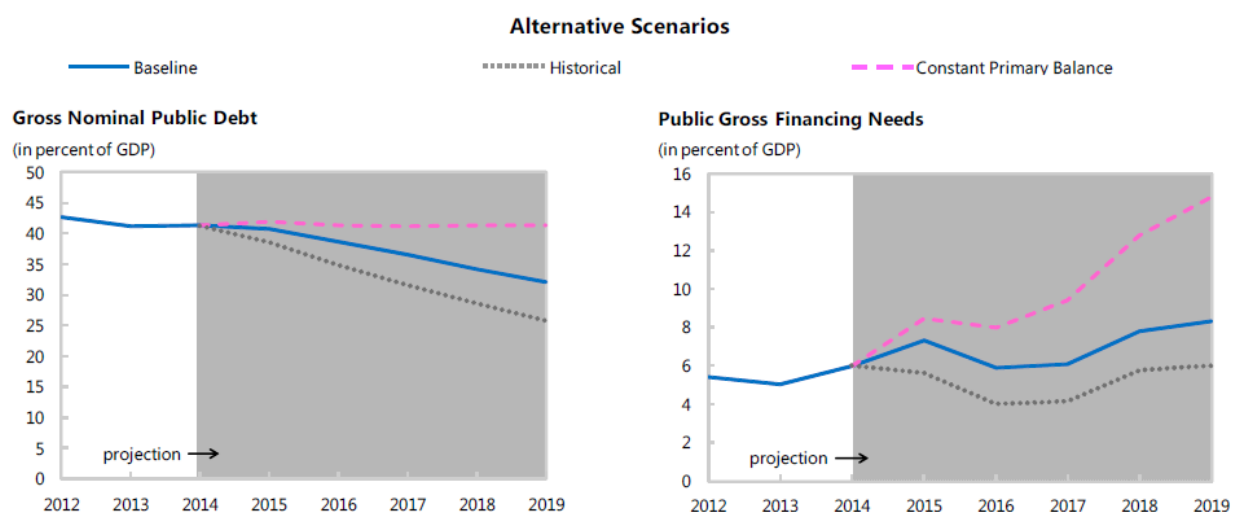
22. **On the public finance side, Panama's fiscal deficit is expected to narrow in the medium term.** Although the Government has amended the fiscal ceiling a few times in the recent past, the Social and Fiscal Responsibility Law has enabled the Government to conduct its fiscal policy in a prudent manner given that any increase needs to be approved by the Congress. Government is committed to reach its fiscal deficit goal of below 1 percent of GDP before 2018 as it is mandated by the Law. The deficit of the nonfinancial public sector is expected to decrease to below 2 percent of GDP in 2015 and below 1 percent in 2018, supported by declining capital expenditures, while revenue is expected to remain at similar levels as a percentage of GDP. The social programs supported by the proposed DPL operation are included into these forecasts. The Canal expansion, scheduled to operate early 2016, is expected to contribute 1 percentage point of GDP in additional non-tax revenue. In addition, the Government's commitment to reduce energy subsidies over the next three years and the recent tariff increase will further ease the expenditure burden. These actions are expected to support the on-going fiscal consolidation process.

23. **Financing needs will be covered through official sources and markets thanks to Panama's credibility and market access.** In actively managing its debt portfolio, the Government has revised its financing needs for 2015 upwards, explaining the request for the proposed DPL in the amount of US\$300 million. The request arises from potentially higher international borrowing costs due to the phasing out of quantitative easing, moderating growth prospects, and the objective of finalizing Panama's public investment program. In the medium term, financing needs are expected to decrease on account of the decreasing debt-to-GDP ratio and contained primary deficits. The year 2015 is an exception to this overall trend due to scheduled amortization payments on external debt. Capital markets will serve as main source of financing.

24. **The debt-to-GDP ratio is expected to continue its overall downward trajectory in 2015, and Panama's risk of public external debt distress is considered to be low.** A Debt Sustainability Analysis was undertaken in June 2014 by the IMF. The Analysis highlights that under a number of alternative scenarios, public debt dynamics are sustainable even in the presence of significant shocks. Panama's public debt-to-GDP ratio is expected to decrease gradually to 31 percent by 2018. External public debt and interest payments are also projected to decrease. The ratios for the present value of public debt and public debt services remain well below their indicative thresholds in the baseline scenario and under alternative scenarios.

25. **The macroeconomic outlook is vulnerable to downside risks.** Uncertain global market conditions, in particular weaker growth in the United States and China, and slow growth in world trade could reduce Panama service exports and FDI inflows. Moreover, an economic slowdown in trading partners could amplify the negative effect of Venezuelan and Colombian policies on the Colon Free Zone exports. There is also some risk that fiscal balances may deteriorate further, which in turn could limit room for maneuver in the presence of negative shocks.

Figure 1. Debt Sustainability Analysis



Source: IMF, Art. IV staff report, 2014.

Table 3: Government's Medium Term Financing Plan
(In percent of GDP)

	<i>Estim.</i>		<i>Projected</i>			
	2013	2014	2015	2016	2017	2018
Financing needs	7.6	6.4	7.2	4.5	3.1	3.5
Amortizations	3.4	2.3	3.1	1.0	0.9	2.0
Domestic	1.6	1.2	1.0	0.8	0.7	1.5
External	1.8	1.0	2.1	0.2	0.2	0.5
Multilateral	0.4	0.4	0.6	0.5	0.5	0.3
Bilateral	0.0	0.0	0.1	0.0	0.0	0.0
Primary deficit	2.3	2.4	2.1	1.3	0.0	-0.6
Interest payments	1.9	1.8	2.1	2.2	2.2	2.2
Financing Sources	7.6	6.4	7.2	4.5	3.1	3.5
Disbursements	7.6	6.4	7.2	4.5	3.1	3.5
External	5.5	5.1	0.9	0.3	0.2	0.2
Multilaterals	0.0	1.7	0.9	0.3	0.2	0.2
o/w new budget support	0.5	1.1	0.6	0.2	0.2	0.0
Bilaterals	0.0	0.0	0.0	0.0	0.0	0.0
Capital Markets	2.1	1.3	6.3	4.2	2.8	3.4
Domestic	1.1	0.6	1.9	1.7	1.3	1.3
International	1.1	0.7	4.4	2.5	1.6	2.1
Financing gap	0.0	0.0	0.0	0.0	0.0	0.0

Source: Ministry of Economy and Finance Update as of January 12, 2015 and World Bank staff calculations.

26. **Panama's macroeconomic framework is deemed adequate for development policy lending.** The 2015-2018 macroeconomic framework is expected to support economic growth, with inflation declining in a context of a fiscal consolidation and a strong and healthy financial system. Even though net exports are projected to decline, the current account deficit is projected to improve and will largely be financed through FDI. The remaining financial needs are expected to be easily met during the forecast period.

3. THE GOVERNMENT'S PROGRAM

27. **Taking office in July 2014, the new Government announced a reform plan with a focus on human development, sustainable economic growth and institutional strengthening.** The Government's plan centers on five themes: (i) fostering wellbeing and human development; (ii) strengthening democracy and rule of law; (iii) fostering sustainable economic development; (iv) ensuring citizen security; and (v) protecting the environment. Within the first theme, the Government emphasizes culturally appropriate development of Indigenous Peoples, promotes youth employment, and invests in signature projects such as the basic sanitation plan that provides potable water to 100 percent of Panamanian households and leaves zero latrines. Under the second theme, the Government focuses on increasing transparency and promoting decentralization. The third theme aims to enhance fiscal sustainability, the efficiency of public service provision, and the sustainability and efficiency of energy supply, among others. The fourth theme supports citizen security through prevention, institutional strengthening, and victim protection. Within the fifth theme, the Government focuses on disaster risk management and protection of the environment.

28. **The policies supported by the proposed operation are linked to the Government's program.** This DPL series fits with themes (i), (iii) and (v) of the Government's reform plan, which seek expanding opportunities for the indigenous and youth, expanding coverage and improving targeting and quality of social programs for the poor, expanding water and sanitation services coverage and improving its management, securing sustainable and reliable energy provision, and modernizing fiscal management. These areas have been identified as priorities in the Systematic Country Diagnosis and included in the Country Partnership Framework (CPF).

4. THE PROPOSED OPERATION

LINK TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION

29. **The proposed DPL series supports the Government of Panama's efforts to promote human development, sustainable economic growth, and institutional strengthening.** The Program Development Objective of the DPL series is to support the Government of Panama's efforts to (i) expand inclusion and opportunities, (ii) improve service delivery, and (iii) modernize fiscal management. Specifically, it aims at supporting the Government in:

- Expanding inclusion and opportunities by: (a) tackling extreme poverty through giving priority to culturally appropriate development in indigenous areas; (b) creating opportunities for youth and increasing incentives for secondary school graduation; and (c) expanding the coverage and improving the targeting and quality of social protection programs for the poor.
- Improving service delivery by: (a) improving water and sanitation management; and (b) securing sustainable and reliable energy provision.
- Modernizing fiscal management by: (a) strengthening the financial planning of Government resources; and (b) increasing the Government's ability to manage fiscal risks from disasters.

30. **The design of the proposed operation builds on lessons learned from previous DPLs**

in Panama and the World Bank's experience in other middle-income countries. The key lessons include supporting Government-led initiatives to obtain ownership of reform, as illustrated by previous operations in Panama. The legal and regulatory framework underpinning the reform program was initiated and developed by the administration, with technical input from the World Bank. DPL objectives were strategically aligned with the Government strategy (inclusion and social protection is one good example). Additional lessons include ensuring strong analytical underpinnings. Key economic and sector work, including the Public Expenditure Review and the Systematic Country Diagnosis, helped inform the reform efforts of Government and identify key areas of development challenges. The reform areas covered in this DPL fall into the five focus areas identified in the Systematic Country Diagnosis: i) education and skills; ii) institutions (including transparency, efficiency, and regulatory framework); iii) energy; iv) Indigenous Peoples; and v) water. In particular, in the area of social protection, water and sanitation and energy, complementarities of the loan program as well as technical assistance through other World Bank projects have helped in establishing a dialogue with the Government on these topics.

PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS

Pillar 1: Expanding inclusion and opportunities

Objective 1: Strengthening the institutional framework and programs for inclusion and opportunities of Indigenous Peoples' development

31. **Panama is home to seven indigenous ethnic peoples with distinct cultural identities and governance structures.**⁸ The Indigenous Peoples represent 12.3 percent of Panama's population. Half of the indigenous population live in five semi-autonomous territories called *comarcas*, which make up 20 percent of the country and are home to the country's richest natural resources and diversity of culture.⁹ The Indigenous Peoples are represented by their own traditional governance structures (ten Congresses and two Councils) which coordinate closely with their traditional leaders. They also serve as the primary interface with external actors.

32. **Areas with a concentration of indigenous populations are characterized by high levels of extreme poverty, lack of public services, and poor social outcomes.** The indigenous populations living in the *comarcas* represent 42 percent of the extreme poor, but less than 7 percent of the country's total population. In the *comarca Ngobe Buglé*, poverty rate stands at 93 percent, higher than poverty rates among Indigenous Peoples in rural Bolivia, Guatemala, Mexico and Ecuador. There is a striking correlation between living in a *comarca* and having little or no access to water, sanitation or even electricity. These disparities in public service provision are reflected in low social development indicators. For example, children in *comarcas* are more likely to drop out of school than anywhere else in Panama; at age 18, only 39 percent of children in the *comarcas* are in school, compared with 47 percent in rural areas and 69 percent in urban ones. Health indicators are also worse in the *comarcas*. In 2008, malnutrition in *Gnobe Buglé* was almost six times higher than in urban areas. Under five mortality in the same *comarca* was almost twice the

⁸ Namely the Ngobe Buglé, Naso Tjërdi, Bri-Bri, Kuna or Guna, Emberá y Wounaan.

⁹ Namely Emberá Wounaan, Gnobe Buglé, Kuna Yala, Madugandi and Wargandi.

national average in 2012 and teenage pregnancy rates in the *Emberá comarca* were almost three times the national average of 15 percent.¹⁰

33. **Indigenous Peoples have not benefited from economic growth and social programs to the same degree as the rest of the population.** Per capita income growth in the *comarcas* was 1.6 percentage points lower than the national growth rate of 6.6 percent, and the income of the bottom 40 percent was 2.4 percent compared to national level of 8.2 percent during 2007-2012 period. Little economic diversification and a lack of access to markets may explain the weak performance in indigenous areas. Moreover, despite substantial Government efforts in increasing social spending and creating new programs, the impact on the *comarcas* has been limited due to low participation of indigenous communities in the design and delivery of social protection programs.

34. **The Government has made the economic, social, and political inclusion of Indigenous Peoples a priority, recognizing the window of opportunity that the elaboration of the National Development Plan for Indigenous Peoples presents.** The plan prioritizes actions and investments in the areas of economic, social, and political development of Indigenous Peoples. It is historical and innovative, as for the first time, it proposes a multi-sectoral, proactive strategy for engagement and investments for and with Indigenous Peoples, based on their own articulation of their aspirations and priorities over the next 15 years. If implemented as envisioned in the plan, for the first time indigenous authorities will participate with the Government as equal partners in the design and delivery of policies and investments for their development and well-being. The plan is the result of 18 month consultations in all *comarcas* and a national conciliation and prioritization process carried out by a temporary national platform since mid-March 2012. The consultative platform included a representative from each Indigenous Peoples' Congress or Council, from the Government, and from the National Assembly. Based on this momentum the Government is advancing its reform agenda in three key areas: (i) the institutional and legal framework for the participation and ownership of Indigenous Peoples of national policies and investments that affect them; (ii) capacity building to enable key stakeholders within relevant sectoral ministries and indigenous representatives to accompany the project cycle; (iii) the adjustment of existing social protection programs according to specific needs and the cultural identity of Indigenous Peoples.

35. **The Government is transforming the temporary consultative platform that prepared the development plan in a permanent and legally backed institution; an indicative trigger for DPL 2.** This permanent advisory and coordination Council for Indigenous Peoples would continue to have the same composition as the temporary platform. The draft law has been finalized and agreed upon between the Ministry of Government and the platform, and it was presented to the Cabinet mid December 2014. The Executive will present the draft to the General Assembly and is preparing the approval through extensive consultations with civil society and key players in Congress to ensure a smooth processing. This mitigates the risks arising from an agenda that has been politically neglected in the past and has generated polarization in the country. After approval by the Cabinet, the law will be presented to the General Assembly in three debates per Panamanian law. Once the draft law passes the first debate, it goes to the Indigenous Peoples Commission within Congress for a technical review and a second debate. Upon approval by the Commission, the draft law is then presented for a final debate to the General Assembly. After this it is approved

¹⁰ Population and Housing Census 2010 and World Development Indicators.

and subsequently signed into law by the President. The approval is expected by October 2015.

36. **In addition, the Government is preparing a law that incorporates the actions of the National Development Plan for Indigenous Peoples; the approval of the law serves as an indicative trigger for DPL 3.** The legal backing of the plan ensures the commitment to the inclusion and opportunities of Indigenous Peoples according to their cultural identity beyond the current administration. The planned robust consultation process by the Government gives the Plan a seriousness and value that effectively reflects Indigenous Peoples priorities. At the same time, having gone through this two years consultation process, significant expectations have been raised among Indigenous Peoples for the Government to take action and implement the Plan. To allow for sufficient time for those consultations and for the preparation of the approval of the law in Congress this measure is included as an indicative trigger for DPL 3.

37. **To ensure the implementation of the development plan, the Government is adopting institutional actions to strengthen capacity for the preparation of projects in line with the plan, selected as an indicative trigger for DPL 3.** The Government is planning training for civil servants of relevant line ministries and indigenous authorities to prepare and support the implementation of the Indigenous Peoples' Development Plan. In particular, the Government is envisaging workshops to share experiences worldwide on how to measure development of Indigenous Peoples according to their own standards. Moreover, training on accompanying the investment cycle is envisaged to ensure the efficient use of public resources. The Ministry of Government, with the help of the World Bank, has prepared a project to support the implementation of the Plan by establishing the necessary preconditions from a legal, institutional, intersectoral, financial, and capacity perspective. This project proposal has been submitted to the Ministry of Economy and Finance (MEF) for consideration through an extraordinary financing window for 2015.

38. **Finally, the amendment of *Red de Oportunidades* to respond to culturally differentiated needs of Indigenous People is selected as an indicative trigger for DPL 2, and the roll-out of culturally differentiated programs is selected as an indicative trigger for DPL 3.** The *Red de Oportunidades* program has increased successful delivery of transfer payments to indigenous program beneficiaries both in *comarcas* and the indigenous communities outside of the *comarcas*. As the program moves forward, it will further tailor its offerings according to the distinct characteristics of its beneficiary population, namely in three main subgroups: (i) urban population in cities (mestizos, *afrodescendientes*, and others); (ii) rural areas (indigenous and non-indigenous rural poor); and (iii) *comarcas* (Indigenous Peoples). This approach focuses on both health and education service providers developing higher quality services that are adapted according to cultural practices. In education, this would include offering multicultural bilingual education options. In health, the program will offer culturally appropriate medical practices and medical practitioners who have been trained in cultural sensitivity and local languages. Moreover, the program's gender dimensions will be strengthened across the three subgroups, by emphasizing women's roles as citizens, entrepreneurs and professionals.

39. **Program Expected results:** Measures supported are expected to put in place the institutional structure for the coordination among Indigenous Peoples and their participation in Government processes and culturally differentiated social protection programs. This will be

measured by the number of projects prepared in line with the National Development Plan for Indigenous Peoples and by the offering of culturally differentiated programs in health and education.

Objective 2: Expanding opportunities for youth

40. **Panama has a relatively high youth unemployment rate and technical skills gaps in priority sectors, which remain unaddressed by the current technical education system.** Although strong economic growth has brought unemployment in Panama down to 3.1 percent in 2012, employment creation has not benefited all population groups equally. The unemployment rate is above average among youths (8.1 percent) and the poor (5.2 percent). Private sector employers report skills gaps in the labor force as one of their top three business constraints.¹¹ A lack of technically qualified workers particularly affects priority sectors such as logistics, tourism, mining and construction. The current social protection system is incomplete in that it does not provide active labor market policies. Moreover, the link between providers of technical vocational education and training and the private sector is weak. Among high school students in 2011, 53 percent were enrolled in technical vocation training, but none of these programs had a mandatory workplace learning component.¹²

41. **The Government has increased payments incentives to the beneficiaries of the *Beca Universal* program differentiated by schooling level (*primaria, pre-media, media* cycles)–Prior Action 1.** Drop-out rates in secondary school continue to be high in Panama, averaging over 40 percent in 2011. Evidence from various conditional cash transfer programs show that cash transfer payments can effectively increase the short run benefits of school attendance, thus reducing school drop-out rates. With this as one of the goals, the Government has increased monthly transfers upon graduation in a differentiated way according to grade level. Effective on October 6, 2014, cash transfers for primary school increased from 20 to 30 B/., for secondary school, these increased from 20 to 40 B/., and for high school transfers increased from 20 to 50 B/.. It is estimated that half a million Panamanian students will benefit from these increases. The associated cost of this program is estimated at US\$117 million a year, US\$50 million higher than the cost of the current flat payment program, 20 B/. in all three grade levels. This effort is complemented by reforms in monitoring and evaluation which are supported by DPL 2 and 3. In particular, DPL 2 supports the mandatory application of the monitoring and evaluation framework of the *Beca Universal* program and the participation in the 2015 Program for International Student Assessment. The Government is committed to participating in this worldwide evaluation of education systems regularly.

42. **The Government has piloted a vocational training program *ProJoven* that provides on the job training to the graduates of the technical branch of secondary education, and legally created a new set of baccalaureates, including the creation of curricula consistent with labor market demand–Prior Action 2.** The *ProJoven* program was launched in October 2014 through an agreement between the Ministry of Labor and the Ministry of Education. It intends to place at least 2,000 sixth year students (last year of high school) of the technical branch of the secondary cycle as interns with private firms. This represents 20 percent of the roughly 10,000

¹¹ World Bank (2014), Social Sector Expenditure and Institutional Review.

¹² World Bank (2014), Technical Vocation Education and Training – Mapping Institutions and Policies.

graduates of technical secondary education each year. Eleven public technical schools and 30 private companies have joined the pilot phase of the program with 550 participants for the first program. The program aims to give graduates a chance to deepen their technical skills to facilitate their transition into the labor market. The Government has also approved and implemented a selection of new baccalaureates, including science, engineering, business, etc., with the aim of providing education better adapted to labor market needs. The indicative triggers of DPL 2 and 3 successively support the piloting phase of *ProJoven* and its national roll-out along with the introduction and roll-out of a bilingual education program.

43. **Program Expected results:** The measures supported are expected to improve the monitoring and evaluation reporting on the performance of *Beca Universal* and improve youth skills for participation in the labor market. This will be measured by the production of semiannual monitoring and evaluation reports on the performance of *Beca Universal* and by 20 percent of students of technical secondary education having graduated from *ProJoven*.

Objective 3: Expanding the coverage and improving the targeting and quality of social protection for the poor

44. **The Government has expanded the coverage and the benefit of social protection program for elderly without pension (*120 a los 65 program*) to provide 120 B/. monthly—Prior Action 3.** In 2009, the Government created the *100 a los 70* program, providing 100 B/. per month to elderly people aged 70 or older without pensions. This program contributed to the country's poverty reduction. For instance, the number of beneficiaries who had been previously poor and rose above the poverty line due to the program was 19,466 as of August 2013. Similarly, 22,610 left extreme poverty due to the program. In September 2014, the Government announced the *120 a los 65* program as the new social protection program for the elderly without pensions, which will pay 120 B/. per month to the most vulnerable elderly over 65 years old without pensions. It is estimated that over 30,000 people will receive the benefit, further reducing poverty. The cost of this program will be US\$118.2 million, an increase of US\$20 million from *100 a los 70* assuming the current enrollment rate of approximately 70 percent.¹³

45. **Targeting cash transfers under *Red de Oportunidades* and reducing leakage in all social programs remains a challenge.** 18 percent of the population in the bottom quintile receives no social assistance of any sort, and not all social spending benefits the poor. Under the previous DPL series, several steps were taken to enhance pro-poor targeting of *Red de Oportunidades*. First, the Government introduced a targeting design that enabled channeling resources to the poor in remote geographic areas.¹⁴ As a result, about 46 percent of beneficiary households are indigenous, reaching almost universal coverage in the *comarcas* (provinces of *Bocas del Toro* and *Darién*, and in the *Kuna Yala*, *Emberá* and *Ngobe Buglé*).¹⁵ Second, a management information system was adopted to address inclusion errors in *Red de Oportunidades* (non-eligible households receiving benefits) and gradually verify eligibility conditions. Third, the proxy means test to determine eligibility was modified to more accurately reflect poverty conditions.

¹³ The fiscal cost of the program with 100 percent of enrollment rate would be US\$241.2 million.

¹⁴ IPEA, 2008.

¹⁵ An impact evaluation of *Red de Oportunidades* is currently being conducted.

46. **Therefore, the Government has initiated the recertification of *Red de Oportunidades* and the transfer of benefits through the banking system.** The national roll-out of the recertification was selected as an indicative trigger for DPL 3. Currently, approximately 90,000 households in poor rural areas are receiving cash transfers from *Red de Oportunidades*. However, in 2012, less than 40 percent of the poorest quintile of the population and less than 10 percent of the second poorest quintile were covered. An estimated 1.5 percent of *Red de Oportunidades* beneficiaries are in the second highest income quintile, indicating that there is significant space to improve efficiency of the program by recertifying beneficiaries. This will significantly reduce targeting errors and ensure an appropriate expansion of a very progressive scheme. The Government has defined priority areas, with lower poverty rates, for the recertification of *Red de Oportunidades*. Furthermore, the use of the banking system to pay out benefits of *Red de Oportunidades* is intended to reduce leakages and will facilitate financial inclusion of the poor which will be further supported through financial training. DPLs 2 and 3 support this agenda.

47. **Program Expected results:** The measures supported are expected to improve the targeting and management of social programs. Indicators are the share of elderly aged 65 or older without other pensions who receive benefits from the *120 a los 65* social protection program and the share of transfers from *Red de Oportunidades* made through the banking system.

Pillar 2: Improving service delivery

48. **This component supports the Government's plan to improve the provision of water and sanitation services and increase the sustainability of the energy sector.** In the energy sector, Panama faces critical challenges associated with the production, delivery, and consumption of electricity. Given the challenges these sectors face in term of coverage and institutional capacity, they are high priority sectors in need of strengthening to improve efficiency and ensure sustainability.

Objective 1: Improving water and sanitation management

49. **The Government has made progress in increasing the provision of water and sanitation services, but more is needed.** According to the 2010 national census, 92.9 percent of Panamanians have access to potable water, and 94.5 percent to sanitation services. In rural areas, coverage levels drop dramatically; potable water averaging 78.1 percent and sanitation 85.2 percent coverage. These numbers drop even further for indigenous populations, where potable water coverage is as low as 28.1 percent and sanitation coverage as low as 6.0 percent. Although coverage levels are high in urban areas, service quality continues to be problematic for the National Water Agency, the *Instituto de Acueductos y Alcantarillados Nacionales* (IDAAN), in particular in poor urban and peri-areas. More than 400,000 people only receive water seven hours a day and there are about 420,000 people with latrines in urban areas.

50. **The water supply and sanitation (WSS) sector in Panama is facing a number of institutional weaknesses.** The main sector actors include the Ministry of Health (MINSa) that is responsible for sector policy and long-term planning, as well as for overseeing service provision in rural areas through the Rural Water Supply Administration; IDAAN, responsible for service provision in urban; and the National Authority of Public Services, *Autoridad Nacional de Servicios*

Públicos (ASEP), in charge of control and regulation of services provided in urban areas. Despite the relatively well designed legal framework, the sector has a number of institutional weaknesses, including unclear roles among the different sector actors, lack of coordinated investment, weak regulatory capacity and limited operational and financial autonomy of IDAAN.

51. **The Government has created a management unit within the *Secretaria de Metas Presidenciales* to carry out a basic sanitation plan to provide 100 percent access to drinking water and 0 latrines—part a) of Prior Action 4.** With the ultimate goal of improving quality of life by providing reliable water 24 hours a day and eliminating the use of latrines, the Government has launched the basic sanitation plan “100/0”.¹⁶ To this end, the Government has created a special management unit to develop and implement the plan, and has published a first tender for the *San Miguelito* area, which will benefit 310 households. The implementation and the rolled out of the basic sanitation plan to pilot regions is selected as an indicative trigger for DPL 2. Another step the Government has taken is the creation of a multi-institutional technical committee for water and sanitation responsible for the elaboration of a water quality monitoring plan. Currently, only water in the Canal area is monitored, therefore having a system that monitors systematically across the nation is an important step toward improving water quality in Panama.

52. **The Government has launched a standardized information system for improving the monitoring of water management in rural areas—part b) of Prior Action 4.** The Government has adopted international best practices in managing water sanitation services in rural areas by launching SIASAR (*Sistema de Información de Agua y Saneamiento Rural*). SIASAR is an innovative platform designed to monitor the development and performance of rural water supply and sanitation services. Through this tool, data collection and analysis becomes more accessible, more precise, and comparable across regions and countries. This data will help in identifying the greatest WSS user needs and the largest gaps in delivery and management capacity. Currently 400 out of total 100,000 rural communities are registered in SIASAR. The national Government, through MINSA, has adopted SIASAR as its monitoring mechanism for rural WSS services. The Government’s plan for the next three years is to increase the share of water boards in rural areas that adopt this system to make the management of the sector more efficient. The national roll-out of SIASAR has been selected as indicative trigger for DPL 3.

53. **Modernizing IDAAN is critical to improving efficiency and quality of water services in Panama.** IDAAN faces operational inefficiencies and financial challenges required to provide quality services. Its lack of resources is partly due to tariffs that do not cover the costs of operation and maintenance. The water tariff has not increased since 1982. As result, IDAAN requires annual grants of approximately US\$15 million to cover its operating deficit. Furthermore, IDAAN lacks operational autonomy and suffers from poor human resource management to function professionally without political influence. The Government has initiated the modernization process of IDAAN by establishing the Transformation and Modernization Unit (*Unidad de Transformación y Modernización*, UTM). UTM will be responsible for identifying and addressing structural institutional issues that are preventing IDAAN from increasing its efficiency. This process will lead to the implementation of strategic measures to address IDAAN’s institutional bottlenecks. Institutional and tariff reforms of IDAAN are indicative triggers for DPLs 2 and 3.

¹⁶ A term coined during the President Varela campaign to indicate 100 percent access to 24/7 water and supply and 0 latrines.

54. **Program Expected results:** The measures supported are expected to improve access to basic sanitation and the monitoring of rural water management by having at least 30,000 households benefiting from the basic sanitation plan and having 50 percent of the rural water boards connected to SIASAR.

Objective 2: Securing sustainable and reliable energy provision

55. **The energy sector faces challenges in increasing supply to meet the accelerated demand.** The rapid economic development that Panama has experienced over the past decades has placed tremendous pressure on the electricity sector to expand and make cost-effective, reliable power available to a growing and increasingly energy-intensive consumer base. The national power supply is largely made up of hydropower (60 percent) and fossil-fuel power plants (40 percent). Power generated is transmitted to three major distribution networks via two primary transmission lines. As demand for electricity has grown, the power generation capacity and the transmission network have failed to keep pace, such that there are currently significant risks of power shortages. The risks are particularly acute during the dry season, when hydro reserves are reduced. Given the vulnerability of the sector to shortages, Panama has been forced to increasingly rely on costly emergency power stations.

56. **Furthermore, higher energy costs present risks to the Government's fiscal sustainability, since it is a highly subsidized sector.** The cost of the subsidy – called the Rate Stabilization Fund – from 2004 to 2012 totaled more than US\$838 million. This is not only a high cost for public finances, but is also poorly targeted. Due to the recent power shortages which required the increased use of less efficient, costly emergency power stations, it is estimated that the Government may spend as much as US\$1 billion to cover electricity subsidies and penalties, and the use of emergency power stations in 2014.

57. **The Government has recognized the urgent need for reforms in the energy sector to create the conditions for increased power generation, strengthened transmission networks, and reduced energy consumption through energy efficiency measures.** In response to the most recent dry season and power shortages, the Government was forced to implement emergency rationing measures. These included restrictions on businesses, schools, government operating hours, and limits on the use of air conditioning during peak energy consumption hours. Avoiding the need to implement costly emergency responses to energy crises in the future will require a more programmatic, strategic approach to energy production and consumption.

58. **The Government has approved a resolution for the adjustment of electricity tariff subsidy–part a) of Prior Action 5.** The Government has identified the main distortions associated with electricity tariffs and has formed a committee to elaborate a plan for subsidy adjustments. Further, ASEP launched public consultations regarding adjustments to the base rates for the electricity tariffs for the period of January 1, 2015 to June 30, 2018. Tariffs on electricity will be increased from 16 cents per kW/h to 17 cents for households consuming 300kW/h to 750kW/h per month and 20 cents for households consuming more than 50kW/h per month. For those who consume less than 300kW/h, there is no change in tariff. The adjustment in electricity subsidies

will also reduce public expenditures by approximately US\$100 million per year, thus increasing fiscal space, while maintaining assistance for the neediest consumers.

59. **The Government has approved a law establishing a regime of incentives to increase the share of renewable energy in the power generation mix—part b) of Prior Action 5.** While the electricity sector in Panama historically has depended on hydropower and fossil fuels, the Government is undertaking reforms to diversify the generation mix towards renewable energy. The vulnerability that such limited diversification represents – hydropower to rainfall shortages and fossil fuels to dramatic price volatility – along with other priorities including environment and domestic natural resource management have led the country to increasingly explore alternative sources of power generation. In the last five years, the Government has taken steps to put in place incentives for the promotion, development, and use of a wider range of alternatives. This has included Law 44 (2011) and Law 37 (2013) which establishes the framework for wind, solar, and other sources. In part, due to the policy measures, a number of renewable energy projects have been contracted. This includes, most recently the commitment by the International Finance Corporation (IFC) for a US\$300 million financing package for the construction of Phase II and Phase III of the *Penonome* wind power plant, the largest wind farm in Central America. Once operational, the 86 wind turbines with an installed capacity of 215 MW are expected to generate 448 GWh of energy per year, roughly equivalent to 5 percent of the country’s total energy demand.

60. **Program Expected results:** The measures supported are expected to increase sustainable and reliable energy provision by reducing the average hours of electricity outages per year.

Pillar 3: Modernizing fiscal management

Objective 1: Strengthening the financial planning of Government resources

61. **The third objective of the DPL series is to improve institutional development by modernizing fiscal management and making it more transparent.** A major challenge in Panama is the lack of a centralized treasury account for Government revenues and expenses which would allow better management of public resources and an adequate evaluation of how resources are transferred. In addition, available technology could be further enhanced to become an integrated system for Government resource planning. Both actions would increase transparency, and would reduce public perception of corruption present in the Government. The implementation of a Single Treasury Account would lead to a smooth allocation of resources through improving cash management, avoiding idle funds and reducing unnecessary financing cost, therefore improving fiscal space. On the other hand, a new model of financial management – the Technological Solutions of the Operational Management Model (ISTMO)– is likely to strengthen budget execution, treasury management, accountability and control. The new system would boost transparency in budget preparation led by the budget office, and could be the foundation for the development of mechanisms to track budget programs and monitor results. It would further support planning of annual budgets. Both the Single Treasury Account and the adoption of ISTMO would increase efficiency, improve fiscal space, and ultimately free up resources for social programs.

62. **The Government has approved the introduction of a Single Treasury Account and channeled all funds of the treasury and MEF through the Single Treasury Account—Prior**

Action 6. Law 56-2013 and Law 19-2014 created the National Treasury System and the Single Treasury Account with the purpose of regulating the organization and operations of the National Treasury System. This new system is based on the unity of cash principle and on centralized administration of public funds by the National Treasury. In addition, a Technical Treasury Committee was created with the purpose of making the National Treasury System operational and implementing the necessary regulations to carry out basic steps in fund management, such as revenues, cash programming, investment, and disbursements.

63. **The ISTMO system is expected to be fully operational by January 2015.** It can be used for budget execution of that year in MEF, and in 24 selected Central Government entities. Configuration of ISTMO for SAP (Systems, Applications and Production in Data Processing) is finished and the consortium in charge has already organized meetings with all the incumbent Directorates, where all the processes that the new system should incorporate have been identified. In addition, gaps on quality standards of the SAP system have been identified. Moreover, 80 percent of the information migration process has already been completed and the catalogue of goods and services of public expenditure for inventories classification has already been defined. The subsequent roll-out of the Single Treasury Account and of ISTMO to the public sector have been selected as indicative triggers for DPL 2 and 3.

64. **Program Expected results:** The measures supported are expected to increase transparency of Government transactions and improve cash management of Government resources by having most of Central Government and decentralized entities funds channeled through a Single Treasury Account and having financial statements for budget execution automatically generated for Central Government entities.

Objective 2: Increasing the Government's ability to manage fiscal risks from disasters

65. **Panama is exposed to a variety of natural disasters as a result of its geographical position.** The country is ranked in 14th place among the countries most exposed to multiple hazards, with 15.0 percent of the total area and 12.5 percent of the population vulnerable to two or more perils. Panama is characterized by its exposure to the impact of long lasting and heavy rainfall, storms, strong lightening, floods, forest fires, waterspouts, earthquakes, tsunamis and episodes of the El Niño-La Niña phenomenon. In November 2012, heavy rains caused floods and landslides in Colon and across the western Caribbean region of Panama, causing an estimated damage of US\$123 million, prompting the Government to declare a national emergency and approve a waiver to exceed the deficit ceiling. In addition to the original patterns of flood risk affecting the rural and poorest areas of the country, flood risk has begun to increasingly affect urban areas leading to more significant economic damages.

66. **The Government has approved a policy for managing fiscal risks related to natural disasters which includes the identification and evaluation of fiscal risks from disasters; the integration of disaster risk analysis into public investment planning; and the design of risk retention and risk transfer tools—Prior Action 7.** The Investment Office, the *Dirección de Inversiones, Concesiones y Riesgos del Estado* (DICRE), has designed a strategic framework that defines the policies to cover the fiscal risk due to the impact of natural disasters. This is a part of the National Comprehensive Disaster Risk Management Policy, approved by Decree No. 1101 of

December 30, 2010 that set policy and institutional framework for disaster risk management. The ultimate goal of better disaster risk management is to contain fiscal risk when facing natural disasters by having a set of financial instruments and procedures in place. The operationalization and implementation of the policy have been selected as indicative triggers for DPL 2 and 3.

67. **Furthermore, DICRE has defined five strategic priorities to be included in the five-year operational plan:** identification; measurement and understanding of fiscal risk from disasters; integration of disaster risk analysis in the planning of public investments; development of the components for the design and implementation of risk retention and risk transfer tools; development of the domestic insurance market; and strengthening of the role of DICRE in designing and implementing financial protection strategies.

68. **The Government has consolidated available instruments and identified additional financial protection instruments as part of a solid and robust strategy for the financial management of disaster risk.** For high frequency but low severity events, retention instruments to be used are budget reallocations and the general contingency budget line that does not require an exemption. For less frequent but more severe events, contingent credit lines and resources from an emergency fund that require a waiver could be used. For very rare but very severe events, the Government could access other retention and transfer resources, such as the Panama Saving Fund and catastrophe insurance. In order to strengthen and complement these instruments, the Government plans to analyze catastrophe insurance, strengthen the co-insurance scheme, create an emergency fund, and establish standards for concessions insurance.

69. **Program Expected results:** The measures supported are expected to increase the ability of the Government to manage fiscal risks from disasters by increasing the availability of contingent financing instruments.

Table 4: DPO Prior Actions and Analytical Underpinnings

Prior Actions	Analytical Underpinnings Key Findings
<i>Expanding inclusion and opportunities</i>	
<i>Objective: Expanding opportunities for youth</i>	
<p>The Government has increased payment incentives to the beneficiaries of the <i>Beca Universal</i> program differentiated by schooling level (<i>primaria, pre-media, media</i> cycles).</p>	<ul style="list-style-type: none"> • Panama Systematic Country Diagnostic (WB 2014) • Panama Social Sector Expenditure and Institutional Review (WB 2014) • School subsidies for the poor: Evaluating the Mexican <i>Progres</i>a Program (Schultz 2004) • The impact of the <i>Bolsa Escolar/Familia</i> conditional cash transfer program on enrollment, dropout rates and grade promotion in Brazil (Glewwe and Kassouf 2012) <p>Key Findings:</p> <ul style="list-style-type: none"> • Conditional cash transfers can significantly increase enrollment and reduce school dropout rates, hence raising lifetime earnings.
<p>The Government has (a) piloted a vocational training program <i>ProJoven</i> that provides on the job training to graduates of the technical branch of secondary education and (b) legally created a new set of baccalaureates including the creation of curricula consistent with labor market demands.</p>	<ul style="list-style-type: none"> • <i>Mejores Empleos en Panamá: El Rol del Capital Humano</i> (WB 2012) • Technical Vocational Education and Training – Mapping Institutions and Policies (WB 2014) • Impacts of Active Labor Market Programs: New Evidence from Evaluations with Particular Attention to Developing and Transition Countries. (WB 2004) • <i>Rentabilidad económica del programa de capacitación laboral de jóvenes chile joven</i>. (Aedo and Valdivia 2009) • Evaluation of training for the unemployed in Mexico: learning by comparing methods (Delajara et al. 2013) <p>Key Findings:</p> <ul style="list-style-type: none"> • Technical skills gaps among employees are a key business constraint. • Technical vocational programs do not provide youth with practical experience. • Positive impact of capacity building programs for youth and the unemployed respectively on formal/salaried employment and beneficiaries’ wages.
<i>Objective: Expanding the coverage and improving the targeting and quality of social protection for the poor</i>	
<p>The Government has (a) expanded the coverage and the benefits of the social protection program for the elderly without pension (<i>120 a los 65</i> program) to provide 120 B/. monthly and (b) launched the recertification of <i>Red de Oportunidades</i>.</p>	<ul style="list-style-type: none"> • Panama Systematic Country Diagnostic (WB 2014) • Review of Social Assistance programs and Recommendations for Priorities and the Way Forward and Social Protection Responses to the triple wave of crises in Central America and Panama (Marques 2009, 2010) • <i>Red de Oportunidades</i>: Conditional cash transfer evidence from Panama (Arraiz, S. Rozo 2011) <p>Key Findings:</p> <ul style="list-style-type: none"> • <i>Red de Oportunidades</i> has led to increased school enrolment and reduced child labor among participating families. • The targeting of <i>Red de Oportunidades</i> remains a challenge. • The modified proxy means test should be used to determine eligibility and recertify existing <i>Red de Oportunidades</i> recipients.

II. Improving service delivery	
Objective: Improving water and sanitation management	
<p>The Government has (a) created a management unit within the <i>Secretaria de Metas Presidenciales</i> to carry out a basic sanitation plan to provide 100 percent access to drinking water and 0 latrines and (b) launched a standardized information system for improving the monitoring of water management in rural areas.</p>	<ul style="list-style-type: none"> • Panama Metro Water and Sanitation Improvement Project No 53372 (WB 2010) • The Political Economy of Urban Water and Sanitation in Panama – IDAAN (Natalicchio and Alvarez 2011) • <i>Memoria Anual del Subsector de Agua Potable y Alcantarillado Sanitario</i> (MINSAs 2010) • <i>Diagnóstico del Desempeño del IDAAN, Estrategia de Reforma</i> (Castalia Strategic Advisors 2011 and 2012) <p>Key Findings:</p> <ul style="list-style-type: none"> • Latrines are still used by 420,000 people in urban areas. • Water quality is currently monitored only in the Canal areas. • Clean drinking water and sanitation facilities are crucial to improving health indicators and the quality of life.
Objective: Securing sustainable and reliable energy provision	
<p>The Government has a) approved a resolution for the adjustment of electricity tariff subsidies and b) approved a law establishing a regime of incentives to increase the share of renewable energy in the power generation matrix.</p>	<ul style="list-style-type: none"> • <i>Política energética: Diagnostico y propuestas, Fundación para el desarrollo económico y social de Panamá</i> (Primola et. al 2013) • <i>Dossier energético Panamá</i>, Inter-American Development Bank (Espinosa et al 2013) <p>Key Findings:</p> <ul style="list-style-type: none"> • High energy subsidies present a large fiscal cost to the Government (US\$838 million for 2004 to 2012) and are regressive. • The energy sector suffers from capacity constraints, and power is largely supplied through hydropower (60 percent) and fossil-fuels (40 percent).
III. Modernizing fiscal management	
Objective: Strengthening the financial planning of Government resources	
<p>The Government has (a) approved the introduction of the Single Treasury Account and (b) channeled all funds of the treasury and MEF through the Single Treasury Account.</p>	<ul style="list-style-type: none"> • Strengthening Public Expenditure Management in Panama – A Basis for Better Government Performance (WB 2014) • Enhanced Public Sector Efficiency Technical Assistance Report No. 59159 (WB 2011) • Panama Public Expenditure and Financial Accountability Assessment (WB, Inter-American Development Bank (IDB), Government of Panama 2012) <p>Key Findings:</p> <ul style="list-style-type: none"> • The multitude of accounts creates significant inefficiencies in budget performance and fragmentation, opaqueness and inaccuracies in financial reporting. • Integrating institutional subaccounts under the Single Treasury Account is essential for efficient and transparent cash and public debt management.
Objective: Increasing the Government's ability to manage fiscal risks from disasters	

<p>The Government has approved a policy for managing fiscal risks related to natural disasters which includes the identification and evaluation of fiscal risk from disasters; the integration of disaster risk analysis into public investment planning; and the design of risk retention and risk transfer tools.</p>	<ul style="list-style-type: none"> • IMF Article IV (IMF 2014) • Panama – Disaster Risk Management Development Policy Loan with a Catastrophe Deferred Drawdown Option No. 60719 (WB 2011) <p>Key Findings:</p> <ul style="list-style-type: none"> • Panama is increasingly vulnerable to natural hazards, compounded by extreme climatic variability, as exemplified by the 2010 and 2012 floods. • The Government needs to continue developing its disaster risk financing strategy, as there are still gaps in its financial protection against adverse natural events.
---	---

LINK TO CPF, OTHER BANK OPERATIONS AND THE WBG STRATEGY

70. **The proposed DPL builds on the analysis of the Systematic Country Diagnosis and is aligned with and envisaged in the CPF.** The DPL aims to contribute to CPF results in all its three pillars: (i) promoting social inclusion and increasing social opportunities, which is a precondition for ensuring the benefits of growth to reach poor and marginalized groups; (ii) expanding service provision supports the access to reliable services for the bottom 40 percent; and (iii) streamlining institutional development, and strengthening fiscal risks contribute to increasing the efficiency and efficacy of public expenditure.

71. **Several World Bank Group financed operations complement this DPL to achieve CPF outcomes:** (i) the support of IFC for the Government in the energy and education sectors are the areas that have the closest links with this DPL series. The IFC’s strategy is to support energy efficient facilities and has joined forces with (International Bank for Reconstruction and Development) IBRD to support the Government’s efforts to address the energy and power sector crisis that has affected the country over the last two years. The focus is mainly on financing renewable energy generation plants and ports and logistic-related services that are necessary for the expansion of the Panama Canal. IFC also focuses on private health and education as well as on Panama-based companies with regional expansion plans focused on health; (ii) the active portfolio comprises three lending operations for a net committed amount of US\$161 million, of which US\$137.8 million remain undisbursed. The portfolio spans a number of sectors, also covered by the DPL series, including water and sanitation, disaster risk management and governance. This engagement has built on synergies with the IFC, specifically on promoting competitiveness through Doing Business Reform advisory services and technical assistance to improve the transparency of the country's tax system and enhance its ability to exchange tax information to meet the standards of the Global Forum; and (iii) while the Multilateral Investment Guarantee Agency has US\$626.1 million in Gross Exposure in two projects in the transport sector, the links with this DPL series are limited.

CONSULTATIONS, COLLABORATION WITH DEVELOPMENT PARTNERS

72. **During President Varela’s campaigning period for the 2014 national elections, wide consultations processes were held across the country with many sectors to confer on the**

policy platform of the *Plan El Pueblo Primero*. As a result of these participatory consultations, the new Government will soon launch comprehensive programs, some of which the World Bank will support as part of this DPL to reduce poverty and boost shared prosperity. For instance, the Ministry of Education and the Ministry of Labor have established an alliance with 17 private companies in Panama to pilot an apprenticeship program for graduate students to access job opportunities and strengthen their skills and capacity for the labor market demand.

73. **Extensive consultations were also held with different stakeholders in Panama for the preparation of the First Programmatic Shared Prosperity Development Policy Loan, the piloting of the Systematic Country Diagnostic and the new Country Partnership Framework.** During round table sessions, the Government, private sector, academia, think tanks, Indigenous Peoples, Afro Panamanian groups, civil society and non-governmental organizations discussed the country's development priorities and challenges for World Bank Group future engagement, such as expanding inclusion and opportunities, improving service delivery, and modernizing fiscal management. The Government is also involved in an open and participatory dialogue with the indigenous groups and has been actively involved in the consultation mechanism of the United Nations Development Program for the preparation of the National Development Plan for Indigenous Peoples.

5. OTHER DESIGN AND APPRAISAL ISSUES

POVERTY AND SOCIAL IMPACT

74. **Government actions supported in this DPL are expected to have positive poverty and social impacts.** The analysis of the potential impacts of the reforms supported under this operation suggests a positive or neutral direct impact on poverty and social development indicators. Progress has been made in implementing measures that affect poor and vulnerable populations in the area of social inclusion, coverage of social programs, access to basic sanitation services and water quality. These measures are expected to have a direct and positive impact on poverty, education and health outcomes. Other reforms in the water and energy sectors will enhance the cost-efficiency of service provision, ultimately benefiting consumers.

75. **Measures related to social protection programs are expected to generate positive impacts for the poor and extreme poor.** The greatest poverty impact is expected from measures to enhance inclusion and economic opportunities for the Indigenous Peoples, given the extreme concentration of poverty in indigenous areas. Measures to enhance opportunities for youth are expected to have both direct and indirect impacts on poverty among this group. The direct effect comes from the increase of *Beca Universal* transfers while the indirect effects come from decreased drop-out rates, especially in secondary school, and through higher employment rates and wages for the beneficiaries of the *ProJoven* program.¹⁷ In addition, the social protection measures for the elderly would reduce poverty in that population group significantly and slightly overall. Annex 5 provides details.

76. **The supported action on improving access to basic water and sanitation services is expected to reduce poverty and improve living conditions of the beneficiaries.** The basic

¹⁷ Glewwe and Kassouf (2009) and Schultz (2004).

sanitation plan will provide basic WSS services to currently under-served poor households, which will lead to improved health outcomes and thus higher chance of accessing education and job opportunities. The monitoring of water quality through the SIASAR system will also improve health outcomes. The modernization of IDAAN and reforms in the energy sector, especially the revision of pricing mechanisms, are expected to enhance the cost-efficiency of service provision, ultimately benefiting consumers.

77. **The electricity tariff reform is expected to have less of an impact on poverty since the largest share of households potentially affected is non-poor.** It is estimated that about 87 percent of all households consume less than 300kW/h, which is not affected by the reform. Although the changes will affect about 6,400 poor households who consume more than 300kW/h, the impact of electricity reforms on overall poverty rates is low, as Table A2 in Annex 5 shows. The change in tariffs will rather affect the depth of poverty. All things equal, poor households affected by tariff changes will have lower disposable income.

78. **Measures to modernize the Government are not expected to directly impact poverty or the distribution of incomes.** However, indirect effects could occur. For example, a more efficient public financial management including the responses to fiscal risks from natural disasters may free up resources for social spending. In addition, increased government transparency could enhance the business environment and therefore, generate more growth and employment.

ENVIRONMENTAL ASPECTS

79. **The measures supported under the proposed DPL are not likely to have significant effects on the environment, forests or other natural resources.** The first and third pillars, expanding social inclusion and modernizing fiscal management, have a primarily administrative nature, therefore, policy actions under these pillars are unlikely to either exacerbate environmental problems or contribute to their remediation. With regard to the second pillar on service provision, the subcomponent on securing sustainable and reliable energy provision could have a positive environmental impact by reducing the use of polluting energy generators. Furthermore, giving proper incentives to lower consumption by increasing the tariff for medium and large consumers will result in less use of emergency stations that use the least efficient fuel generators. The subcomponent on improving access and efficiency of water and sanitation is likely to improve water resource and waste water management in small communities and peri-urban areas.

PUBLIC FINANCIAL MANAGEMENT, DISBURSEMENT AND AUDITING ASPECTS

80. **Panama's public financial management (PFM) and public procurement systems are sound.** Panama has no Central Bank and uses the United States dollar as currency. The budget is published promptly after its approval in the official gazette. The published budget and data on budget execution are publicly available online. A joint IDB – World Bank Public Expenditure and Financial Accountability assessment was published in July 2013. The report highlights that Panama's PFM systems are characterized by: (i) timely review and approval of the national budget by the National Assembly; (ii) good and timely public debt management and reporting; (iii) readily accessible information on government expenditure to the public; and (iv) permanent reconciliation of payroll registries management. At the same time, several areas of PFM would benefit from

further improvement, particularly in relation to budget preparation and execution: (i) budget credibility and predictability is affected by significant and numerous budget modifications throughout the year; (ii) predictability of the availability of funds for commitment of expenditures is uneven; (iii) a mechanism for the proper control of payment arrears should be put in place; (iv) quality and comprehensiveness of budgetary reports and annual financial statement could improve; and (v) a strengthened internal audit function and internal control framework is required.

81. The Government is moving ahead to further strengthen its PFM. The Government is implementing a set of key reforms to strengthen and modernize planning and budgeting, the financial management system, the financial control framework, and procurement systems. The World Bank has been supporting the Government in the improvement of PFM through the DPL series (P123255, P127332, and P146942), as well as the Enhanced Public Sector Efficiency Technical Assistance Loan (P121492). A cornerstone of the new Government Financial Management Model is the implementation of a new integrated financial management system (ISTMO), which aims at providing a modern platform that integrates accounting, budgetary and logistics functions. To support the operation of ISTMO, Panama is pursuing a major reform in public accounting through the adoption and gradual implementation of the International Public Sector Accounting Standards and the expansion of the Single Treasury Account. These elements are expected to improve management practices in the use of public resources throughout the budget cycle, which would enhance efficiency, effectiveness of public programs, transparency and accountability in the use of public resources. This would be achieved through the provision of good quality reports and more comprehensive financial statements. An important challenge ahead to better support the country effort is to put in place a new control framework.

82. The proposed loan will follow IBRD's disbursement procedures for DPLs. Once the loan is approved and becomes effective, IBRD would make the single loan disbursement to MEF's Single Treasury Account. Upon its deposit, the DPL disbursement will become available to finance budgeted expenditures. The account is denominated in United States dollars, which has legal tender in the country, and is held at the National Bank of Panama, the financial agent of the Government. The World Bank analyzed the audit report on the 2013 financial statements of the National Bank of Panama. During the review of said report and the external audit reports as well as the World Bank's experience with special designated accounts for investment lending, nothing came to the attention of IBRD indicating that the banking control environment into which the loan proceeds will flow is other than adequate. On such basis, no audit will be required for the deposit account, and no additional fiduciary arrangements are considered necessary at this time. Upon IBRD's request, the Borrower will provide written confirmation that the amount of the loan has been credited to an account available to finance budgeted expenditures. If the proceeds of the loan are used for ineligible purposes as defined in the Loan Agreement, IBRD will require the Borrower to refund an amount equal to the amount of said payment to IBRD promptly upon notice from IBRD. Amounts refunded to IBRD upon such request shall be cancelled.

MONITORING AND EVALUATION

83. MEF is responsible for the implementation of the DPL operation. As the main implementing agency, MEF will coordinate with other Government agencies involved in the implementation of the DPL, including Ministry of Social Development, *Metas Presidenciales*,

MINSA, IDAAN and the Vice Ministry of Indigenous People. Together with MEF and the National Institute of Statistics, these institutions collect the data for the monitoring indicators. MEF and the IBRD have agreed to monitor program progress supported by the DPL series.

84. **The World Bank has Grievance Redress process in place.** Communities and individuals who believe that they are adversely affected by specific country policies supported as prior actions or tranche release conditions under a World Bank Development Policy Operation may submit complaints to the responsible country authorities, appropriate local/national grievance redress mechanisms, and/or the WB's Grievance Redress Service (GRS). The GRS ensures that complaints received are promptly reviewed in order to address pertinent concerns. Affected communities and individuals may submit their complaint to the WB's independent Inspection Panel which determines whether harm occurred, or could occur, as a result of WB non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the World Bank's attention, and Bank Management has been given an opportunity to respond. Information on how to submit complaints to GRS can be found at <http://www.worldbankorg/GRS>. Information on how to submit complaints to the World Bank Inspection Panel can be found at visit www.inspectionpanel.org.

6. SUMMARY OF RISKS AND MITIGATION

85. **This risk assessment suggests that this operation entails a moderate level of risk.** The most relevant risks to the achievement of the Program Development Objectives for this operation include macroeconomic risks, risks associated with sector strategies and policies, institutional capacity for implementation, and specific political and social risks associated with the strengthening of the institutional framework for Indigenous Peoples' inclusion.¹⁸ On the macroeconomic risk, there are risks associated with collecting lower than expected fiscal revenue that might compromise the financing needs of the programs supported by this operation. However, the risks are moderate given Government's commitment on fiscal consolidation, including savings from reducing energy subsidies.

86. **Risks associated with political environment, governance and stakeholders are substantial.** It is mainly related to the actions to strengthen the institutional framework for the inclusion of Indigenous Peoples. Lack of political will and inability to prioritize resources could lead to the laws supported by this operation not being passed by the National Assembly, the National Development Plan for Indigenous Peoples not being included in the five-year National Investment Plan, and the implementation of the Plan getting delayed or not funded. To mitigate these risks, the Government is trying to create broad support in the Executive Branch and the civil society through extensive consultations to promote the approval of the laws, and exploring different financing mechanisms and emphasizing the need for long term financing. The Ministry of Government is promoting the inclusion of the National Development Plan for Indigenous Peoples both as part of their Ministerial strategy as well as through a project submitted to MEF's Project Bank. This project would allow them to prepare for the implementation of the Plan.

¹⁸ According to the Standardized Operations Risk-rating Tool, risks can be classified under nine categories: political and governance, macroeconomic, sector strategies and policies, technical design of program, institutional capacity for implementation and sustainability, fiduciary, environment and social, stakeholders, and others.

87. **Risks associated with sectoral strategy and policies are moderate.** The Government’s sectoral strategy to reach Indigenous Peoples is currently not well articulated or funded and the participation of traditional authorities in policy making is weak. The Government aims to mitigate this risk by undertaking reforms that support the necessary institutional pillars to enhance Indigenous Peoples’ participation and coordination. In addition, the lack of a long term vision, clear leadership, and a weak institutional and legal framework in the water and energy sectors also pose risks to the operation. In the water sector, the Government is responding to this by creating the UTM to address structural challenges in IDAAN. In the energy sector, the Government is engaging with the World Bank team to identify key governance challenges and elaborate an action plan to resolve these.

88. **Risks associated with institutional capacity for implementation are moderate.** The Vice Ministry of Indigenous Peoples has low capacity to design and implement programs and coordinate with external actors. To mitigate this risk, the Government will provide capacity building and close accompaniment to these institutions for at least the first years of existence. Water and energy sectors also have low institutional and financial capacity to implement reform and enforce regulation. The Government is engaging with the World Bank team to elaborate a strategy to strengthen institutional capacity. Finally, MEF lacks institutional capacity to support users in the rollout of ISTMO. To mitigate this risk, short-term consultants were hired to train staff for the transition.

Table 5: Standardized Operations Risk-rating Tool for the DPL Series in Panama

Risk Categories	Rating
1. Political and governance	Substantial
2. Macroeconomic	Moderate
3. Sector strategies and policies	Moderate
4. Technical design of project or program	Low
5. Institutional capacity for implementation and sustainability	Moderate
6. Fiduciary	Low
7. Environment and social	Low
8. Stakeholders	Substantial
9. Other	
Overall	Moderate

ANNEX 1: POLICY AND RESULTS MATRIX

Prior actions and (Indicative) Triggers			Results
Prior Actions under DPL 1	(Indicative) Triggers for DPL 2	(Indicative) Triggers for DPL 3	Medium term results indicators
I. Expanding inclusion and opportunities			
<i>Objective 1: Strengthening the institutional framework and programs for inclusion and opportunities of Indigenous Peoples' development</i>			
	<p>(Indicative) Trigger #1: The Government has institutionalized the National Council of Indigenous Peoples as the primary national consultative body which integrates the Indigenous Peoples for participation in Government processes.</p> <p>(Indicative) Trigger #2: The Government has amended <i>Red de Oportunidades</i> to respond to culturally differentiated needs of Indigenous People.</p> <p><i>Ministry of Government, Viceministry of IP, MIDES (Ministry of Social Development)</i></p>	<p>(Indicative) Trigger #1: The Government has approved a law incorporating the actions of the National Development Plan for Indigenous Peoples.</p> <p>(Indicative) Trigger #2: The Government has adopted institutional actions to strengthen capacity for the preparation of projects in line with the National Development Plan for Indigenous Peoples.</p> <p>(Indicative) Trigger #3: The Government has rolled out culturally differentiated programs for beneficiaries of <i>Red de Oportunidades</i> nationally.</p> <p><i>Ministry of Government, Viceministry of IP, MIDES</i></p>	<p>Result: Institutional structure for the coordination among Indigenous Peoples and their participation in Government processes in place and culturally differentiated programs available for Indigenous Peoples.</p> <p>Indicator: Number of projects prepared in line with the National Development Plan for Indigenous Peoples. (Baseline 2014: 0; target 2017:3)</p> <p>Indicator: Culturally differentiated programs in health and education are available for beneficiaries of <i>Red de Oportunidades</i>. (Baseline 2014: standard programs; target 2017: differentiated programs)</p>
<i>Objective 2: Expanding opportunities for youth</i>			
<p>Prior Action 1: The Government has increased payment incentives to the beneficiaries of the <i>Beca Universal</i> program differentiated by schooling level (<i>primaria, pre-media, media</i> cycles).</p> <p><i>Evidence: law 14, August 2014.</i></p>	<p>(Indicative) Trigger #3: The Government has strengthened the monitoring and evaluation of the education system by (a) mandating the application of the monitoring and evaluation framework of the <i>Beca Universal</i> program; and (b) participating in the 2015 Program for International Student</p>	<p>(Indicative) Trigger #4: In response to evaluation reports, the Government has improved (a) the performance of the <i>Beca Universal</i> Program; and (b) secondary education policies.</p>	<p>Result: Improved monitoring and evaluation reporting on the performance of <i>Beca Universal</i>.</p> <p>Indicator: Semiannual monitoring and evaluation reports are produced on the performance of <i>Beca Universal</i>. (Baseline 2014: 0; target 2017: 2)</p>

<p>Agency: IFARHU</p>	<p>Assessment which aims to evaluate education systems worldwide. Agency: MEDUCA</p>	<p>IFARHU</p>	
<p>Prior Action 2: The Government has (a) piloted a vocational training program <i>ProJoven</i> that provides on the job training to graduates of the technical branch of secondary education; and (b) legally created a new set of baccalaureates, including the creation of curricula consistent with labor market demands.</p> <p>Evidence: <i>Convenio MITRADEL and MEDUCA; Decreto Ejecutivo 21, January 2014.</i></p> <p>Agency: MITRADEL MEDUCA.</p>	<p>(Indicative) Trigger #4: The Government has (a) developed the curricula for the new technical baccalaureates; and (b) piloted the program <i>Panama bilingüe</i> and trained teachers in bilingual teaching.</p> <p>MITRADEL MEDUCA.</p>	<p>(Indicative) Trigger #5: The Government has (a) completed the roll out of the <i>ProJoven</i> program nationally; (b) approved and implemented the employment strategy with a focus on youth; and (c) rolled out all three components (teacher training, after school program, and pre-school component) of <i>Panama bilingüe</i> nationally.</p> <p>MITRADEL MEDUCA.</p>	<p>Result: Improved youth skills for participation in the labor market.</p> <p>Indicator: 20 percent of students of technical secondary education have graduated from <i>ProJoven</i>. (Baseline 2014:0; target 2017: 20)</p>
<p>Objective 3: Expanding the coverage and improving the targeting and quality of social protection for the poor</p>			
<p>Prior Action 3: The Government has expanded the coverage and the benefits of the social protection program for the elderly without pension (<i>120 a los 65</i> program) to provide 120 B/. monthly.</p> <p>Evidence: <i>law 15, September 2014.</i></p> <p>Agency: MIDES</p>	<p>(Indicative) Trigger #5: The Government has (a) introduced a new payment modality by paying out benefits of <i>Red de Oportunidades</i> through the banking system; and (b) piloted a financial training for the beneficiaries of social protection programs.</p> <p>MIDES</p>	<p>(Indicative) Trigger #6: The Government has (a) rolled out nationwide the recertification of beneficiaries of the <i>Red de Oportunidades</i> program; and (b) rolled out the financial training program nationally.</p> <p>MIDES</p>	<p>Result: Improved targeting and management of social programs.</p> <p>Indicator: Percent of elderly aged 65 or older without other pension receive benefits from the <i>120 a los 65</i> program. (Baseline 2014: 27 percent; target 2017: 42)</p> <p>Indicator: The Government provides <i>Red de Oportunidades</i> transfers through the banking system. (Baseline 2014: 0; target 2017: 60 percent of funds)</p>

II. Improving service delivery			
Objective 1: Improving water and sanitation management			
<p>Prior Action 4: The Government has (a) created a management unit within the <i>Secretaria de Metas Presidenciales</i> to carry out a basic sanitation plan to provide 100 percent access to drinking water and 0 latrines; and (b) launched a standardized information system for improving the monitoring of water management in rural areas.</p> <p><i>Evidence: Executive Decree N°1221; signed agreement on the adoption of SIASAR</i></p> <p><i>Agency: MINSA/Secretaria de Metas Presidenciales, DISAPAS (MINSA)</i></p>	<p>(Indicative) Trigger #6: The Government has (a) implemented the basic sanitation plan to provide 100 percent access to drinking water and 0 latrines in pilot regions; and (b) has approved a strategy for institutional and tariff reforms of IDAAN.</p> <p><i>MINSA/Secretaria de Metas Presidenciales/IDAAN</i></p>	<p>(Indicative) Trigger #7: The Government has (a) rolled out the standardized information system nationwide; and (b) implemented the institutional and tariff reforms of IDAAN.</p> <p><i>MINSA/Secretaria de Metas Presidenciales/IDAAN</i></p>	<p>Result: Improved access to basic sanitation and improved monitoring of rural water management.</p> <p>Indicator: The basic sanitation plan has at least 30,000 households as beneficiaries. (Baseline 2014: 0, target 2017: 30,000)</p> <p>Indicator: 50 percent rural water boards are connected to SIASAR. (Baseline 2014: 400, target 2017: 5000)</p>
Objective 2: Securing sustainable and reliable energy provision			
<p>Prior Action 5: The Government has approved (a) a resolution for the adjustment of electricity tariff subsidies; and (b) a law establishing a regime of incentives to increase the share of renewable energy in the power generation matrix.</p> <p><i>Evidence: Cabinet resolution 177, December 2014; Law 37, June, 2013.</i></p> <p><i>Agency: Secretary of Energy, National Electricity Transmission Company, ASEP</i></p>	<p>(Indicative) Trigger #7: The Government has approved a national energy efficiency program designed to reduce energy consumption.</p> <p><i>Secretary of Energy</i></p>	<p>(Indicative) Trigger #8: The Government has taken measures to reform the institutional and regulatory framework of the energy sector.</p> <p><i>Secretary of Energy</i></p>	<p>Result: More sustainable and reliable energy provision.</p> <p>Indicator: Average hours of electricity outages/year are reduced. (Baseline 2014: 53; target 2017: 36.7, annual average)</p>

III. Modernizing fiscal management			
Objective 1: Strengthening the financial planning of Government resources			
<p>Prior Action 6: The Government has (a) approved the introduction of the Single Treasury Account; and (b) channeled all funds of the treasury and MEF through the Single Treasury Account.</p> <p><i>Evidence: Law 56, September 2013 and Law 19, September 2014.</i></p> <p><i>Agency: Treasury</i></p>	<p>(Indicative) Trigger #8: The Government has (a) channeled all the funds of the accounts of public service entities in Education, Health and Social protection of the Central Government through the Single Treasury Account; and (b) rolled out the newly designed financial planning and budgeting system, ISTMO, in Central Government entities.</p> <p><i>Treasury, Dirección Nacional de Contabilidad, MEF</i></p>	<p>(Indicative) Trigger #9: The Government has (a) channeled the remained funds of the public sector to the Single Treasury Account; and (b) rolled out the ISTMO program to all public sector entities.</p> <p><i>Treasury, Dirección Nacional de Contabilidad, MEF</i></p>	<p>Result: Increased transparency of Government transactions and improved cash management of Government resources.</p> <p>Indicator: Share of central government and decentralized entities funds channeled through a Single Treasury Account is increased. (Baseline 2014: 0; target 2017: 100% for Central Government funds and 85% for decentralized Government entities.)</p> <p>Indicator: Financial statements for budget execution are automatically generated for Central Government entities. (Baseline 2014: no; target 2017: automatic generation)</p>
Objective 2: Increasing the Government's ability to manage fiscal risks from disasters			
<p>Prior Action 7: The Government has approved a policy for managing fiscal risks related to natural disasters which includes the identification and evaluation of fiscal risk from disasters; the integration of disaster risk analysis into public investment planning; and the design of risk retention and risk transfer tools.</p> <p><i>Evidence: executive decree 578, November 2014.</i></p> <p><i>Agency: DICRE</i></p>	<p>(Indicative) Trigger #9: The Government has operationalized the policy through the approval of the five-year operational plan.</p> <p><i>DICRE</i></p>	<p>(Indicative) Trigger #10: The Government has taken actions in line with the five-year operational plan</p> <p><i>DICRE</i></p>	<p>Result: Increased ability of the Government to manage fiscal risks from disasters.</p> <p>Indicator: Availability of contingent financing instruments is increased. (Baseline 2014: 5 instruments and mechanisms; target 2017: 2 additional instruments)</p>

ANNEX 2: LETTER OF DEVELOPMENT POLICY—Draft



República de Panamá
Ministerio de Economía y Finanzas
Despacho del Viceministro de Economía
Apartado 0816-02886

January 19, 2015
DdCP/FO/022

Mr.
Jim Yong Kim
World Bank
Washington D.C.

Ref: Letter of Development Policy for the First Programmatic Shared Prosperity Development Policy Loan

Dear Mr. Kim:

Panama's new Government took office in July 2014 and has swiftly begun implementing a reform plan with development goals for human development, sustainable economic growth, and institutional strengthening.

I. The Strategic Government Plan

This Government announced a reform plan with a focus on human development, sustainable economic growth and institutional strengthening. The Government's plan centers on five pillars:

- Fostering wellbeing and human development.
- Strengthening democracy and rule of law.
- Fostering sustainable economic development.
- Ensuring citizen security.
- Protecting the environment.

Within the first pillar, the Government emphasizes culturally appropriate development of Indigenous Peoples, promotes youth employment, and invests in signature projects such as the basic sanitation plan "100/0" that provides potable water to 100 percent of Panamanian households and leaves zero latrines. Under the second pillar, the Government focuses on increasing transparency and promoting decentralization. The third pillar comprises policies to enhance fiscal sustainability, the efficiency of public service provision, and the sustainability and efficiency of energy supply, among others. The fourth pillar supports citizen security through prevention, institutional strengthening, and victim protection. Within the fifth pillar, the Government

focuses on disaster risk management and protection of the environment, for example in the form of biodiversity.

II. Macroeconomic policy

Maintaining macro-fiscal stability is the highest priority of this administration. The macroeconomic policy pursued since the beginning of the current administration, is aimed at ensuring economic stability, strengthening the investment climate through healthy and prudent management of public finances and prioritizing social investment.

Panama has recovered from the 2008 global financial crisis faster than other countries in the region. While most countries have not yet been able to return to their pre-crisis growth rates, Panama realized higher rates of economic growth following the global crisis than preceding it (9.4 percent on average over 2010-2013, compared with 7.0 percent on average between 2002-2007). The key drivers of this growth performance are strong public investment, a parallel increase in Foreign Direct Investment (FDI) and private investment in general, and the continued importance of the Panama Canal and its expansion, which has fed back into other sectors, including transport and logistics as well as the financial sector. The strong growth performance has started to moderate since 2013, but remains at high levels.

On the public finance side, Panama's fiscal deficit is expected to narrow in the medium term. Even though the Government has amended the fiscal ceiling few times in the recent past, this law has helped the Government to conduct its fiscal policy in a prudent manner given that any increase needs to be approved by the Congress. Thus, the Government is committed to reach its fiscal deficit goal of below 1 percent of GDP before 2018 as it is mandated by the Social Fiscal Responsibility Law.

III. Objectives and components of the program

The Development Policy Loan will provide important support to the Government's strategic plan, in particular with regards to promote human development, sustainable economic growth, and institutional strengthening, through the following actions:

- **Expanding inclusion and opportunities**

The Government is supporting key steps that Indigenous Peoples have articulated, consulted upon and prioritized to strengthen inclusion and opportunities for Indigenous Peoples. The Government is committed to use the momentum created by the formulation of Indigenous Peoples' National Development plan and agreement between different Indigenous Groups on this plan. The Indigenous Peoples' National Development Plan in Panama was elaborated by a round table including a representative from each Indigenous Peoples' Congress or Council, a representative from the Executive Branch and a representative from the National Assembly. After an 18-month process of comprehensive consultations in all the Indigenous Peoples territories and a national conciliation and prioritization process, the Platform produced the Indigenous Peoples' National Development Plan as well as a proposed law to convert the Platform into a legally established permanent advisory and coordination Council for Indigenous Peoples.

To improve inclusion and opportunities for Indigenous Peoples, the Government is strengthening the institutional framework, is building capacity, and is culturally differentiating existing social programs. In

terms of strengthening the institutional framework for the coordination among different Indigenous Peoples at the national level and their participation in Government processes, the Government is taking three major steps: 1) the legal establishment of the National Indigenous Peoples Council; 2) the upgrading of the Vice Ministry of Indigenous Affairs into a Ministry; 3) the approval of the national development plan as law to ensure the commitment to the inclusion and opportunities of Indigenous Peoples according to their cultural identity beyond the current administration. As this topic has been neglected in the past and has created tensions this institutional reform effort will be accompanied by a thorough consultation process with the civil society to ensure a broad consensus in Panama. In terms of capacity building, the Government is preparing capacitation for key stakeholders within relevant sectoral ministries and indigenous representations to ensure that they can accompany the project cycle to ensure an efficient use of public resources spent following the priorities defined in the Indigenous Peoples' National Development Plan. Finally, the Government is adjusting existing social protection programs such as Red de Oportunidades according to specific needs and the cultural identity of Indigenous Peoples.

The Government has launched ProJoven Panama, and has updated the system of baccalaureates to align the skill set of young graduates more closely with labor market demand. The program aims to give graduates a chance to foster their technical skills to facilitate their transition into the labor market, and help them attain a level sufficient to start university studies. The Government has also approved and implemented a selection of new baccalaureates including science, engineering, business, etc., with the aim of updating and providing education and training for the youth that better respond to labor market needs. Furthermore, the Government has increased payments of the Conditional Cash Transfer program Beca Universal and differentiated them by student grade level. It is estimated that a half million Panamanian students will benefit from the increase.

The Government has expanded the coverage and the benefit of the 100 a los 70 program, which became 120 a los 65 through law 15 of September 1, 2014. It is estimated that over 30,000 people will receive the benefit, further reducing poverty. The Government has also transformed the role of social workers to improve the quality of assistance to the poor. Furthermore, social workers will also provide training to beneficiaries for certain programs. For example, the Government is planning a banking strategy of social program to promote financial inclusion; once launched, social workers will be giving training to the beneficiaries to access the benefits. In addition, the Government has initiated the recertification of Red de Oportunidades. This will significantly reduce targeting errors and ensure an appropriate expansion of a very progressive scheme.

- **Improving service delivery**

The new Government has made water sanitation services a priority and has made progress in increasing access to water and improving sanitation services. With the ultimate goal of improving quality of life by providing reliable water 24 hours a day and eliminating the use of latrines, the Government has launched the basic sanitation plan "100/0". Despite the relatively well designed legal framework, the sector has a number of institutional weaknesses, including unclear roles among the different sector actors, lack of coordinated investment, weak regulatory capacity and limited operational and financial autonomy of the Instituto de Acueductos y Alcantarillados Nacionales (IDAAN). The Government has initiated the modernization process of IDAAN by establishing the Transformation and Modernization Unit, responsible for identifying and addressing structural institutional issues that are preventing IDAAN to increase its efficiency.

Through the Secretary of Energy, the Government has taken steps to increase the efficiency of the energy sector through the removal of tariff distortions. It has identified the main distortions associated with electricity tariffs and has formed a committee to elaborate a plan for subsidy adjustments. In the last five years the government has taken steps to put in place incentives for the promotion, development, and use of a wider range of alternatives. This has included Law 44 (2011) and Law 37 (2013) which establishes the framework for wind, solar, and other sources. In part, due to the policy measures, a number of renewable energy projects have been contracted.

- **Modernizing fiscal management**

A major challenge in Panama is the lack of a centralized treasury account for Government revenues and expenses which would allow better management of public resources and an adequate evaluation of how resources are transferred. In addition, available technology could be further enhanced in order to become an integrated system for Government resource planning. Both actions would increase transparency in different areas, and would reduce public perception of corruption present in the Government. The Government has taken measures to introduce a Single Treasury Account and implement a new integrated information model, based on the unity of cash principle and on the centralized administration by the National Treasury of the public funds.

In addition, the Government has taken measures to cover the fiscal risk due to the impact of natural disasters. The Investment Office, the Dirección de Inversiones, Concesiones y Riesgos del Estado (DICRE), has designed the strategic framework that defines the guiding policy framework to cover the fiscal risk due to the impact of natural disasters. The ultimate goal of better disaster risk management is to contain fiscal risk when facing natural disasters by having a set of financial instruments and procedures in place.

The support of the World Bank will be essential to implement the above mentioned actions and to support the ambitious strategic objectives that the Government has set for itself.

The Government of the Republic of Panama requests the approval of the program.

Yours sincerely,


Duicidío De La Guardia
Minister
DDLG/KCVMRC



ANNEX 3: FUND RELATIONS ANNEX



INTERNATIONAL MONETARY FUND
WASHINGTON, D.C. 20431

Facsimile Number
1-202-623-4661

January 16, 2015

Mr. John Panzer
Director
Macroeconomics and Fiscal Management Global Practice
The World Bank
1818 H St N.W.
Washington D.C. 20433

Dear Mr. Panzer:

Attached is the assessment letter requested by the World Bank for the "First Programmatic Shared Prosperity Development Policy Loan."

In keeping with previous practice, the letter cannot be included in any document intended for publication, without the consent of the Panamanian authorities.

Sincerely yours,

A handwritten signature in blue ink, appearing to read "Alejandro Werner".

Alejandro Werner
Director
Western Hemisphere Department

Attachment

cc: SPR

PANAMA—ASSESSMENT LETTER FOR THE WORLD BANK

January 16, 2015

This letter updates the assessment contained in the 2014 Article IV Consultation staff report dated May 9, 2014. A staff visit took place during September 23–26, 2014.

1. **Panama's economy slowed down in 2013 after the strong expansion of 2011–12, but growth remains robust.** GDP grew by 8.4 percent in 2013 and is estimated to grow at about 6½ percent in 2014. The slowdown mainly reflects a contraction in Colon Free Zone activity (in part associated with difficulties in trade relations with Venezuela and Colombia), a deceleration in the construction sector—including delays in the Canal expansion—and an overall slowdown in public investment from the high levels of the past several years. Headline inflation declined to 1 percent y/y in December from 3.7 percent at the end of 2013, owing mainly to lower oil prices and price controls (imposed on 22 food items since July). Buoyant FDI inflows, including in the mining and energy sector, are projected to continue to finance most of the current account deficit (estimated at about 11 percent of GDP for 2014). The banking sector is generally healthy: banks are well capitalized, profitable, and liquid.
2. **Downside risks to the baseline outlook mostly relate to the potential for external shocks.** A protracted slowdown in trading partners or an abrupt surge in global financial volatility would have a substantial economic and financial impact, but Panama's relatively strong fundamentals give it scope to manage well such risks.
3. **A tighter fiscal stance would be desirable to build additional fiscal buffers against external shocks.** For the first three quarters of 2014, the fiscal deficit reached 4.4 percent of GDP. The annual deficit is expected to be about 4 percent of GDP, exceeding the ceiling (2.7 percent of GDP) imposed by Social and Fiscal Responsibility Law (SFRL). In 2015, the deficit is likely to reach about 3½ of GDP, again above the 2 percent ceiling but within the special provision of the SFRL law that permits a larger deficit if revenues from the canal are lower than provided for in the SFRL. Going forward, it will be important for Panama to develop a multi-year strategy to safeguard the credibility of the SFRL, and to reverse both the substantial drop in revenues and the increase in current expenditures that has been seen since 2013.
4. **The authorities are strengthening financial transparency and financial sector supervision, in line with IMF staff recommendations.** An AML/CFT assessment conducted by IMF staff in 2012 highlighted significant shortcomings. Panama was included in the Compliance Document by the FATF in June 2014. The authorities are actively working to address the AML/CFT deficiencies and to improve transparency, with the goal of making Panama compliant with FATF requirements by mid-2015. Ensuring continued progress on this front is of paramount importance.
5. **Medium-term economic potential is supported by the ongoing Canal expansion, as well as private investments in the mining, energy and logistics sectors.** Foreign direct investments in copper mining are expected to further diversify the economy, increase revenues, and foster growth. Well-planned investments in the energy sector, with private sector participation, would help reduce the cost of energy and facilitate savings in the public sector. Going forward, further improvements in training, education, and health care will be necessary to complement capital investment, raise productivity, facilitate job reallocation, and improve living standards.

Table 1. Panama: Selected Economic and Social Indicators

Population (millions, 2013)	3.9	Poverty line (percent, 2011)	27.6			
Population growth rate (percent, 2013)	1.6	Adult literacy rate (percent, 2010)	94.0			
Life expectancy at birth (years, 2011)	76.0	GDP per capita (USD, 2013)	10,474			
Total unemployment (March 2014)	4.3	IMF Quota (SDR, million)	206.6			
			Est. Proj.			
	2010	2011	2012	2013	2014	2015
	(Percent change)					
Production and prices						
Real GDP (1996 prices) 1/	7.5	10.8	10.7	8.4	6.3	6.8
Consumer price index (average)	3.5	5.9	5.7	4.0	2.6	2.3
Consumer price index (end-of-year)	4.9	6.3	4.6	3.7	1.0	2.4
Domestic demand (at constant 1996 prices) 1/						
Public consumption	15.3	1.6	5.9	4.9	20.3	4.8
Private consumption	27.4	19.3	-3.6	11.0	8.3	8.8
Public investment 2/	23.3	34.9	26.4	14.3	-8.7	-13.0
Private investment	5.9	11.8	9.7	11.3	15.9	15.3
Financial sector						
Private sector credit	13.6	16.8	14.1	12.1	9.0	9.0
Broad money	11.6	7.8	10.4	8.8	9.5	10.0
Average deposit rate (1-year)	2.9	2.1	2.2	2.1
Average lending rate (1-year)	7.5	6.9	7.2	7.2
External trade						
Merchandise exports	12.8	29.4	35.9	-8.8	4.7	-0.4
Merchandise imports	18.9	42.3	5.5	5.9	4.4	-0.7
	(In percent of GDP)					
Saving-investment balance						
Gross domestic investment	25.5	27.2	28.6	30.0	29.8	29.3
Public sector	12.0	12.8	12.9	13.7	11.6	9.4
Private sector	13.5	14.4	15.7	16.3	18.2	19.9
Gross national saving	14.2	11.3	18.8	17.8	19.0	19.1
Public sector	8.0	8.1	7.8	7.5	4.2	2.9
Private sector	6.2	3.2	11.0	10.3	14.8	16.2
Public finances 2/						
Revenue and grants	29.5	29.0	28.9	28.0	26.5	25.3
Expenditure	33.0	33.4	32.2	33.1	33.1	30.8
Current, including interest	21.0	20.6	20.1	19.4	21.4	21.5
Capital	12.0	12.8	12.1	13.7	11.6	9.4
Overall balance, including ACP 3/	-3.5	-4.4	-3.3	-5.0	-6.5	-5.6
Overall balance, excluding ACP 3/	-1.8	-2.1	-1.5	-3.0	-4.3	-3.6
External sector						
Current account	-11.4	-15.9	-9.8	-12.2	-10.8	-10.2
Net exports from Colon Free Zone	1.8	0.8	1.5	2.5	1.9	1.5
Net oil imports	1.0	1.4	0.2	0.8	1.0	0.7
Foreign direct investment	8.9	9.4	9.1	10.8	9.2	8.9
Total public debt						
Total debt 2/	44.1	43.8	42.6	41.6	45.0	45.9
External 2/	39.7	37.7	32.9	33.1	36.2	35.4
Domestic	4.4	6.1	9.7	8.5	8.9	10.5
Memorandum items:						
GDP (in millions of US\$, current price, 1996-base) 1/	27,053	31,320	35,938	40,471	44,570	49,171
GDP (in millions of US\$, current price, 2007-base) 1/	28,814	33,271	37,956	42,648	46,968	51,816

Sources: Comptroller General, Superintendency of Banks and IMF staff estimates.

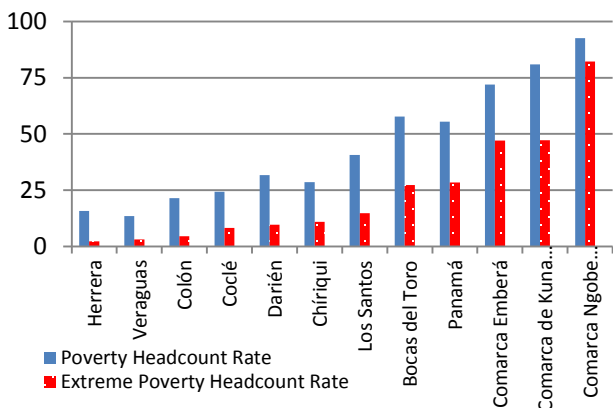
1/ Complete national accounts data are not available and staff GDP ratios and projections are still based on GDP with base year of 1996. GDP figures are being revised upward. The revision encompasses changing the base year from 1996 to 2007 as well as enhancing the computation methodology due to the implementation of key recommendation of the new 2008 System of National Accounts (2008 SNA). The upward revision to nominal GDP is between 5.6 to 8.2 percent, depending on the year.

2/ Includes Panama Canal Authority (ACP).

3/ Starting from 2015, includes overspending allowed under Article 34 of Law 38 of 2012.

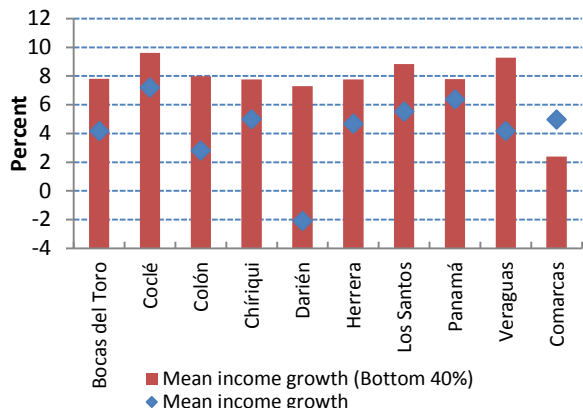
ANNEX 4: POVERTY AND SERVICE DELIVERY

Figure A1. Poverty Head Count (Percent, 2012)



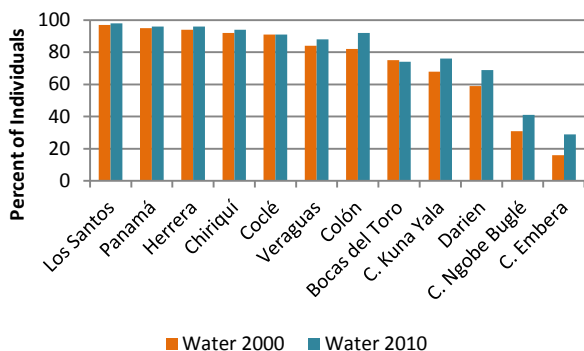
Source: World Bank staff estimations based on Panama household surveys 2012.

Figure A2. Shared Prosperity (Mean income growth, percent, 2007-2012)



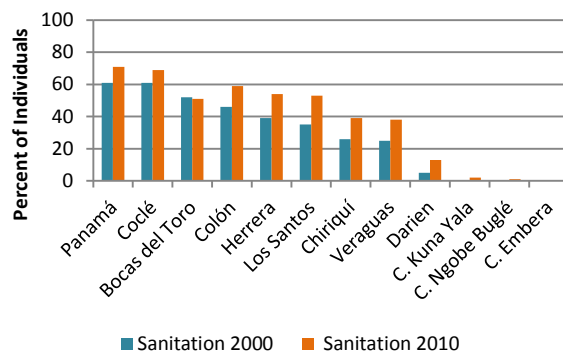
Source: World Bank staff estimations based on Panama household surveys 2007 and 2012.

Figure A3. Change in Access to Piped Water in the Dwelling, 2000-2010



Source: Authors' calculations based on Panama 2000 and 2010 Population and Housing Censuses

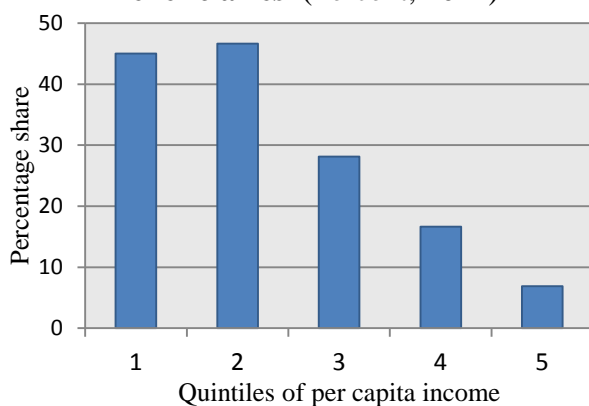
Figure A4. Change in Access to Sewage Connection in the Dwelling, 2000-2010



ANNEX 5: POVERTY AND SOCIAL IMPACT ANALYSIS

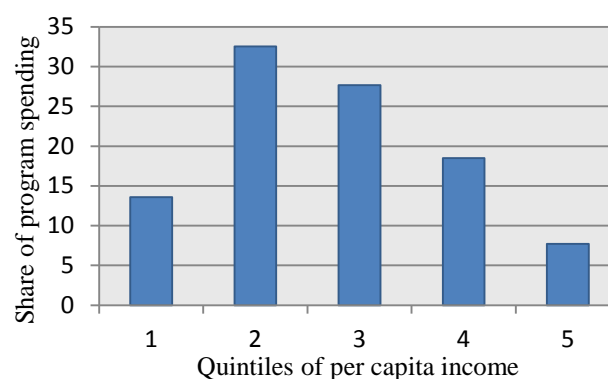
The extension of the non-contributory pension scheme is expected to significantly reduce poverty among the elderly and poverty in the general population slightly. For households with members that receive pensions, the share of the pension of total per capita income of households in the lowest two quintiles is over 40 percent, showing that pensions are an important resource for the poor. Regarding its impact on poverty, the extension of the pension program from *100 a los 70* to *120 a los 65* would reduce poverty rates among the population of age 65 and above from 13.9 percent to 7.4 percent, and poverty rates among the general population from 25.9 percent to 24.6 percent. Although the poverty rate among the elderly is slightly higher for males than females, the impacts of the reform are slightly larger on female beneficiaries than males as is shown in Table 5. Rates of extreme poverty would be reduced in a similar way.

Figure A5. Average Share of Pensions in per Capita Income for Households with Beneficiaries (Percent, 2012)



Source: World Bank staff estimations based on Panama household surveys 2012.

Figure A6. Share of Total Pension Expenditures by Quintile



Source: World Bank staff estimations based on Panama household surveys 2007 and 2012.

Table A1: Poverty Impact of Extending *100 a los 70* to *120 a los 65*
(Poverty headcount, in percent)

	All individuals Current results	Poverty after enrolling all elderly	Poverty among 65 and older	Poverty among 65 and older after enrolling all elderly
Overall Poverty				
All	25.91	24.64	13.83	7.38
Male	25.75	24.32	15.77	8.28
Female	26.06	24.94	12.14	6.6
Extreme Poverty				
All	11.14	10.53	3.88	1.68
Male	11.10	10.50	4.67	2.03
Female	11.18	10.55	3.19	1.38

Source: World Bank staff calculations.

However, extending the benefits to all elderly above 65 without additional pensions is a regressive measure, as poverty is less prevalent among the elderly than among the younger population groups. The aim of the *120 a los 65* program is to provide pensions to individuals

receiving no other pension, and living in poverty, vulnerability or marginalization. However, in practice, only individuals with pension income from another source are excluded from the program. In fact, both the elderly and the elderly without other pensions are predominantly found in the middle and higher income deciles. Therefore, reducing poverty through the non-contributory and de facto non-targeted pension program comes at a large fiscal cost. The share of total pension expenditures by quintile shows that about 45 percent of transfers are spent among the first two income quintiles and 26 percent among the two richest quintiles, confirming that there is still scope for improving targeting considering the importance of benefits for household income of the poorest against that of the richest.

Table A2: Poverty Impact of Electricity Tariff Changes
(Poverty headcount, in percent)

	Before	After
Extreme poor	17.5	17.7
Moderate poor	15.0	15.0
Non poor	67.5	67.3
Total	100	100

Source: World Bank staff calculations.