DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

PANAMA

INVESTMENT CLIMATE AND TRADE ADJUSTMENT PROGRAM

(PN-0160)

LOAN PROPOSAL

The project team consisted of the following team members: Martin Chrisney, Project Team Leader; Luis Zavaleta, Pedro Saenz, Diego Belmonte, Jose Agustin Aguerre (RE2/FI2); Fabrizio Opertti, Stefano Tinari (RE2/SC2); Mario Umaña, Federico Changanaqui (RE2/OD3); Javier Jimenez (LEG/OPR); Rafaela Varela (COF/CPN); and Yolanda Galaz (RE2/FI2) who was in charge of document production.

TABLE OF CONTENTS

Electronic Links and References	
Basic Socioeconomic Data	http://www.iadb.org/RES/index.cfm?fuseaction=externallinks.countrydata
Status of Loan in Execution & Loans Approved	http://ops/approvals/pdfs/PNen.pdf
Tentative Lending Program	http://idbdocs.iadb.org/WSDocs/getDocument.aspx?docnum=683729
Information available in the files of RE2/FI2	http://idbdocs.iadb.org/WSDocs/getDocument.aspx?docnum=665990
Annex II Policy Letter	http://idbdocs.iadb.org/WSDocs/getDocument.aspx?DOCNUM=686363
Annex III Results Matrix	http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=667900
Annex IV Quantitative Targets	http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=667903
Annex V Tracking Indicators	http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=668189

ABBREVIATIONS

AAC	Civil Aviation Authority (Autoridad Aeronáutica Civil)
ACP	Panama Canal Authority (Autoridad del Canal de Panamá)
AMP	Panamanian Maritime Authority (Autoridad Marítima de Panamá)
ANAM	National Environmental Authority (Autoridad Nacional del Ambiente)
CICC	Interamerican Convention against Corruption (Convencón Interamericana contra la Corrupción)
CICYT	Inter-Ministerial Council for Science, Technology and Innovation (Consejo Interministerial de Ciencia, Tecnología e Innovación)
CLICAC	Commission for Competition and Consumer Affairs (Comisión de Libre Competencia y Asuntos del Consumidor)
CNTC	National Commission for Transparency against Corruption (Comisión Nacional de Transparencia contra la Corrupción)
CONACYT	National Commission for Science, Technology and Innovation (Comisión Nacional de Ciencia, Tecnología e Innovación)
COPE	Energy Policy Commission (Comisión de Política Energetica)
CSS	Social Security Program (Caja de Seguro Social)
DPL	Development Policy Loan
FRL	Fiscal Responsibility Law (Ley de Responsabilidad Fiscal)
FTA	Free Trade Agreement (Tratado de Libre Comercio)
FTZ	Free Trade Zone of Colon (Zona Libre de Colon)
GDP	Gross Domestic Product
ICAO	International Civil Aviation Organization (Organización de Aviación Civil Internacional)
IFARHU	Institute for Developing Human Resources (Instituto para el Fomento y Aprovechamiento del Recurso Humano)
INAFORP	National Institute for Professional Formation (Instituto Nacional de Formación Profesional)
IPAT	Panamanian Tourism Institute (Instituto Panameño de Turismo)
IVM	Disability, Retirement, and Death Program (Programa de Invalidez, Vejez y Muerte)
MEF	Ministry of Economy and Finance (Ministerio de Economía y Finanzas)
MICI	Ministry of Commerce and Industry (Ministerio de Comercio e Industrias)
MIF	Multilateral Investment Fund (Fondo Multilateral de Inversiones)
NFPS	Non-Financial Public Sector (Sector Público No Financiero)
PBL	Policy-Based Loan
PENCTI	National Strategy for Science, Technology, and Innovation (Plan Estrategico Nacional para Ciencia, Technología e Innovación
RE2/FI2	Regional Operations Department II/ Finance and Basic Infrastructure II

ROSC	Report on Standards and Codes
SENACYT	National Secretariat for Science and Technology (Secretaría Nacional de Ciencia y Tecnología)
SME	Small and Medium Enterprises
UTPP	Technical Unit for Public Policy (Unidad Técnica de Política Pública)
VICOMEX	Vice-Ministry of International Trade (Viceministerio de Comercio Exterior)
WTO	World Trade Organization (Organización Mundial de Comercio)

PROJECT SUMMARY

PANAMA
INVESTMENT CLIMATE AND TRADE ADJUSTMENT PROGRAM
(PN-0160)

Financial Terms and Conditions [1]				
Borrower: Republic of Panama			Amortization Period:	20 years
Guarantor: N/A			Grace Period:	5 years
Executing Agency: Ministry of Economy and Finance			Disbursement Period:	18 months
Source	Amount	%	Interest Rate:	Variable
IDB (OC)	100 million	100	Supervision and Inspection Fee:	0.0
Local	0	0		
Other/Cofinancing	0	0	Credit Fee:	0.25%
Total	100 million	100	Currency:	US Dollars from the Single Currency Facility

Project at a Glance

Project objective:
The goal of the operation is to address some of the factors necessary for sustained, higher economic growth based on private sector activity and investment. To achieve this goal the Program is divided into two pillars: (i) fiscal stabilization, and (ii) improvements in the investment climate and trade adjustment.

Special contractual clauses:
The program will be carried out based on the terms and conditions of the loan contract. The policy conditions are contained in Annex I.

Exceptions to Bank policies: None

Project consistent with Country Strategy: Yes [X] No [ ]

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

Procurement: As a Policy-Based Loan this operation does not involve procurement of goods and services.

Verified by CESI on January 13, 2006 (meeting 02-06)

[1] The interest rate, credit fee, and inspection and supervision fee mentioned in this document are established pursuant to document FN-568-3 Rev. and may be changed by the Board of Executive Directors, taking into account the available background information, as well as the respective Finance Department recommendations. In no case will the credit fee exceed 0.75%, or the inspection and supervision fee exceed 1% of the loan amount (*)

(*) With regard to the inspection and supervision fee, in no case will the charge exceed, in a given six-month period, the amount that would result from applying 1% to the loan amount divided by the number of six-month periods included in the original disbursement period.

I. Frame of Reference

A. Introduction

1.1 The present Policy-Based Loan (PBL) supports the Government of Panama's economic program to promote sustained, equitable economic growth. To achieve this goal the authorities have undertaken major reforms that improve the fiscal and debt outlook, address imbalances in the social security system, and open the economy to international markets. The operation supports these measures with a two-tranche loan for US$100 million that will consolidate the reforms undertaken and broaden the effort in areas that will facilitate the adjustment to free trade by improving the investment climate.

B. General Background on the Panamanian Economy

1.2 Panama is a small, open economy based largely on service activities, most notably the Panama Canal, offshore banking services, and the world's second largest free trade zone (Free Trade Zone of Colon -- FTZ). Services, which account for nearly 80 percent of GDP, are linked with international markets based on Panama's geographic location, a dollarized economy, and its commercial policy. At the same time, the production of goods is largely directed towards the small domestic market; exports (excluding the FTZ) amount to less that 10 percent of GDP.

1.3 With a GDP growth rate of 5.5 percent in 2005, Panama's economy continued growing at a higher rate than the regional average of 4.3 percent. Among the positive factors was strong growth in world trade that increased the demand for services. The most dynamic service sectors were the Panama Canal, the FTZ, financial services, ports, and tourism. Preliminary estimates indicate that the unemployment rate, although still high, continued declining from 11.8 percent in 2004 to 9.6 percent in 2005.

1.4 In 2005, the fiscal deficit of the non-financial public sector (NFPS) excluding Panama Canal Authority (*Autoridad del Canal de Panamá – ACP*) was reduced to about 3.6 percent of GDP compared to almost 5 percent in 2004. This was due mainly to an increase in public revenues supported by strong economic growth and the increase in dividends from government owned companies. There were also some positive effects on tax collections from the fiscal package implemented at the beginning of the year, and austerity in public expenditures.

1.5 Panama has a relatively high level of public debt and correspondingly high interest payments. At the end of 2005, the estimated public debt was 62.9 percent of GDP, excluding government debt held by the Social Security Program (*Caja de Seguro Social* -- CSS) and including the prefinancing of the 2006 budget and the debt buy-back operation in November 2005. Interest payments were equivalent to about 4.6 percent of GDP. The government accounts include substantial financial assets in a Trust Fund for Development (Fondo Fiduciario), equivalent to 11

percent of GDP. A fiscal package introduced in February 2005 helped to maintain the rating of Panama's debt just two steps below investment grade by Standard and Poor's. According to the J.P. Morgan EMBI+, Panama's sovereign bond spreads declined to record lows, reaching 196 basis points in December 2005. This has helped the Government to continue a good track record of debt management by refinancing and extending its debt maturity profile during windows of opportunity in international markets. [1]

1.6 On the external side, strong external demand fostered the growth in non-traditional exports, which reached 8.4 percent of GDP. The commercial activity in the FTZ benefited from the improvement in regional economic conditions and its net exports increased from 0.4 percent of GDP in 2004 to 2.1 percent of GDP in 2005.

1.7 The industrial structure is dominated by micro, small and medium enterprises that account for 98 percent of all firms. The majority of these are dedicated to commercial and retail activity. At the same time, there is a high and rising level of informality in the economy. Over the past five years, informal employment has risen from 39 to 44 percent of the workforce. The corollary to this informality and underdeveloped domestic productive capacity is a high level of poverty and worrisome income inequality, among the worst in Latin America. In spite of a per capita income of a middle-income country, 40 of every 100 Panamanians are poor. In rural areas, the level rises to 59 for non-indigenous groups, and 95 in indigenous areas.

1.8 Notwithstanding a high level of investment in fixed capital formation, averaging 24 percent from 1990-2003, the economy has not had poverty-reducing growth. In fact, the impact of growth on poverty reduction was less than 1/5th that of other Latin American economies.[2] Explaining this outcome are a small domestic market that limits the scale of domestic goods production and the weak linkages between local firms and the service exports that dominate the economy. As well, the relatively high capital intensity of investment results in a low impact on employment generation. Lowering the level of poverty requires both sustained, high economic growth and structural changes in the economy.

C. The Challenges for Growth

1.9 Achieving sustained growth requires greater private sector investment and trade. International experience shows that investment and trade are critical factors to successful growth and poverty reduction, even considering the upfront adjustment costs when trade reforms are undertaken. In the case of Panama, to achieve 5

---

1 The most recent debt swap operation in January 2006, included $1.36 billion of new 30-year bonds in exchange for securities maturing between 2023 and 2034.

2 See Office of Evaluation and Oversight (RE-305-3) citing data from ECLAC. These data indicate that growth alone will not provide for a rapid reduction in poverty given the current distribution of income and structural features of the economy.

percent annual growth in GDP requires exports to grow by approximately 7 percent a year (Compite Panama, 2005).

Table 1-1

Macroeconomic Indicators						
Macro data	**2000**	**2001**	**2002**	**2003**	**2004**	**2005p**
Real GDP (rate of growth)	2.7	0.6	2.2	4.2	7.6	5.5
Inflation (rate of change)	1.4	0.0	1.8	-0.3	1.6	3.4
Current account balance (% GDP)	-9.5	-1.5	-0.8	-3.9	-7.9	-5.1
Unemployment rate (%)	13.3	13.7	13.7	13.8	11.8	9.6
Debt (% GDP)	68.7	64.7	63.7	63.0	65.9	62.9
Fiscal data						
Non-financial public sector deficit (% GDP)	-0.4	-2.3	-3.3	-4.7	-4.9	-3.6
Tax receipts (% GDP)	9.4	8.6	8.6	9.8	8.5	na

1. Macroeconomic Stability and Trade

1.10 Fundamental to creating the conditions for private-sector led growth, are: (i) greater *macroeconomic stability*; and (ii) *greater trade openness* through bilateral and multilateral agreements that provide credible and stable rules for commerce. As a dollar-based economy, without the benefit of monetary and exchange rate policy tools, the government must carefully manage its fiscal position to maintain macroeconomic stability. When the Torrijos Administration assumed power in 2004 it inherited an economy that faced a large fiscal deficit, a growing contingent debt from social security accounts (expected to be 90 percent of GDP by 2010), and a large public sector debt. In this context, the authorities needed to take steps to: (i) increase revenues and cut expenditures; (ii) contain the growth in the stock of public debt through improved fiscal outcomes and asset-liability management (of both the stocks and flows); and (iii) lower the widening financial and actuarial deficits of the CSS.

1.11 **Fiscal Stabilization.** By 2004, the tax base had eroded to 8.5 percent of GDP owing to the low elasticity of tax receipts with respect to growth. At this level, tax receipts were 30 percent lower than the average among Central America economies. The tax base was weakened by the numerous exemptions and special regimes provided for in the tax code. The exemptions on corporate income (*personas jurídicas*) led to varying effective tax rates between sectors, eroding the neutrality of the system and diminishing fiscal revenues. Estimates of these ¨tax expenditures¨ show an average annual level of 1.3 percent of GDP, a cost of approximately 15 percent in foregone tax revenues. Rigidity in current expenditures, in part from the high share of salaries and the servicing of public sector debt, also contributed to large and growing deficits and higher public sector debt. In February 2005, the Fiscal Equity Law (Law 6 of 2005) was passed to

address the underlying problems in the tax code and to strengthen expenditure controls.

1.12 **Social Security System.** Public sector liabilities include those of the under-funded CSS, a ¨pay as you go¨ system with partial collective capitalization. Pensions are funded from current contributions, income on reserves, and government transfers. For some time, the CSS has had rising actuarial deficits and, starting in 2002, financial deficits were recorded. Recent estimates show that based on previous cash flow projections the pension reserves would disappear in approximately 10 years leaving the government with a large contingent debt. By some estimates the liability would total US$13 billion (International Labor Organization, 2001). To address the financial viability of the CSS, where the largest deficiencies are in the Disability, Retirement, and Death (IVM) program, the authorities proposed and the Legislature approved a parametric reform in June 2005. However, widespread protests followed congressional approval and lead to the launch of a new policy dialogue. Based on a consensus-building process with civil society, a revised law was prepared and passed by the Legislature in December 2005 that will substantially improve the system. Nevertheless, the new formula will require continued government contributions of US$75 million a year through 2009, rising in later years. [3]

1.13 **Fiscal Responsibility Law.** Beginning in 2002, the government operated under the Fiscal Responsibility Law (FRL) as a commitment mechanism for sound fiscal policy. The law stipulates that the authorities should achieve primary surpluses, while limiting the overall NFPS deficit to 2 percent of GDP. A target for net public sector debt was set at 50 percent of GDP by 2017, while net external debt was to fall below 35 percent of GDP. By the end of 2004, faced with a large deficit inherited from the previous administration, the new authorities suspended the application of the law through the end of 2005. Currently, the law has been reinstated and modifications are under review by the authorities.

1.14 **Trade Opening.** Starting in 1997, Panama initiated a market opening by joining the World Trade Organization (WTO) and lowering tariffs. Presently, the authorities are negotiating trade agreements to further open the economy and make permanent its preferred access to markets like the United States, its largest trading partner.[4] The impact on tariffs of future Free Trade Agreements (FTA) and WTO negotiations adds further to the need for improved fiscal management. By the government's estimates, foregone tariff revenues from the current FTA negotiations could total US$75 million through 2009.

---

[3] Starting in 2007-09 the contribution will be US$75 million, increasing to US$100 million (2010-2012) and US$140 million (2013-2060) for a total of US$7.2 billion, equivalent to US$1.5 billion in net present value terms.

[4] Additionally, Panama has negotiated agreements with Taiwan, Singapore, and El Salvador; and has partial agreements with Colombia and the Dominican Republic.

2. The Investment Climate and Trade Adjustment

1.15 Greater access to international markets through trade agreements, however, does not automatically guarantee higher growth. Comparative country experiences show that growth occurs when policies are in place to enhance the economy's productive capacity (*supply response*). Studies indicate that a key to the successful export-led growth of countries in Southeast Asia was their stable macroeconomic environment and favorable supply-side factors. Better trade and development outcomes are statistically correlated with policies that: (i) improve infrastructure to lower operational costs; (ii) create an better environment for domestic and foreign investment; (iii) develop capital markets to improve access to financing; (iv) support labor training; and (v) promote good institutions with transparency and good governance (United Nations, 2005).

1.16 In general these factors are part of the investment climate – the conditions that affect a firm's decision to invest productively, create jobs, and expand (World Development Report, 2005). When reforms in these areas accompany trade opening, the gains are more rapid and less costly in terms of displaced economic activity (United Nations, 2005).

1.17 **Infrastructure.** In infrastructure services there are three important challenges that will impact directly on domestic production and its linkages with international markets: (i) the expansion of shipping and maritime activities; (ii) increased air traffic for cargo and tourism; and (iii) the impact of high energy costs on the economy.

1.18 *Maritime activity* is an important link between the local economy and international markets. The Panama Canal accounts for 5 percent of global cargo movements and the sector generates significant direct and indirect employment. Faced with the increasing use of Post-Panamax ships, which exceed the Canal's current size capacity, the government has announced plans for a national referendum to authorize the Panama Canal Authority to finance a new system of locks that could cost several billion dollars. Outside the Canal, the port sector is regulated by the Panamanian Maritime Authority (*Autoridad Marítima de Panamá --AMP*), which was established in 1998. The major ports are the most efficient in Latin America with significant private investments in the main facilities in Colon and Balboa. Currently, there are 12 smaller ports under the management of AMP. The expanded use of these ports will facilitate cabotage activities linked to Panama's main ports, as well as fishing and tourism activity. Based on existing demand studies, the ports of Aguadulce, Almirantes, Bocas del Toro, Vacamonte and Muelles Fiscales de Panamá have already been identified as candidates for greater private sector participation. For these reasons, an updated legal framework is needed to take advantage of greater shipping activity and enable new maritime services, such as ship repair, and new private investment in ports and related services.

1.19 A modernized *airport infrastructure* is needed to spur growth in tourist activity outside of Panama City, where the main international airport has been corporatized and expansion is underway. In recent years, air traffic continues to grow with the increase in cargo operations, as witnessed by the development of Fort Howard, and tourism growth. For the period 2005-2009, the Civil Aviation Authority (AAC) has a Strategic Plan for the sector to bring existing norms and institutions up to international standards, update infrastructure and services, and promote the development of the sector as a base for tourism and cargo activity. Upgrading airport infrastructure is needed owing to the lack of investment. Currently there are 4 international airports under public sector control, including the International Airport of Tocumen. Among these international airports several are attractive for private investment owing to their potential role in developing tourism activities (Enrique Malek, Bocas del Toro, and Río Hato).

1.20 Finally, *energy generation and distribution* presents a growing constraint on production. The sector has been buffeted by higher energy prices that have led the authorities to use a Compensation Fund to offset electricity price increases to consumers since 2003, while a further subsidy was set for gasoline prices beginning in 2005. These energy subsidies are not likely to be sustainable. To meet growing energy demand, alternative energy sources, in addition to the development of hydropower, will gain importance in the future, as will greater energy efficiency. The Energy Policy Commission (*Comisión de Política Energetica -- COPE*), part of Ministry of Economy and Finance (MEF), is charged with setting policy and defining strategy for the sector. Its mandates include ensuring adequate energy supply, expanding coverage, promoting energy efficiency, protecting the environment, respecting legal rights of investors, and promoting renewable energy.

1.21 **Conditions for Foreign and Domestic Investment**. Panama has a business-friendly environment, including an efficient international banking system, free trade zones, and access to global shipping routes. Notably, Panama has a history of vibrant commercial activity and secure property rights based on its commercial code and legal tradition. Registering property, for instance, is less expensive and time consuming compared to other regional economies.[5] Still, the prospect of trade agreements presents new challenges.

1.22 First, institutions related to trade and investment promotion should be prepared to address the effects of lower tariff and non-tariff barriers. An improved institutional framework should be in place to monitor and enforce treaty commitments (including 18 bilateral investment treaties already negotiated). These areas are the responsibility of the Ministry of Commerce and Industry (MICI) and, in particular, the Vice Ministry for International Trade (VICOMEX). Among measures needed are faster processing of export and investment

[5] In Panama, registering a property takes 44 days and costs 2.4 percent of the property value compared to 76 days and 4.8 percent in Latin America and the Caribbean (Doing Business Indicators of the World Bank).

documentation with one-stop shops for exporters and foreign investors (*ventanillas únicas*), streamlined procedures for exports and investment, and a strategic plan for implementing Free Trade Agreements.

1.23 Second, domestic markets require adequate supervisory and regulatory institutions to ensure competition. Under a trade opening, a larger international business presence will bring new challenges to market regulators. Notably, there will be more joint ventures between local and foreign firms, greater use of trademarks and intellectual property rights, and the challenge of providing more expeditious decisions and better enforcement in competition policy. Over the past 10 years, the Commission for Competition and Consumer Affairs (*Comisión de Libre Competencia y Asuntos del Consumidor -- CLICAC*) has worked to improve domestic market competition, consumer protection, and intellectual property rights.[6] However, the experience of the past decade shows that CLICAC has been hampered by slow procedures for the judicial review of cases, a limited ambit for its review of actions relating to legal barriers to entry, and weak enforcement abilities.[7]

1.24 Third, an additional barrier to the investment climate is regulation that inhibits business development. Creating new firms and expanding existing ones will be important to the dynamics of trade adjustment. Current regulations make it relatively easy to register a new enterprise (7 procedures and 19 days). However, obtaining the licenses and permits to start operations can take 22 steps over 128 days, at a cost equal to 114 percent of national per capita income (World Bank). This added cost is not only a barrier to the entry of new firms, but even more importantly, represents a burden to SMEs and microenterprises in the informal sector that would like to formalize their businesses. Many procedures, especially at the local or municipal level are duplicative and result in additional costs or required "donations".[8] In general, these regulations add to a firm's start up costs and can burden smaller enterprises with red tape.

1.25 **Labor Training**. A critical element to the economy's supply response will be improving labor productivity. In the past, labor productivity has been low and high real wages by regional standards. Rigidities in the legal code include restrictions on hiring and firing practices that contribute to the persistence of high employment and low productivity. Nevertheless, reforming the Labor Code is difficult and not currently on the menu of policy options. In the meantime, weaknesses in the labor market are aggravated by the lack of a coordinated policy to improve the delivery of training services.

---

6 At its inception, CLICAC was supported by ATN/MT-6284-PN from MIF in 1998.

7 To date, none of the cases brought by CLICAC has reached judgment in the courts, notwithstanding the creation of special courts for this purpose in Article 141 of Law 29.

8 One study notes that in the *Juntas Comunales* there is a particular lack of transparency, procedures are cumbersome, and that the ¨donations¨ are arbitrary but expected as part of the process. (AMPYME 2004).

1.26 A major source of training has been the National Institute for Professional Formation (INAFORP*)*, an institution financed with payroll taxes. The same funding source also supports training efforts by the Labor Ministry (MITRADEL), Panamanian Tourism Institute, IFARHU (scholarship programs), and COSPAE (a private entity). Given the number of institutions involved in the sector, including the recently announced proposal to create a new training authority to provide oversight and strategic direction, there is a lack of clear roles and institutional coordination. As a result, budget resources are spread thin and training delivery is less effective in meeting private sector demand. Without a modern, integrated training system, the capacity to provide skill upgrading for the workforce is limited, hampering growth in key areas identified by the private sector such as data call centers, ship repairs, and tourism.

1.27 **Technology and Innovation.** Apart from these constraints, the economy has a low affinity for absorbing technology. According to the data on technological development, Panama is ranked 53rd among 104 countries (World Economic Forum, 2004). Among countries in Latin America, public investment in technology is one of the lowest at 0.21 percent of GDP. Given the current trade opening, businesses must increasingly create and market new products and services that are competitive both nationally and internationally. The starting point for this transformation is a low level of technology adoption. Exports incorporate relatively low levels of technology, with only 18 percent of firms investing in innovation, and only 6 percent meeting the ISO 9000 requirements. Overall, research and development have not been drivers for economic growth. To address these concerns, in 2005, a National Strategy for Science, Technology, and Innovation, (*Plan Estrategico Nacional para Ciencia, Technología e Innovación* – PENCTI) was approved that sets out a sector-based approach to innovation and technology adoption.

1.28 Panama also has an under-developed potential for electronic commerce based on its extensive network of fiber optic cable, data storage facilities, and links with institutions like the *Ciudad de Saber*, *Tecnoparque Internacional de Panamá*, and Panamanian Business Accelerator. The legal framework for electronic commerce is the Digital Signature Law (Law 43 of 2001), which outlines the use of electronic signatures, exchange of electronic documentation, and supports the development of providers of certification services for contracts and other documents.[9] The legal framework, however, has not been widely accepted and implementation has been slow.

1.29 **Finances.** On the other hand, of the factors that improve the investment climate, financial capital does not present a binding constraint. An open capital market, large presence of foreign banks, and market-based interest rates indicate that working capital is available. Nevertheless, the existence of state banking intermediaries, targeted credit for rural activities and housing, and limited venture

[9] Support for the development of the e-commerce market was provided by the MIF (TC-99-11-09-6), which supported demand among SMEs and public awareness regarding the legal framework.

capital markets indicates areas for improvement.[10] Further, the stability and soundness of the banking system, which lacks a lender of last resort, should be carefully assessed and recommendations made to further minimize any systemic risks.

1.30 **Governance and Transparency**. The perception persists that Panama has weak institutions and little transparency. In 2005, Transparency International's Corruption Perception Index placed Panama in the 41st percentile (65 out of 158 positions) and the 50th percentile among countries in Latin America and the Caribbean (11 out of 22). According to the indices used to evaluate public governance prepared by the World Bank (Kaufmann, Kraay, Mastruzzi 2005) compared with other countries of a similar income level, Panama has worse outcomes in government effectiveness, regulation, rules of the game, and corruption, showing a decline from 1998 to 2004. The Torrijos administration has taken a strong stand with a ¨zero tolerance¨ policy for corruption. This topic is even more relevant given that most trade agreements include provisions on government procurement and anti-corruption policy.

1.31 In 2004, to carry out its commitments under the Inter-American Convention against Corruption (CICC) and the United Nations Convention against Corruption, the government created the Anti-Corruption Council (*Comisión Nacional de Transparencia contra la Corrupción* -- CNTC) to be headed by the Minister of the Presidency with the participation of civil society organizations.[11] The Council is charged with providing legislative proposals, education campaigns, carrying out administrative investigations of cases of corruption, and approving an ethics code for the public sector. As well, the administration eliminated restrictive rules that had been applied to the Law on Transparency, thus providing freer public access to information.[12] The authorities have also initiated an effort to enhance efficiency by improving transparency in government procurement. In October 2005, the authorities launched *PanamaCompra.* The program will transform procurement procedures by automating them under the country's first Electronic System for Public Contracts.

D. Panamanian Government's Strategic Vision

1.32 In mid-2005, the Administration released a document outlining its strategic vision for 2005-2009 that set out a policy of prudent fiscal management and greater openness to international markets (Government of Panama, 2005). The

---

[10] The issues of the financial sector are not addressed in this PBL, but are planned to be the focus of a PBL in 2007.

[11] Executive Decree No. 179, (October 2004) created the CNTC and its executive secretariat. The council includes the Minister of the Presidency, the Attorney General, the Controller General, the Public Defender, a representative of the National Business Council (*Consejo Nacional de la Empresa Privada*), the National Council of Unionized Workers (*Consejo Nacional de Trabajadores Organizados*), a representative of the Ecumenical Council, and representatives of social organizations.

[12] The new administration voided Decree 124 of 2002 which had placed restrictions on who had access to public information and provided greater discretion to public officials in blocking access to information than originally contemplated in the Law on Transparency (Law 6 of 2002).

Government's agenda provides clear quantitative goals that include reducing extreme poverty by 20 percent by 2009 (Annex IV).[13] These targets also include reductions in the fiscal and CSS deficits, and a lower external debt.

1.33 The government's strategy is based on a diagnostic of the structural weaknesses that limit attaining higher income and employment. Among them are the lack of openness in certain sectors (such as agriculture); high costs of local production; low levels of human capital and technological innovation; and, finally, an unsustainable fiscal position. As well, the strategy emphasizes the negative impact on economic and social development from a lack of transparency in the public sector and endemic corruption.

1.34 To achieve favorable growth and employment outcomes, the strategy endorses an outward-oriented economic policy based on trade agreements. At the same time, it emphasizes improving domestic markets by expanding infrastructure for exports, especially ports, and eliminating market distortions that create barriers to entry. While creating sound public finances is based on control of current expenditures, broadening the tax base, increased transparency in public procurement, and better-defined fiscal targets.

1.35 The authorities have opted for a step-wise approach to implement the reform agenda, starting with the fiscal reform package, then addressing social security, and following in other areas, such as the planned referendum on the expansion of the Panama Canal.

E. The Program's Strategy

1.36 The proposed PBL supports the government's agenda of fiscal, pension, and trade reform at a critical early stage in its implementation. In any reform program, the process, its timing, and credibility are critical elements to success, in addition to the quality of the policies undertaken (IDB 2005). This PBL and other Bank lending instruments should be tailored to the circumstances and stage of implementation of the Government's reform agenda in order to maximize their impact.

1.37 The present two-tranche PBL recognizes that the government has established a clear sequencing of reforms over the medium term, including quantitative targets for the fiscal accounts and debt, and has signaled its commitment to the reform process.

1.38 The first tranche of US$70 million will be disbursed based largely on the impact of reforms to the tax code and pension system already approved by the Legislature. This stage focuses on macroeconomic stability and reinforcing the credibility of the administration's economic program. The IDB has contributed to

[13] The target is consistent with the Millennium Development Goal to cut extreme poverty to 15.7 percent of the population by 2015. Extreme poverty is measured as the percentage of the population that lives on less than $1 a day, which in 2000 measured 23.9 percent.

the design of this reform program through studies on the tax system and expenditures reform (Arenas de Mesa and Gnazzo, 2005; Sabiani and Gnazzo, 2004) and support to the pension reforms, including developing the modeling to estimate the impact of the various reform proposals on the actuarial deficits of the CSS. The policy conditions for the second tranche of US$30 million include proposed laws and institutional changes that address factors needed to improve the investment climate and facilitate the trade adjustment process. Moreover, additional actions that support the reform process are presented in the Government's Policy Letter (Annex II).

1.39 The front-loading of the PBL tranches recognizes the importance of the fiscal and pension reforms, including the financial costs to the government of the pension reform. The subsequent tranche supports additional measures that move the policy reform process forward by initiating needed legal and institutional changes. The overall program will provide funding equivalent to 22 percent of the expected annual NFPS deficit and less than 8 percent of gross financing needs.

1.40 The government has also requested a US$5 million technical cooperation loan (PN-L1009) that will be prepared in 2006 (request received from MEF on January 11, 2006 and is expected to be submitted to the Board by June 2006). The technical cooperation loan will support compliance with conditions for the second tranche, actions specified in the Policy Letter, and the development of future activities in the government's reform agenda. These resources will support the fiscal reforms (revising the Fiscal Responsibility Law), technical studies to identify options for public private partnerships in airports, support to private investment in ports with technical assistance on contractual and environmental issues, competition studies for various sectors, and the development of consensus-based strategies for labor training, among other topics. In general, the technical cooperation will finance studies, consensus building, preparation of legal documents, and implementation of reforms, as needed.

1.41 A related operation in the Bank´s Country Strategy (2005) is the US$100 million PBL planned for 2007 that contemplates reforms in the financial sector, focused mainly on public sector banking. In order to provide greater flexibility to the IDB's support for the government's policy reforms, that loan may also include reforms that follow from the current PBL and technical cooperation loan. For that reason, the overall reform process will be monitored with outcome indicators (Results Matrix Annex III) as well as a set of selected *tracking indicators* (Annex V and Section III.F.).

1.42 To ensure the Program's effectiveness several criteria were applied to select the policies adopted. These criteria were: (i) a demonstrated consistency with the determinants of growth identified in analytical work on the subject, (ii) support for the actions that are consistent with the government's own reform agenda; (iii) support from analytical and technical work by the Bank; and (iv) an implementation timeframe compatible with that of the Program. These criteria are highlighted in the descriptions presented in this report (Sections I & II).

F. The Bank's Strategy

1.43 The Bank's Country Strategy for 2005-2009 (GN-2385-1) aims at promoting sustained economic growth and the reduction of inequality. To achieve these goals, the Bank's Country Strategy proposes two strategic objectives: (i) improving the competitiveness of the economy; and (ii) developing human and physical capital. Strengthening governance and transparency is also adopted as a transversal theme to support the Country Strategy.

1.44 At an operational level, the Country Strategy's identifies several key areas for Bank intervention. On the macroeconomic front, the Country Strategy identifies fiscal sustainability as a key issue, emphasizing reforms in the tax code and the pension system. On a sector level, basic infrastructure is highlighted including expanded services in electricity, water and sanitation, roads, along with greater energy integration, and the promotion of private sector participation. Finally, to broaden the sources of growth, the Country Strategy highlights improving the business climate and formalization of smaller firms, as well as improved trade policy management.

1.45 The PBL provides operational support for the strategic objectives of the Bank's Country Strategy. Moreover, there is also considerable complementarity between the proposed PBL and other Bank operations. The policy reforms described in Section II are supported by both current and future investment activities of the IDB, including: (i) the *Program to Strengthen International Commerce* (1641/OC) that assists the government in FTA negotiations and in updating of the institutional framework of the Vice-Ministry of International Trade (VICOMEX); (ii) the *Program to Foster Competitiveness* (1410/OC) that has led both to the development of clusters of firms in the strategic sectors of logistics, tourism, agroindustry and information technology, and the preparation of a draft National Competitiveness Strategy that has been an input into the design of the current operation; (iii) *Strengthening of Management Capacity of the Maritime Authority of Panama* (PN-0152) that develops the environmental assessment capacity of the AMP; and (iv) the *Program for the Modernization of the Labor Market* (1403/OC) that promotes private provision of training services.

G. Coordination with other Donors

1.46 In recent years, the World Bank has had a more limited presence in Panama, but in 2005 it prepared an Interim Strategy Paper outlining its efforts to reengage in a dialogue with the authorities and to build up its knowledge base. As part of its lending program the World Bank plans a Development Policy Loan (DPL) for 2006 based on the government's medium-term strategy and advances already achieved in fiscal and social security reform. According to the Interim Strategy, following the completion of its Country Assistance Strategy a programmatic series of DPLs is planned.

1.47 In the area of investment climate, the World Bank and IDB have plans in 2006 to co-finance an Investment Climate Assessment to identify barriers to business activity. Joint work has also been initiated to assess the government's fiduciary capacity, namely its budgeting and control measures. Currently, project teams from both institutions are working on a Country Financial Accountability Analysis and a Country Procurement Assessment Report, which will be completed in early 2006. Other analytical work planned by the World Bank includes a Poverty Assessment and a Public Expenditure Review.

1.48 For its part, the IMF is conducting a Report on Standards and Codes (ROSC) for fiscal activities that should be finalized by early 2006 and will cover issues relating to transparency in the fiscal accounts and reporting, as well as the classification of public expenditure, and public debt management. In the meantime, an Article IV report is being prepared, and the Project Team has obtained a preliminary macroeconomic review by the IMF team that provides a favorable assessment of the current fiscal management and economic prospects for the near term.[14]

H. Lessons Learned from Bank Operations

1.49 During the 1990s, the IDB contributed to Panama's policy reforms through a combination of financial and non-financial products.[15] In particular, support was provided for the privatization of public utilities in energy and telecommunications, and the creation of a regulatory framework for the private provision of infrastructure services. In collaboration with the IMF and World Bank, the IDB co-financed the debt-restructuring program and supported financial sector reforms. Notwithstanding some successes, the financial sector policies fell short of their goals to reform public sector banks and social security.

1.50 Among the lesson learned from these experiences are: (i) the importance of political willingness to follow through with the reform process;[16] (ii) the need for built-in flexibility to account for unforeseen changes during implementation; and (iii) the riskiness of policy conditions linked to the future approval of laws. In policy reform programs, timing is critical with success more likely when programs start early in a new administration and have a high degree of ownership.

1.51 The proposed operation takes into account these lessons. The IDB is well positioned to assist the authorities based on its previous analytical work on the fiscal reforms and its policy dialogue with the government and private sector

---

[14] The letter, dated November 3, 2005, updates the Article IV completed in 2005 (April 12, 2005). The Project Team expects to have a copy of the new Article IV by February 15, 2006 and will prepare its own assessment of the macroeconomic situation prior to Board presentation.

[15] See Program to Reform Public Enterprises (688/OC-PN, 689/OC-PN, approved in 1992); Program for the Reform of Basic Infrastructure (969/OC-PN, 970/OC-PN, approved in 1996); Financial Sector Reform (1073/OC-PN, 1074/OC-PN approved in 1997).

[16] See Evaluation of the Country Program (CPE) Panama: 1991-2003, Revised version, Inter-American Development Bank (RE-305-3).

during the preparation of the Country Strategy. As a result, the PBL's Policy Matrix is consistent with the Government's own agenda and the IDB's goals for its lending program. The current operation only considers approved laws as part of its first tranche conditions in the Policy Matrix, while the actions in the subsequent tranche are based on Executive Decrees or the presentation of laws to the Legislature. Additionally, the follow-on operations, a technical cooperation loan and a future PBL, offer a greater degree of flexibility to define actions in support of the reform agenda.

II. OBJECTIVES AND DESCRIPTION OF THE PROGRAM

2.1 The operation addresses some of the factors necessary for sustained, higher economic growth. Evidence shows that achieving higher growth depends not only on creating the appropriate macroeconomic conditions and trade openness, but also on initiatives that enhance the economy's supply capacity. Taking this into account, the operation is divided into two pillars: (i) fiscal stabilization, and (ii) improvements in the investment climate and trade adjustment.

2.2 The first pillar of the operation recognizes the advances made in stabilizing the fiscal deficit and debt as a result of recent reforms introduced by the Torrijos administration. The second pillar focuses on creating an investment climate conducive to greater private sector participation in infrastructure provision (airports and ports); lower transactions cost (improvements in market competition and institutional reforms); raising labor productivity and innovation; developing a strategic framework to adjust to free trade (energy, investment, and trade); and addressing corruption and transparency issues.

2.3 Clearly this operation only addresses a subset of the factors necessary to support sustained, higher economic growth. Growth outcomes depend on other factors beyond the control of policymakers and the scope of this operation. For this reason, the policies chosen should not be viewed in isolation; but rather as part of a broader reform process. The present PBL proposes two tranches to support the reform process initiated by the Administration, and is integrally linked with the IDB Country Strategy that includes further assistance to the Government's reform agenda.

A. Macroeconomic Policy Environment

1. Macroeconomic Conditions

2.4 **Objectives.** The new Administration is committed to reduce the fiscal deficit, address the growing liabilities of the CSS, and to control external public sector debt. The measures outlined below aim to *create a stable macroeconomic environment consistent with greater private investment and more rapid, sustainable economic growth.*

2.5 **Policy Conditions.** The Government will maintain a sound macroeconomic policy framework consistent with the operation's objectives. Compliance will be

assessed based on annual Article IV consultations with the IMF and the independent evaluation of Bank Staff. In these assessments, particular attention will be paid to the fiscal balance and the finances of the CSS.

2. Fiscal Stabilization

a) Fiscal Reform

2.7 **Objectives.** This component addresses controlling the fiscal deficit in the context of the Fiscal Equity Law (Law 6 of 2005). The changes in the tax code mandated in the law are expected to raise revenues by 1.5 percent of GDP. The law broadens the tax base eliminates certain production incentives that lacked focus and were not effective, eliminates incentives to non-traditional exports, and ends the exemption on foreign-sourced income. Additionally, a minimum corporate tax of 1.4 percent on gross income is to be assessed and paid in advance of yearly corporate tax obligations. A minimum tax of 6 percent on personal income for those earning above US$60,000 per year is applied as well, and non-income salary benefits are included in the income base. In order to contain government spending, which had risen excessively in past years, the law limits public sector employment to its levels of 1999, with an exemption given for essential services in education, health, and security. The potential reduction in wage payments alone could amount to 0.7 percent of GDP over the next five years.

2.8 **Policy Conditions.** The first tranche condition has been complied with based on the approval of the Fiscal Equity Law (February 2005) and its implementation rules (October 2005). For the second tranche, the authorities will also present an action plan for the restructuring of public institutions over the period 2006-2009 in a manner consistent with Article 1 of the Fiscal Equity Law that requires reductions in personnel.

b) Social Security Reform

2.9 **Objectives.** To control the large and growing actuarial and financial deficits of the CSS required adjustments in the contributions by employers and employees, as well as other parametric changes that are specified in Law 51 (December 2005). The operation supports the approved ¨two pillar system¨ of: (i) defined benefits for those 36 years old or older in 2006, and (ii) a mixed system for younger workers and new entrants from 2008. In the latter case, individual savings accounts will be offered and maintained by the CSS. Even though the new law did not raise the retirement age, it does provide for a 4 percentage point increase in employer/employee contributions (to 13.5 percent) and a 5 year increase in years of service (20 years). Owing to these changes the Government will contribute annually to the pension fund to cover the actuarial deficit, an amount equivalent to US$1.5 billion in net present value terms.

2.10 **Policy Conditions.** For the first tranche condition, Law 51 of 2005 has been approved, establishing greater financial sustainability of the CSS over the medium

term. By the second tranche, the implementing regulations for the pension reform will be published in the *Gaceta Oficial*.

c) Controlling Indebtedness

2.13 **Objectives.** The objective is to improve fiscal and debt management by establishing clear and transparent rules while also improving public sector asset and liability management. The existing FRL should be modified to provide a clearer definition of the target deficit measure (to be measured on an accrual basis and exclude the ACP), while permitting adjustments to account for the cyclicality of fiscal spending. At the same time, proper evaluation of both the liabilities and assets of the public sector, which include shares in enterprises in energy, telecommunications, and airports and a large trust fund, should be made to ensure the proper management of net debt and financing cash flows.

2.14 **Government's Commitment in the Policy Letter.** The authorities will present reform proposal to update the FRL to improve its effectiveness as described above. The final outcome of this effort will be monitored through the level of the NFPS deficit and net external debt. Additionally, MEF will provide an evaluation of public assets and liabilities that provides recommendations for the asset-liability management of the overall balance sheet and cash flows for the treasury.

B. Investment Climate and Trade Adjustment

2.16 The Panamanian authorities have sought to use the negotiation of free trade agreements as a tool to open new markets and attract foreign direct investment. These agreements require adjustments in the domestic policy framework to take advantage of new commercial opportunities through improvements in: (i) infrastructure services, (ii) labor training; (iii) competition in local markets; (iv) the promotion of investment and exports; (v) innovation, and (vi) governance and transparency. As indicated previously, these areas, in combination with an appropriate macroeconomic policies, support the economy's supply response and help maximize the benefits from greater international market access (para. 1.15).

1. Infrastructure

2.17 In the past decade, there have been profound reforms in the area of infrastructure provision. Improved coverage and quality of service were based on greater private participation in the construction, operation, and maintenance of infrastructure assets in roads, telecommunications, energy, ports, and airports. The basis for private provision was a institutional framework that included a public regulatory entity created in 1996, followed by the legal and institutional framework for participation of the private sector in electricity and telecommunications in 1997, and the legal framework for concessioning public works in 1998.[17] Notwithstanding these achievements, greater international trade,

[17] These were Law 26 of 1996, Law 6 of 1997, and Law 5 of 1998, respectively.

the potential impact of the Canal expansion, and increased tourism will require further improvements in this framework.

2.18 **Objectives.** These policies focus on *creating an investment climate conducive to greater private participation in infrastructure provision in order to improve the coverage, efficiency and quality of services.*

a) Maritime

2.19 **Objectives.** To more fully benefit from Panama's comparative advantage in maritime activity several steps are needed. First, an updated legal framework for commercial activities is needed to facilitate greater linkages with the national economy, new financing instruments, and improve the legal framework for arbitration and maritime tribunals based on international standards. Clearer rules will also support the development of new maritime activity, such as ship repair, which will become more important as Panama develops its port and canal activities. Second, the legal framework for concessioning ports and port services needs updating in order to enhance the transparency and efficiency of the process.

2.20 **Policy Conditions.** As a second tranche condition, a legal framework will be presented to the Legislature to develop maritime activity with support for developing financial instruments, expansion of flagship activities, and ports. In addition, the AMP will publish rules that provide greater transparency for concessions of the operation, administration, maintenance and construction of facilities and services.

b) Aviation

2.22 **Objectives.** To improve the conditions for private participation in the airport sector these measures aim to: (i) upgrade legal norms according to international standards for regulation, inspection, and operation; (ii) identify mechanisms to attract private participation in airport and airport facilities through public-private partnerships; and (iii) maintain the Category One rating for operational safety.[18] This latter objective is supported by an IDB group operation for airport security that offers training, institutional upgrading, and equipment under a grant by the Multilateral Investment Fund (MIF) (Strengthening of Airport Security TC-02-05-04-0, US$0.88 million).

2.23 **Policy Conditions.** By the second tranche, legal modifications to ensure compliance of aviation rules with international standards, identifying measures to update national norms and rules, will be presented to the Legislature.

2.24 **Government's Commitment in the Policy Letter.** The AAC will also identify means to expand private participation in airport services to ensure safe and

---

[18] Since 2004 the AAC has regained a Category One rating for operational safety, which had been lost when the country was decertified in 2001.

efficient operations. Moreover, the AAC will confirm that it has maintained operational security at the level required to keep its Category One ranking.

c) Energy

2.25 **Objectives.** Clear strategic guidelines that have the support of the private sector and civil society are needed for the sector. The operation assists in the preparation of a consensus-based, national energy strategy that supports private sector participation in energy provision and conservation. The strategy will address issues related to expanding coverage ─especially in rural areas─ improving energy efficiency, promoting alternative energy sources, and expanding integration with regional sources of energy supply.

2.26 **Government's Commitment in the Policy Letter.** A strategy will be prepared that outlines a consensus based approach to developing the energy sector. The strategy will be prepared as part of an IDB group operation funded by the MIF (Integrated Review of the Regulatory and Policy Framework for Energy, PN-M1002, US$0.72 million).

2. Promotion of Investment and Exports

2.27 **Objectives.** The aim of this component is to strengthen the administrative capacity of MICI by *creating an improved institutional framework to promote foreign investment, export of goods and services, and adjustment to free trade*. These actions will strengthen MICI's ability to negotiate, implement and monitor trade agreements through the creation of a Chief Negotiator's Office. At the same time, the mandate of the MICI to establish the one-stop shops for exports and investment will be given greater legal force, assisting in coordinating the simplification of administrative procedures with other government entities. The new structure will also create an institutional mechanism to respond to complaints of ¨*dumping*¨ and to investigate safeguards measures as permitted under WTO and bilateral trade agreements, thus creating greater confidence by the private sector in the process of trade opening.

2.28 **Policy Conditions.** In the first tranche, the legal framework restructuring MICI to strengthen its roles in promoting investment, exports, and treaty implementation will be presented to the Legislature. For the second tranche, the implementing rules for the restructured organization will be presented, including those for VICOMEX and its dependencies. The offices for trade negotiation and administration will also have their implementing rules and organizational structures completed including those for a unit for investigations related to "dumping" and safeguard measures.

2.29 **Government's Commitment in the Policy Letter.** The MICI will present an agenda of complementary actions to support trade adjustment (investment programs, training, public outreach, legal reforms) based on consultation with civil society and the private sector.

3. Competition and Access in Local Markets

2.30 **Objectives.** These policies will *enhance market competition through improved market regulation and reduction in barriers to entry in order to achieve greater efficiency in local production and consumption.* One goal is to reduce unnecessary delays in business startup by allowing the ¨rapid opening¨ of firms once they have received a commercial or industrial license and that are not on a negative list. More importantly, ¨silent consent¨ will be given to the firms if the public institutions do not respond within a fixed time, an effective means to reduce costs for smaller firms that cannot afford long waiting periods before they begin operation. In terms of competition regulation by CLICAC, the existing legislation should be updated to make judicial procedures more effective, favoring oral process, limits on delays in proceedings, and raising the level of potential fines relative to the size of the firm in cases of absolute monopolistic practices. Further, the authority will be given a mandatory role in reviewing legal barriers to competition that result from the codes and practices in Panama's legal system.

2.31 **Policy Conditions.** By the second tranche, authorities will have designed and presented to the Assembly a legal framework to simplify the process of formalizing firms that do not present a risk to public health, safety or the environment. In addition, the authorities will present a proposal of an updated legal framework for the operation of CLICAC that ensures it is effective in addressing monopoly and consumer protection issues. The framework will provide guidelines for more expeditious review of cases, expand CLICAC's review to include legal barriers that may limit competition, and raise fines to make enforcement more effective.

4. Labor Training

2.32 **Objectives.** This component of the operation will *develop a strategy to promote private provision of training and define the role of the public sector in setting norms and regulations for training provision.* The proposed institutional framework will help workers to meet the demands of the labor market as new market opportunities arise.

2.33 **Government's Commitment in the Policy Letter.** A strategy document will be prepared and approved by the authorities that highlights the public and private sectors' roles in training, proposes reforms to the present system, and measures to move towards a system that favors greater private delivery of training services with appropriate regulation and supervision by the public sector. The document will outline a coherent institutional framework for the use of public funds that meets the needs of the private sector, provides for monitoring systems to ensure the quality of training, and promotes competition in the provision of training services. The document will be discussed and agreed upon by public and private sector actors.

5. Technological Innovation

2.34 **Objectives.** The actions outlined here are geared to promote a *strategy for innovation and technology adoption focused on supporting private enterprise (individual firms, clusters, and sectors) and a proposal for the regulatory changes needed to support the development of electronic commerce.* In addition to a National Strategy, detailed sector plans are needed for agriculture, biotechnology, electronic commerce, and manufacturing, among others, based on the strategy's guidelines. Additionally, new mechanisms are needed to provide financial and technical support for the adoption of technology by the private sector. The operation will also support changes to the legal framework for electronic commerce with modifications to the Digital Signature Law. The development of a secure and modern system of electronic commerce will support development of shipping and cargo activities, and support secured property transactions of various kinds.

2.35 **Policy Conditions.** By the second tranche, legal modifications to the Digital Signature Law should be submitted to the Legislature to support growth in use of electronic media for commerce. To advance the development of electronic commerce, the legal framework should be updated, to provide greater clarity on its application to data protection, penalties for inappropriate activities, and the administration of electronic certification.

2.36 **Government's Commitment in the Policy Letter.** A detailed implementation plan will be presented for the implementation of the approved National Strategy that offers a timeline, monitoring indicators, and identifies responsible institutions.

6. Governance and Transparency

2.37 **Objectives.** This component seeks to *create a legal framework that strengthens public sector transparency and governance to lower transactions costs and uncertainty and improve public procurement through the use of electronic media.* The authorities need to review the domestic legal framework in light of its international commitments, such as the CIIC, and make the necessary improvements. Further, the use of electronic media for publishing procurement notices will be implemented adding greater transparency in procurement by disseminating information on purchases of goods and services.

2.38 **Policy Conditions.** For the first tranche, the authorities will have: (i) established the CNTC with its secretariat and budget for its operation, and (ii) established the legal basis for *PanamaCompra* requiring the publication of public bidding requests using electronic media. For the second tranche, the CNTC will present proposed legal changes to substantially update national law based on Panama's international commitments under the CIIC and United Nations conventions against corruption.

2.39 **Government's Commitment in the Policy Letter.** The electronic system for publishing public procurement requests will be functioning and reporting will be made on the number of procurement notices published.

C. Cost and Financing

1.52 The total amount of the operation will be US$100 million from Ordinary Capital (OC) and the Single Currency Facility of the Bank.

III. PROGRAM EXECUTION

A. The Borrower, Guarantor and Executing Agency

3.1 The Government of Panama will be the borrower. The Ministry of Economy and Finance (MEF) will be the sole responsible agency to the Bank, delegating executing oversight to the Ministry's Technical Unit for Public Policy (UTPP), which will coordinate with other government agencies during implementation.

B. Project Execution and Administration

3.2 The UTPP has extensive experience in working with the Bank on sector lending operations, and its staff works on fiscal, macroeconomic, and trade policy issues. Among its functions will be: (i) overseeing the completion of the various conditions through coordination with other Ministries and agencies; (ii) presenting the materials for Bank review prior to tranche disbursements; and (iii) compiling and presenting updated monitoring data.

3.3 As described in the loan contract, the Borrower is responsible for maintaining appropriate accounting records of loan proceeds and loan resources should be deposited in segregated accounts. The accounting system should provide sufficiently detailed information to permit the verification and identification of the use made of program resources and to demonstrate that these funds have not been used for the procurement of ineligible goods or services. Furthermore, the Borrower undertakes to submit an audited financial statement to the Bank, upon its request, on the use made of loan resources within ninety (90) days following such request. The accounting system should generate timely financial statements and other reports, as required, and to permit audits to be conducted. In addition, the Borrower will cooperate in providing all necessary assistance and information required to fulfill these requirements.

3.4 The *Consejo de Gabinete,* an inter-ministerial group headed by the Ministry of Economy and Finance, will review the material presented for compliance of the conditions of the Policy Matrix. The Council acts as a focal point for coordination among the various Ministries and government entities involved and, therefore, will help to ensure consistency among the actions and timeliness in their delivery.

C. Procurement of Goods and Services

3.5 The present operation does not include procurement of goods and services.

D. Execution Period and Disbursement Schedule

3.6 The loan is to be disbursed in two tranches subject to the conditions presented in the Policy Matrix of up to US$70 million and US$30 million, respectively. The conditions for the first tranche have been complied with according to the Means of Verification and the disbursement will be conditioned on Board approval of the loan operation. The second tranche disbursement is expected within 18 months of the initial disbursement. The operation's disbursements are frontloaded owing to the extent of the reforms undertaken so far and their fiscal impact, including the fiscal commitments of the authorities to the CSS (para. 1.12) and the anticipated initial loss of revenue from its Free Trade Agreements (para. 1.14).

E. Policy Letter

3.7 The Government of Panama and the Bank have agreed on a Policy Letter, which presents the operation in the broader context of the Government's economic strategy. Also included are complementary actions by the Government that will support the goals of the PBL and that can be supported by a future technical cooperation loan (PN-L1009).

F. Monitoring and Evaluation

3.8 The UTPP will update the outcome indicators for the loan as identified in the Results Matrix. Furthermore, at the request of the IDB, the UTPP will prepare annual updates of these variables as contained in a data set prepared by the Project Team and which are included in the project files. In general, the data are readily available from public sources, and the UTPP has the staffing and capacity to obtain any additional information from the co-executing agencies. In the case of data on the use of electronic commerce by businesses, the Project Team has recommended the preparation of a survey, while in the case of ports and airport data will be collected from the appropriate authorities once they have identified the services that will be concessioned. As necessary, the Bank and the Borrower have agreed to use existing financial resources or those from the planned technical cooperation loan (PN-L1009) to ensure the completeness of baseline indicators and to update them periodically. Further, the Borrower has agreed to cooperate with and assist the Bank with any additional evaluation or assessment to be carried out eventually.

3.9 A set of *tracking indicators* is also provided as a means to monitor the status of the overall reform process in the medium term (Annex V). These indicators, however, are not part of the policy conditions of the present operation. Instead, they reflect follow-on activities to the Government's commitments in the Policy Matrix and the Policy Letter. These activities include, among others: (i) a revised Fiscal Responsibility Law; (ii) implementation of a plan to optimize the use of

public sector assets to improve debt sustainability; (iii) the concessioning of ports and airports and their services; and (iv) the implementation rules for the Digital Signature Law, Maritime Code; and Competition Authority. These indicators may help guide the formulation of components for a future PBL already included in the Country Strategy.

IV. VIABILITY AND RISKS

A. Environmental Impact

4.1 Given that the present operation does not finance investments, no significant environmental impacts are foreseen. Indirect impacts could occur from support to those sectors and/or institutions with weak legal frameworks in environmental or social matters. For that reason, the Project Team has focused on assessing these capacities under the current legal framework. The legal framework for environmental review has been in place since 1994 (Law 30) and has been updated to include an environmental classification system and standard review procedures for all projects. The National Environmental Authority (ANAM) conducts environmental reviews for all public and private projects that have been classified as environmentally sensitive. In addition, all Environmental Impact Assessments contain an Environmental Management Plan that addresses potential impacts (direct and indirect), includes all necessary monitoring mechanisms, and defines the responsibilities of the project's promoter.

4.2 During project preparation a preliminary review of current environmental legislation was conducted within the various sectors that the operation may indirectly influence, specifically the port, aviation, and energy sectors. The objective was to ensure that any future project that a public or private promoter may undertake, based on the reforms proposed, would be subject to appropriate review and mitigation efforts. In this context, the AMP is creating an Environmental Unit to serve as a principal advisor on all environmental and social matters under support of PN-0152. The Unit will be responsible for the inclusion, compliance and supervision/enforcement of the environmental variable in all aspects, including any future reforms and concessions in the sector. For the aviation and energy sectors there were no environmental and social risks pre-identified during project preparation. Nevertheless, as part of the environmental and social strategy of the operation, the Bank will make available during project execution, resources from PN-L1009 for activities required to ensure the inclusion of any environmental and/or social aspects that may arise.

B. Social Impact and Benefit

4.3 The impact of reforms proposed is expected to be positive and contribute to higher income and employment generation. Sound macroeconomic policies and improvements in the investment climate are critical elements to facilitate the economic adjustments to trade. Better fiscal management will help lower credit risk and improve funding costs for both the Government and the private sector,

leading to lower debt-servicing costs and greater access to long-term funding. Improvements in the legal framework for infrastructure will attract the private financing and management skills needed to expand, update, and improve services in ports and airports. Achieving consensus among the various actors on strategies for energy, training, and innovation will provide an important building block for future reforms by increasing stakeholder ownership. While a stronger institutional base for promoting trade, ensuring competition in local markets, and reducing start-up costs for firms will promote more dynamic markets. Finally, transparency in government procurement and accountability of public officials will not only lower costs, but also will enhance the credibility of the public sector among the domestic and international investor community. All these elements will contribute to increased investment and trade, and contribute to higher income and employment.

4.4 The operation does not foresee direct negative social impacts from its activities. The impact of the reforms in the tax code is largely equity-enhancing as it provides greater transparency in the system and eliminates exemptions and incentives that favored the upper deciles of the income scale (Goodin, 2005). Additionally, the reforms of the pension system ensure that intergenerational equity is maintained by permitting those under the existing system to remain under the previous rules, while permitting younger employees to participate in the mixed system. Social costs, however, may result from the adjustments in production and consumption related to the impact of increased trade. The actions outlined in the operation help to mitigate these costs by supporting a more responsive economic adjustment by: (i) supporting private participation in infrastructure as a means to lower operational costs and improve quality of service; (ii) promoting greater dynamism in markets; (iii) strengthening institutions that regulate market activities; and (iv) strengthening public sector governance and transparency.

4.5 The operation does not qualify as a social equity-enhancing project, as described in the indicative targets mandated by the Bank’s Eighth Replenishment (Document AB-1704).

C. Institutional Viability and Risks

4.6 The operation faces several types of risks that could limit its effectiveness. First, the reform program could lose public support and suffer setbacks. The main thrust of the PBL and its related activities is to ensure that the public support for the reform agenda continues by setting near term targets within a longer-term program. As demonstrated in the earlier work on the tax code and pension system, IDB technical contributions have been important to maintaining momentum in the reform process. Further, the Bank intends to consult with the private sector during implementation on a regular basis to ensure feedback on the operation. Second, the authorities may fail to implement the next steps for the policies launched in the operation. The follow-on technical cooperation loan, already in preparation, will help sustain the reform program through its analytical

work and consensus building efforts. Third, there exists the risk that the trade opening may be delayed. In this regard, the conclusion of the negotiated treaties will depend on factors outside the control of the present operation. However, the Government has made a clear case for a trade opening and its support for bilateral agreements with other trade partners indicates a good faith effort.

INVESTMENT CLIMATE AND TRADE ADJUSTMENT PROGRAM (PN-0160)

POLICY MATRIX

Objectives/Areas of intervention	First Tranche	Second Tranche	Means of Verification
I. Macroeconomic framework			
A. Fiscal stabilization ***Objective: Create a macroeconomic environment conducive to greater private investment and rapid, sustainable economic growth.***			
1. Maintain a macroeconomic framework conducive to achieving the program's objectives	1.a. Maintained a macroeconomic framework conducive to achieving the program's objectives and the guidelines established in the Sector Policy Letter	1.b. Maintained a macroeconomic framework conducive to achieving the program's objectives and the guidelines established in the Sector Policy Letter	1.a. and 1.b. Consultation with the IMF; IDB analysis
2. Reduce fiscal deficit with expansion of tax base and control of current spending	2.a. Approved, enacted, and put in force appropriate legal framework to expand tax base and control fiscal spending (Law 6 of 2005)	2.b. Approved an action plan to restructure public sector institutions, as mandated in Article 1 of Law 6 of 2005	2.a. Fiscal Equity Law (Law 6) published in Official Gazette 25,232 of 3 February 2005; regulations, Executive Order 143 of 27 October 2005, published in Office Gazette 25,419 of 1 November 2005 2.b. Approval by the Ministry of Economy and Finance
3. Reduce financial and actuarial deficit of the Social Security Fund (CSS)	3.a Approved, enacted, and put in force reforms to the legal framework of the CSS in order to reduce its actuarial deficit and make it financially sustainable in the long run (Law 51 of 2005)	3.b. Approved, enacted, and put in force regulations under the new legal framework of the CSS (Law 51 of 2005)	3.a. Law amending the Social Security Fund Act, Law 51, published in Official Gazette 25,453 of 28 December 2005 3.b. Publication in the Official Gazette

Objectives/Areas of intervention	First Tranche	Second Tranche	Means of Verification
II. Investment climate and trade adjustment			
A. Infrastructure ***Objective: Create an investment climate conducive to greater private participation in infrastructure provision in order to improve the coverage, efficiency and quality of services.***			
Maritime sector 1. Create an updated legal framework for the maritime sector		1. Presented a proposal to reform the maritime sector's legal framework, which includes naval financing, maritime procedures, and flagship activities (AMP)	1. Presentation of the draft to the Legislative Assembly.
2. Reduce obstacles to private sector investment in infrastructure and port services		2. Approved, enacted, and put in force regulations for infrastructure concessions and the provision of maritime port services that promote transparency for the private sector's participation in the operation, administration, maintenance, and construction of maritime infrastructure and port services (AMP)	2. Publication in the Official Gazette
Airport sector 3. Adjust laws regulating the sector to be consistent with international standards		3. Presented a proposal to reform the legal framework of the air transportation sector to ensure complementarity and consistency with international standards in the sector	3. Presentation of the draft to the Legislative Assembly

Objectives/Areas of intervention	First Tranche	Second Tranche	Means of Verification
B. Promotion of investment and exports ***Objective: Create an improved institutional framework to promote foreign investment and the export of goods and services***			
1. Strengthen the Ministry of Commerce and Industry (MICI) in its function of formulating public policies	1.a. Presented a proposal to reform the legal framework of the MICI, which includes the reorganization of the ministry in order to strengthen its role in the promotion of exports and investments, commercial negotiations, administration of commercial treaties, and trade protection (MICI)	1.b. Approved, enacted, and put in force regulations and the administrative organization of the MICI in order that (i) the Vice Ministry for International Trade (VICOMEX) be comprised of: (a) the National Investment Promotion Directorate; and (b) the National Export Promotion Directorate, and (ii) that the Office of the Chief of International Commercial Negotiations be comprised of: (a) the International Trade Negotiations Office; and (b) the Office of International Trade Treaty Administration and Trade Defense	1.a. Presentation of the draft to the Legislative Assembly 1.b. Publication in the Official Gazette
C. Competition and formalization in local markets ***Objective: Enhance market competition through improved regulatory framework and reduction in barriers to entry***			
1. Establish transparent and efficient mechanisms for administrative and legal processes in the area of market regulation		1. Presented a proposal to reform the regulatory framework of the Commission for Competition and Consumer Affairs (Law 29 of 1996) in order to expand its authority and modernize its administrative structure to verify compliance with regulations in the area of consumer protection and free economic competition and reaffirm the authority to analyze the laws and regulations pertaining to competition in the local market (MICI)	1. Presentation of the draft to the Legislative Assembly
2. Reduce obstacles to the formalization of companies		2. Presented a proposal to reform the legal framework for the formalization of businesses in order to simplify the process for companies engaged in activities that do not present a high risk to the public	2. Presentation of the draft to the Legislative Assembly

Objectives/Areas of intervention	First Tranche	Second Tranche	Means of Verification
D. Technological innovation ***Objective: Support the development of a system for efficient electronic commerce and transactions***			
1. Create a suitable legal framework to develop electronic commerce and transactions		1.a Presented a proposal to amend the Digital Signature Law (current Law 43 of 2001) which: (i) ensures that international security standards are applicable, (ii) establishes penalties, and (iii) indicates the roles and functions of the institutions that certify digital signatures of both companies and individuals	1.a. Presentation of the draft to the Legislative Assembly
E. Governance and transparency ***Objective: Create a legal framework that strengthens public sector transparency and governance to lower transaction costs and legal uncertainty***			
1. Increase the transparency of public institutions	1.a Created and started operations of the National Commission for Transparency against Corruption (CNTC)	1.b. Presented a proposal to reform the legal framework for the fight against corruption in order to bring it in line with the requirements set out in the international conventions of the Organization of American States and the United Nations against corruption	1.a. Executive Order 179 of 27 October 2004 published in Official Gazette 1.b. Presentation of the draft to the Legislative Assembly
2. Increase the efficiency and transparency of government procurement	2.a. Approved, enacted, and put in force the legal framework to establish an electronic procurement system that is accessible to the public and improves efficiency and transparency of public procurement		2.a. Executive Order 98 of 2 September 2005 published in Official Gazette

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

PROPOSED RESOLUTION DE-__/__

Panama. Loan ___/OC-PN to the Republic of Panama. Investment Climate and Trade Adjustment Program

The Board of Executive Directors

RESOLVES:

That the President of the Bank, or such representative as he shall designate, is authorized, in the name and on behalf of the Bank, to enter into such contract or contracts as may be necessary with the Republic of Panama, as Borrower, for the purpose of granting it a financing to cooperate in the execution of an investment climate and trade adjustment program. Such financing shall be in the amount of up to US$100,000,000, which is part of the resources of the Single Currency Facility of the Bank's Ordinary Capital, and will be subject to the Financial Terms and Conditions and the Special Contractual Conditions of the Project Summary of the Loan Proposal.

(Adopted on __ _______ 200_)

LEG/OPR/RGII/IDBDOCS#667676
PN-0160