PROGRAM INFORMATION DOCUMENT (PID)
APPRAISAL STAGE

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Report No.: AB7854

Operation Name	Panama Second Shared Prosperity Development Policy Loan
Region	Latin America and the Caribbean
Country	Panama
Sector	General energy sector (20%); General education sector (20%); Sanitation (20%); Public administration- Other social services (20%); Central government administration (20%)
Operation ID	P154819
Lending Instrument	Programmatic Development Policy Financing
Borrower(s)	Republic of Panama
Implementing Agency	Ministry of Economy and Finance
Date PID Prepared	July 11, 2016
Estimated Date of Appraisal	July 8, 2016
Estimated Date of Board Approval	September 8, 2016
Corporate Review Decision	Following the corporate review, the decision was taken to proceed with appraisal of the operation.

I. Country and Sector Background

Panama is an upper middle income country with a GDP of about US$46 billion and a per capita gross national income of about US$ 11,130, compared to a Latin America and the Caribbean (LAC) average of US$9,000. Panama is a multi-ethnic country with a population of about 3.8 million, and, with an area of 75,420 square kilometers. The economy is service-oriented and over 75 percent of the population live in the urban areas.

Over the past 15 years, sound macroeconomic and structural policies have contributed to remarkable economic growth and poverty reduction in Panama. In 2015, GDP expanded by 5.8 percent in Panama, compared to a contraction of 0.1 percent in the Latin American and the Caribbean (LAC) region. More generally, over the 2008-15 period, Panama grew by 6.9 percent on average, outpacing the LAC average (2.6 percent) and that of emerging and developing economies (5.2 percent). High economic growth helped to reduce the poverty rate (US$4 per day poverty line) from 26.2 percent in 2008 to 18.7 percent in 2014. Moreover, growth was widely shared, with the income of the bottom 40 percent of the population growing faster than that of the national average. As a result, Panama's Gini coefficient in 2014 (0.51) was 2.5 percentage points lower than in 2008. Nonetheless, challenges in social inclusion persist. Notably, extreme poverty continues to be concentrated in indigenous areas. Moreover, the Panamanian youth, with limited education and low attainment rates, is facing significant labor market challenges and is vulnerable to crime and violence. Finally, large inequalities remain in access to basic services, including electricity, water, and sanitation.

Panama continues to have a sound macroeconomic policy framework. The country's high external current account deficit of the past few years, driven to a large extent by the Panama Canal expansion and other infrastructure works, is projected to narrow gradually to 6 percent of GDP by 2018 and will continue to be mostly financed by foreign direct investment (FDI). Panama's inflation is projected to remain low during 2016-2018 (in the 1 to 2 percent range). On the fiscal front, the public debt levels are at manageable levels, around 38 percent of GDP in 2015. Moreover, the expected reduction of the fiscal deficit from 2.3 percent of GDP in 2015 to 1.5 percent by 2018, in line with the targets set forth in the Social and Fiscal Responsibility Law (SFRL), will provide additional maneuvering space. Fiscal consolidation will also be supported by reforms aimed at strengthening fiscal and public financial management, including the reduction of electricity subsidies and improvements in tax administration.

Panama has made progress in strengthening legislation on Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT). In February 2016, was removed by the inter-governmental Financial Action Task Force (FATF) from its "Grey List" of countries with inadequate legal provisions on these matters. Similarly, in October 2015, the Organization for Economic Co-operation and Development's (OECD) Global Forum on Transparency and Exchange of Information for Tax Purposes accepted Panama into Phase 2 of the tax information exchange process. However, recent events have highlighted the need to bring the framework for international tax transparency closer to accepted international standards and ensure the effective implementation of the recently-adopted AML/CFT legal regime. In April 2016, 11.5 million documents were leaked from a private legal firm based in Panama. This was followed in May 2016 by the revelations regarding the alleged involvement of a Panamanian conglomerate in money laundering and drug trafficking activities. The weaknesses in the AML/CFT implementation and the shortcomings in the area of international tax transparency, highlighted by the recent events, will likely create challenges for the October 2016 Global Forum review of the country's progress under Phase 2 and the forthcoming assessments by both FATF and the OECD in mid-2017 of the country's transparency and financial integrity frameworks.

II. Operation Objectives

The proposed operation is the second in a series of three Development Policy Financing (DPF) operations supporting the Government's program aimed at (i) strengthening the frameworks for international tax transparency, financial integrity, and fiscal management; (ii) strengthening institutional arrangements to support social assistance and education; and (iii) enhancing the regulatory and financial sustainability framework of service delivery in the energy and water sectors.

While the proposed second operation in the DPF series continues to support the reform agenda to improve fiscal management, inclusion and opportunities, and service delivery, its scope has been enhanced to support reforms in the areas of international tax transparency and financial integrity. In line with the original design of the series, the operation continues to support mutually reinforcing efforts to: (i) strengthen fiscal management, through reforms to improve debt management, gradually pursue fiscal decentralization to support service delivery, and improvement of public finance systems; (ii) strengthen institutional arrangements to support social assistance and education; and (iii) enhance the regulatory and financial sustainability framework of service delivery in the energy and water sectors. The program has also been revised to support the path of adherence of Panama to the Common Reporting Standards (CRS), as well as include measures to ensure an adequate implementation of the AML/CFT regime.

The policies supported in the proposed DPF are aligned to the Government's program, and in particular support the objectives of the Social and Economic Strategy 2015-2019. The strategy's key priorities include actions aimed at promoting inclusion (social strategy) and increasing the country's competitiveness (economic strategy) along six areas: (i) economic development; (ii) social development; (iii) human development; (iv) infrastructure; (v) environmental sustainability; and (vi) governance. The proposed second operation consolidates progress achieved under the first operation, and lays the groundwork for future collaboration in additional reform areas, including international tax transparency, AML/CFT, decentralization, and public investment management.

The DPF program has the following expected benefits: First, a stronger framework for international tax transparency and financial integrity is expected to improve investors' confidence and support economic growth, while the strengthening of fiscal management is expected to support the ongoing consolidation process and help ensure fiscal sustainability. Second, an improved transparency and better targeting of social protection systems will help direct resources to those that need them the most, while an improved quality of education will contribute to advancing opportunities, particularly for the vulnerable youth, and support the competitiveness agenda to boost long term productivity growth. Finally, an enhanced regulatory and financial sustainability framework of water and energy service delivery will help increase the fiscal space needed to safeguard social assistance and education programs.

The key results indicators include the following:

- Panama complies with CRS requirements related to the availability of tax information, ensuring that (i) ownership and identity information is available for all relevant entities; and (ii) reliable accounting records are kept for all relevant entities (Baseline 2014: No; Target 2017: Yes)
- Number of Banks supervised (on-site and off-site) in a year using the new anti-money laundering supervision procedures (Baseline 2014: 0; Target 2017: 50)
- Share of investments by local governments that follow SINIP (*Sistema Nacional de Inversiones Públicas*) norms and procedures (Baseline 2014: 0 percent; Target 2017: 70 percent)
- Share of central government debt that is paid electronically (Baseline: 2014: 0 percent; Target 2017: 100 percent)
- Number of available disaster financial protection instruments of the Panama's DRFI Strategic Framework that underwent a cost-benefit analysis (Baseline 2014: 0; Target 2017: 2)
- Share of central government funds channeled through a Treasury Single Account (Baseline 2014: 0 percent; Target 2017: 90 percent)
- Percentage of the extreme poor benefiting from at least one social assistance program (Baseline: 2014: 37 percent; Target: 2017: 60 percent)

- Percentage of total funds from social assistance programs transferred through the social card *(Clave Social)* (Baseline 2014: 0 percent; Target 2017: 30 percent)
- Number of reports prepared by MEDUCA based on the results of international student assessments (Baseline 2014: 0; Target 2017: 2)
- Number of teachers participating in the International Teacher Training of *Panama Bilingüe* (Baseline 2014: 0; Target 2017: 1,500)
- Public expenditures on electricity subsidies are reduced by at least 50 percent in nominal terms relative to their level in 2014 (Baseline 2014: US$320 million; Target 2017: US$160 million).
- Number of Rural Water Management Boards connected to the standardized information system for improving the monitoring of water management in rural areas (SIASAR) (Baseline 2014: 400; Target 2017: 1,400)

III. Rationale for Bank Involvement

The proposed operation supports the administration's efforts to promote inclusion and increase country's competitiveness. In order to strengthen the frameworks for international tax transparency, financial integrity, and fiscal management, the DPF focuses on policy measures aimed at (i) bringing Panama's legal framework on AML/CFT and the international tax transparency in line with the global standards and ensuring their effective implementation; (ii) supporting gradual decentralization process and improved public investment management; (iii) strengthening institutional arrangements for debt management; (iv) safeguarding public finances from the financial implications of natural hazards; (v) improving financial management system. The DPF also supports actions to strengthen institutional arrangements to support social assistance and education by improving (i) the efficiency and transparency of social assistance programs; and (ii) the quality of education services. Finally, to enhance the regulatory and financial sustainability framework of service delivery in the energy and water sectors, the DPF supports actions to advance public service delivery by securing financially-sustainable and reliable energy provision through the reduction of subsidies and the promotion of efficiency standards within the energy sector. There is a broad consensus in Panama to maintain sound fundamental macroeconomic and poverty reduction policies over the medium- and long-term.

IV. Tentative financing

Source:		($m.)
Borrower/Recipient		
IBRD		300
Others (specify)		
	Total	300

V. Institutional and Implementation Arrangements

Panama's Ministry of Economy and Finance (MEF) is responsible for the implementation of the program supported by the proposed DPF. As the main implementing agency, MEF will coordinate with other Government ministries and agencies involved in the implementation of the DPF, in particular the Ministry of Social Development, Ministry of Health, National Water

Supply and Sanitation Administration, and the National Secretariat for Energy. Together with MEF, these institutions will collect the necessary data to assess implementation progress and evaluate results.

The Bank staff will focus on monitoring progress towards the expected results of the program development objectives. The monitoring and evaluation of the operation will be also carried out through the ongoing policy dialogue during the preparation of the third operation and the accompanying technical assistance projects.

VI. Risks and Risk Mitigation

The proposed DPF faces substantial risks. The recent events related to the leaked documents and the alleged involvement of a financial conglomerate in money laundering activities underscore the need to strengthen the frameworks for international tax transparency and financial integrity. This situation prompted the broadening of the engagement under the DPF series to include reforms in these areas. This also increased the risks to the achievement of the Program Development Objectives. The most relevant risks defined for this operation are political risks and the risks related to institutional capacity for implementation. Macroeconomic risks, risks associated with sector strategies and policies, technical design of the program, as well as risks associated with stakeholders are considered moderate.

The Government has shown a strong commitment to mitigate these risks and to implement the reform program. Specifically, to mitigate *political risks*, the authorities are utilizing a continuous consultation process and raising awareness on key policy measures. In addition, the authorities have thus far demonstrated a credible commitment to the reform program and there is consensus among the major political parties on the need to improve tax transparency and financial integrity, advance social inclusion, and modernize fiscal management. This consensus has enabled the passage of a number of important legislative reforms, including the amended AML/CFT Law and the Decentralization Law. To mitigate *risks related to institutional capacity for implementation*, the authorities have taken steps such as the reorganization of key sectoral units to improve program implementation, and the establishment of supervisory arrangements across policy areas, including the creation of Metas Presidenciales. In addition, reform implementation across all pillars of this operation is being supported by advisory activities and technical assistance from the World Bank Group, IMF, IDB, OECD, and other development partners. The World Bank Group support focuses on strengthening the tax transparency, social protection and education systems, strengthening water sector management, and improving fiscal management. To further mitigate institutional capacity risks, the Government is providing capacity building, for instance by training staff and hiring of consultants to support the implementation of key measures, including the preparation of new legislation to adhere to the Common Reporting Standards for the Automatic Exchange of Tax Information, the rollout of the Integrated Financial Management System (ISTMO), and the improvement of targeting mechanisms for social protection programs.

VII. Poverty and Social Impacts and Environment Aspects

Poverty and Social Impacts

This DPF supports actions that are expected to have largely neutral or positive effects on poverty and income distribution in the short term, and overall positive effects over the medium and long-term. The analysis carried out on the potential effects of the reforms supported under the operation suggests a positive or neutral direct impact on poverty and social development indicators. While some measures may have immediate implications of the household income (reforms of social transfers and electricity subsidy reform), the majority of actions are of institutional nature and will be broadly neutral for poverty in the short term. Rather, through stronger institutions, enhanced regulatory framework and improved procedures within the public administration, they are expected to support poverty reduction and boosting shared prosperity over the medium and long term.

Environment Aspects

The measures supported under the proposed DPF are not expected to have significant effects on the environment, forests or other natural resources. A detailed assessment of the expected environmental impacts of the reforms is provided in the program document. Pillars 1 and 2 of this DPF, Strengthening the Frameworks for International Tax Transparency, Financial Integrity, and Fiscal Management and Strengthening Institutional Arrangements to Support Inclusion in Social Assistance and Education, are primarily institutional in nature and thus, unlikely to have significant effects on the environment. Reforms supported under Pillar 3 – Enhancing the Regulatory and Financial Sustainability Framework of Service Delivery in the Energy and Water Sectors – might have more direct effect on the environment. Specifically, the reform related to reducing energy subsidies could have both positive and negative environmental effects. On one hand it will incentivize increased energy efficiency among consumers, thus contributing to better utilization of energy resources. On the other hand, the increase in electricity tariffs could also potentially lead to fuel substitution by the most vulnerable groups to cheaper traditional fuel, in particular firewood, thus contributing to higher indoor and outdoor pollution and deforestation. The negative environmental effect is mitigated by the design of the reform whereby electricity will remain subsidized for poorer households and for consumers in the western region of the country, which bears higher structural electricity costs.

VIII. Contact point

World Bank

Contact: Marco Antonio Hernández Ore
Title: Senior Economist
Tel: (202) 473-6802
Email: marcohernandez@worldbank.org

Borrower

Contact: Katyuska Correa de Jiménez
Title: Director, Public Finance Department, Ministry of Economy and Finance
Tel: +507 504-3070
Email: kcorrea@mef.gob.pa

IX. For more information contact:

The InfoShop
The World Bank
1818 H Street, NW
Washington, D.C. 20433
Telephone: (202) 458-4500
Fax: (202) 522-1500
Web: http://www.worldbank.org/infoshop