

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

NICARAGUA

PROGRAM TO SUPPORT FISCAL AND SOCIAL MANAGEMENT IMPROVEMENT

(NI-L1011)

LOAN PROPOSAL

This document was prepared by the project team consisting of: Sandra Bartels (FMM/CNI), Project Team Leader; Rafaela Varela (CID/CNI); Laura Ripani (SCL/SPH); Gustavo Zuleta (SCL/SPH); Roberto A. Camblor (ICF/FMM); Dougal Martin (CID/CNI); Manuel Márquez Fariña (INT/INT); Miguel Coronado (LEG/SGO); Ida Fernández (ICF/FMM); and Cecilia Bernedo (ICF/FMM).

CONTENTS

PROJECT SUMMARY

| | | |
|------|--|----|
| I. | DESCRIPTION AND MONITORING OF OUTCOMES..... | 1 |
| A. | Background, problem to be addressed, and rationale..... | 1 |
| B. | Fiscal situation..... | 2 |
| C. | Internal Revenue Service (DGI) | 3 |
| D. | Customs Administration (DGA)..... | 5 |
| E. | Management of public expenditure | 5 |
| F. | Fiscal transparency..... | 6 |
| G. | Social expenditure..... | 6 |
| H. | Objective and components..... | 7 |
| I. | Outcome indicators and milestones for subsequent operations..... | 9 |
| J. | Expected outcomes of the program | 10 |
| II. | FINANCIAL STRUCTURE AND PRIMARY RISKS OF THE PROGRAM | 11 |
| A. | Financial tool..... | 11 |
| B. | Coordination with other financial and cooperation agencies | 12 |
| C. | Social and environmental risks | 12 |
| D. | Other key issues and risks..... | 12 |
| III. | IMPLEMENTATION AND MANAGEMENT PLAN | 13 |
| A. | Summary of implementation arrangements..... | 13 |
| B. | Summary of agreements for monitoring outcomes | 13 |
| IV. | POLICY LETTER | 13 |

| ANNEXES |
|---|
| PRINTED ANNEXES: Annex I: Policy matrix |

| ELECTRONIC LINKS |
|---|
| REQUIRED 1. Policy letter http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=1389478 2. Means of verification http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=1367311 3. Results matrix http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=1367312 OPTIONAL 1. Risk analysis http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=1565260 |

APPENDICES

Proposed resolution

ABBREVIATIONS

| | |
|-------|--|
| CFAA | Country Financial Accountability Assessment |
| CGR | Contraloría General de la República [Office of Government Accounting] |
| DGA | Derechos Arancelarios de Importación [Customs Administration] |
| DGI | Derechos Arancelarios de Importación [Internal Revenue Service] |
| FSO | Fund for Special Operations |
| GDP | Gross Domestic Product |
| IMF | International Monetary Fund |
| MDG | Millennium Development Goals |
| MHCP | Ministry of Finance [Ministerio de Hacienda y Crédito Público] |
| MTBF | Medium-term budget framework |
| OC | Ordinary Capital |
| PAM | Performance assessment matrix |
| PBL | Policy-based loan |
| PCR | Project completion report |
| PEF | Programa Económico Financiero [Economic Financial Program] |
| PEFA | Public Expenditure and Financial Accountability |
| PER | Public Expenditure Review |
| PFA | Public Financial Administration |
| PGR | Presupuesto General de la República [National General Budget] |
| PIP | Public Investment Program |
| PRGF | Poverty Reduction and Growth Facility |
| PRS | Poverty Reduction Strategy |
| RUC | Registro Unico del Contribuyente [Master Taxpayer Register] |
| SIGFA | Sistema Integrado de Gestión Financiera y Administrativa [Integrated Financial and Administrative Management System] |

PROJECT SUMMARY

NICARAGUA PROGRAM TO SUPPORT FISCAL AND SOCIAL MANAGEMENT IMPROVEMENT (NI-L1011)

| Financial Terms and Conditions | | | | | |
|--|----------------|----------|---------------------------------|--------------|--------------|
| Borrower: Republic of Nicaragua | | | | OC | FSO |
| Executing agency: Ministry of Finance | | | Amortization period: | 30 years | 40 years |
| Source | Amount | % | Grace period: | 5.5 years | 40 years |
| IDB: FSO | US\$10 million | 50 | Disbursement period: | 12 months | 12 months |
| OC | US\$10 million | 50 | Interest rate: | Variable | 0.25 |
| Local | US\$0 | 0 | Inspection and supervision fee: | * | N/A |
| Other/Cofinancing | US\$0 | 0 | Credit fee: | * | N/A |
| Total | US\$20 million | 100 | Currency: | U.S. dollars | U.S. dollars |
| Project at a glance | | | | | |
| <p>Project objective: The objective of this program is to improve fiscal and social management through more efficient and more transparent revenue collection and expenditures, in order to contribute to sustained economic growth and poverty reduction. This programmatic policy-based loan consists of a series of three fast-disbursing operations, the first being the present loan in the amount of US\$20 million.</p> <p>Special contractual conditions: The operation's single tranche will be disbursed once the authorities have submitted to the Bank the agreed documentation, certifying fulfillment of the conditions in Annex I.</p> <p>Exceptions to Bank policies: None.</p> <p>Project consistent with country strategy: Yes [X] No []</p> <p>Project qualifies as: SEQ [X] PTI [] Sector [] Geographic [] Headcount []</p> <p>Procurement: N/A</p> <p>Verified by ESR on: 28 January 2008</p> | | | | | |

* The credit fee and inspection and supervision fee will be established periodically by the Board of Executive Directors as part of its review of the Bank's lending charges, in accordance with the applicable provisions of the Bank's policy on lending rate methodology for Ordinary Capital loans. In no case will the credit fee exceed 0.75% or the inspection and supervision fee 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. DESCRIPTION AND MONITORING OF OUTCOMES

A. Background, problem to be addressed, and rationale

- 1.1 Nicaragua's economic performance has been gradually improving since 2001. The economy has been growing moderately, at an annual average rate of 3% in real terms, with average inflation of 8%¹ and high levels of international reserves. Exports have doubled to nearly US\$2 billion, and public debt contracted from 236% of GDP in 2002 to 101% by year-end 2007. The fiscal balance moved from a deficit of 7% of GDP in 2001 to a modest surplus in 2006 and 2007. In addition, the financial sector stabilized in the wake of crises in 2000 and 2001.
- 1.2 Despite the improvement in macroeconomic indicators, poverty levels in the country have not come down substantially, but only slightly: overall poverty fell between 1993 and 2001, from 50% in 1993 to 46% in 2001.² Similarly, extreme poverty declined from 19% in 1993 to 17% in 1998 and 15% in 2001, then rose again, to 17% in 2005. Nicaragua will be unable to bring poverty down substantially without significantly higher and sustained long-term economic growth, and a marked improvement in the allocation of expenditure on poverty reduction programs. To this end, fiscal management must be strengthened, since it plays a pivotal role in supporting public policy and the government's program in general, as well as the performance of public expenditure aimed specifically at poverty reduction.
- 1.3 The key objective of the government's current Economic Financial Program [Programa Económico Financiero] (PEF) (2007-2010) is to create economic conditions that would significantly reduce poverty. With this objective in mind, the current administration is trying to generate additional tax revenues to finance increased public investments and spending on reducing poverty. To achieve this objective, budget programming must be better aligned with the goals of the PEF.
- 1.4 On the basis of the 2007-2010 PEF, Nicaragua reached agreement with the International Monetary Fund (IMF) under the Poverty Reduction and Growth Facility (PRGF) in October 2007. The IMF program will guarantee US\$110 million in loans to the country in 2008-2010. In return, Nicaragua is committed to maintaining a stable macroeconomic policy environment, while creating sufficient fiscal space to increase expenditure on poverty reduction. In addition, in late 2007 a group of donors comprising the Budget Support Group (six bilateral donors, the European Commission, the World Bank, and the IDB) agreed on a set of indicators and priority actions for the government's agenda, which are included in the "Budget Support Matrix" document.
- 1.5 As part of the IDB and World Bank assistance strategies, and with a view to helping the Nicaraguan government implement its poverty reduction and growth

¹ In recent months, the inflation indicator has increased significantly, reaching a year-on-year rate of 16.88% in December 2007. This partly reflects a regional trend fueled by higher world oil and food prices.

² Data from the 2007-2010 Economic Financial Program (PEF).

strategy, the banks issued a joint “Country Financial Accountability Assessment” (CFAA),³ which analyzed the country’s Public Financial Administration (PFA). In addition, in 2006 the government reached agreement with the Bank, the World Bank, the European Commission, and the Department for International Development to implement the Public Expenditure and Financial Accountability (PEFA) Performance Measurement Framework, based on international best practices. This framework, developed under the Public Expenditure and Financial Accountability program,⁴ includes the report on PFA performance and a set of indicators, based on the Highly Indebted Poor Country Initiative public expenditure tracking benchmarks, the IMF Fiscal Transparency Code, and other international standards. Accordingly, this programmatic policy-based loan was designed on the basis of four basic tools: (i) the 2007-2010 PEF; (ii) the IMF agreement; (iii) the Budget Support Matrix; and (iv) the CFAA and PEFA indicators.

B. Fiscal situation

- 1.6 Over the last 15 years, central government tax revenues, the principal component of nonfinancial public sector aggregate data, increased from 10.3% of GDP in 1990-1992 to 15.3% in 2003-2005, as shown in Table 1.1. Despite this improvement, revenues were still not sufficient to meet the physical and social infrastructure needs required for the country’s development.
- 1.7 This means that the country must continue to raise revenue collection to a sustainable level, by enhancing the efficiency of the tax and customs administration, thus increasing taxpayer compliance while promoting greater horizontal taxpayer equity and preventing tax evasion. Also, it will change the composition of public expenditure allocated to poverty and fiscal transparency.

³ World Bank and IDB (2003), report updated in 2006.

⁴ Program sponsored jointly by the World Bank, IMF, European Commission, Department for International Development, the French Ministry of Foreign Affairs, the Royal Norwegian Ministry of Foreign Affairs, the Swiss State Secretariat for Economic Affairs, and the Strategic Partnership with Africa [see the PEFA website (www.pefa.org) for additional information on the reference framework (PEFA, 2005)].

**Table I.1: Central Government Revenues -
Selected Years**

| NICARAGUA - CENTRAL GOVERNMENT REVENUES - SELECTED YEARS | | | | | | | | | |
|--|-------------|-------------|-------------|---------------|-------------|-------------|-------------|---------------|-------------|
| 1. As % of GDP | 1990 | 1991 | 1992 | Average 90-92 | 2003 | 2004 | 2005 | Average 03-05 | 03-05/90-92 |
| Tax revenues | 8.1 | 10.9 | 11.9 | 10.3 | 14.8 | 15.1 | 15.9 | 15.3 | 1.5 |
| Social security contributions | 0.9 | 1.5 | 1.7 | 1.4 | 3.4 | 3.5 | 3.5 | 3.5 | 2.5 |
| Nontax revenues | 0.3 | 0.6 | 0.6 | 0.5 | 1.2 | 1.4 | 1.3 | 1.3 | 2.7 |
| Transfers | 0.7 | 0.4 | 0.1 | 0.4 | 0 | 0 | 0 | 0.0 | 0.0 |
| Revenues excluding donations | 10.0 | 13.3 | 14.3 | 12.5 | 19.4 | 19.9 | 20.7 | 20.0 | 1.6 |
| Capital donations and revenues | 0.9 | 7.3 | 2.8 | 3.6 | 3.4 | 3.3 | 3.3 | 3.3 | 0.9 |
| Total revenues | 10.9 | 20.6 | 17.0 | 16.2 | 22.8 | 23.2 | 24.0 | 23.3 | 1.4 |
| 2. Structure - As % | 1990 | 1991 | 1992 | Average 90-92 | 2003 | 2004 | 2005 | Average 03-05 | |
| Tax revenues | 81.4 | 81.9 | 83.1 | 82.1 | 76.3 | 75.7 | 76.7 | 76.2 | |
| Social security contributions | 9.3 | 10.9 | 12.2 | 10.8 | 17.7 | 17.4 | 17.0 | 17.4 | |
| Nontax revenues | 2.6 | 4.5 | 3.9 | 3.7 | 6.1 | 6.9 | 6.3 | 6.4 | |
| Transfers | 6.7 | 2.7 | 0.8 | 3.4 | 0.0 | 0.0 | 0.0 | 0.0 | |
| Revenues excluding donations | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | |

Sources: In-house document based on ECLAC, Central Bank and Internal Revenue Service (DGI)

C. Internal Revenue Service (DGI)

- 1.8 In recent years, a tax reform started to be implemented with a view to augmenting the tax revenue base by eliminating exemptions and deductions, reducing inequality, heightening administrative efficiency, and eliminating arbitrary tax rules. To this end, two tax laws were introduced: the Tax Base Expansion Act [Ley de Ampliación de la Base Tributaria] (LABT) in September 2002 and the Fiscal Equity Act [Ley de Equidad Fiscal] (LEF) in May 2003, amended in June 2005. In addition, the International Monetary Fund has been helping to strengthen the DGI over the last four years through technical assistance for a strategic plan to strengthen the Internal Revenue Service [Dirección General de Ingresos] (DGI). The IMF's technical assistance program produced the following basic results: (i) the structure of the DGI's central office was reorganized, making it possible to assign clear responsibilities to each of the tax administration's key functions (normal collection, audits, and forcible collection); (ii) the large taxpayer unit was converted to a genuine national large taxpayer unit, with appropriate procedures for audits of non-filers and late filers and improved audit efficiency; (iii) new procedures for auditing non-filers and late filers were introduced, starting with more extensive audits of large and medium-sized taxpayers; (iv) the functioning of the audit area was improved by increasing the external tax information available; (v) a reliable register of taxpayers was established; (vi) a plan of actions to enforce the tax code was established; and (vii) training plans were developed for DGI employees.
- 1.9 Despite the progress, there is still some way to go. To pursue the institutional strengthening process begun some years before, the DGI must continue to

implement its Strategic Plan⁵ if it is to consolidate the progress achieved. The specific areas that should be addressed immediately are:

- a. Updating of the Master Taxpayer Register [Registro Unico del Contribuyente] (RUC), a weak point of the Strategic Plan. This is in line with the key role the Master Taxpayer Register plays in supporting the operations of tax administration. Also, the updating of the RUC is essential in controlling evasion and documentation (invoicing and goods in transit), which is conducive to formalization, as well as for mass control (cross invoicing between suppliers and customers), the principal tool for controlling evasion in modern tax administrations.
- b. A failure to update the Taxpayer Register systematically and to keep records of taxpayer obligations distorts data on the true number of taxpayers. So, it is vitally important to upgrade this area, since it is involved in most Tax Administration functions (i.e., locating taxpayers for collection notices or audits, among other activities).⁶ More effort is needed to widen the tax base in order to improve the equity of the system and to continue developing tax enforcement capacity.
- c. Another critical aspect in the process of DGI modernization is to finish implementing the collection system (tax payments) through the banks. Although such a payment system is now in place for large taxpayers, it should be broadened to include medium and small taxpayers, who account for most tax payment services and transactions.

⁵ The Strategic Plan was formulated as part of the assessment of the status of the institutional situation, prepared by the IMF technical assistance mission. Among the problems addressed two important issues stand out; the first is related to the master taxpayer register and the second ensues from the first: i) *A Taxpayer Register that has not been updated and was limited in scope, and ii) High rate of noncompliance in the filing and payment of tax returns.*

⁶ The Bank through a TC (NI-T1051) is assisting the DGI with the review and update of the RUC, which will facilitate the establishment of a new register and tax identification number based on international standards.

D. Customs Administration (DGA)

- 1.10 With respect to the DGA, in the last seven years, Customs has been meeting and even exceeding the revenue goals set in its budget estimates, for two main types of duties: import duties and tariffs and the value added tax (VAT) on imports. Revenues increased from 2.661 billion córdobas in 2001 to over 5.7 billion córdobas in 2007, for a 115% total increase in nominal terms over the period.
- 1.11 It should be noted that these goals were achieved during a period when tariff rates were being reduced, translating into less revenue from import duties and tariffs and a smaller VAT tax base associated with each import transaction. Moreover, improved customs management facilitates trade in a more favorable business climate, and attracts investment, thereby reactivating the economy and boosting imports.
- 1.12 Improving DGA management is key to raising customs revenues. Also, as the border control agency, the DGA can further refine the inspections and payments area, but to do so calls for certainty about customs operations. Currently, given the volume of transactions, risk management, and the demands of trade facilitation, it will only be possible to meet these requirements efficiently and effectively with advanced systems that can electronically receive, process, and disseminate information.
- 1.13 To this end, the new customs management IT system must be put in place in order to have paperless customs management. This means it will be necessary: (i) to formulate new techniques for a posteriori audits, through technical assistance and training for newly hired personnel in company audits; (ii) to improve the techniques and tools for identifying and applying risk analysis, which must be part of the new management IT system; (iii) to strengthen the recently created customs laboratory, with the addition of a specialized library and the equipment to achieve a high operational level and international quality certification; (iv) to create a digital file management system for customs declarations and attached documents; and (v) to upgrade customs infrastructure.

E. Management of public expenditure

- 1.14 The enactment of the Financial Administration and Budget Procedures Act [Ley de Administración Financiera y del Régimen Presupuestario] (Law 550) of August 2005, as amended, illustrated a positive attitude by the executive and legislative branches towards improving the transparency and administration of public finances. In addition, based on the central government's budget bill for fiscal 2006, methodological changes were introduced to budget policies to move away from the incremental practices existing up to that time, and to ensure better control of resources. The first step was to set ceilings on institutional expenditure and establish a process of policy reconciliation between the sector demands of the ministries and the targets of the medium-term financial program. This process modified the previous criteria of setting ceilings on each institution's current and capital expenditure based on the financial program. Secondly, a medium-term

budget framework was formulated for each institution's programs and goals. Thirdly, a process to gradually incorporate donor-financed programs and projects was instituted.

- 1.15 Despite these successes, there are still significant challenges to further tightening public expenditure management. These challenges are: (i) lack of clarity regarding beneficiary priorities and the criteria for prioritizing public investment in budget formulation; (ii) absence of budget information on available resources, especially international cooperation resources; (iii) the medium-term budget framework does not cover the entire public sector; (iv) there are no tools or procedures for linking the physical and financial aspects of budget formulation or for incorporating them into the integrated financial and administrative management system (SIGFA); and (v) the purpose and operational and financial budget classifiers are not adapted to the international public finance data system.

F. Fiscal transparency

- 1.16 The Nicaraguan government has made considerable headway in performing the first external audit of the 2005 National Budget [Presupuesto General de la República] (PGR). The audit identified a number of shortcomings in the internal control systems of audited institutions.⁷ Nevertheless, public access to information is limited by the absence of key documents, such as financial statements, reports on resources received by service provider units, and comprehensive records of procurement processes. Likewise, progress must be made in areas such as the fiscal transparency of decentralization and the monitoring of aggregate public sector fiscal risk. Here, the current administration has determined that fiscal control of transfers to municipios will be exercised by containing the total public sector deficit under the PRGF agreed with the IMF.

G. Social expenditure

- 1.17 As to the need for greater efficiency in resource allocation for poverty reduction, one of indicators in the budget support matrix is poverty expenditure as a percentage of GDP. This illustrates the government's interest in making a major budget effort to reduce existing poverty rates by allocating significant resources to poverty reduction. However, in qualitative terms, social expenditure in general and expenditure on poverty reduction in particular, suffer from: (i) poorly coordinated efforts within and between institutions and agencies; (ii) scattered efforts; and (iii) lack of coverage. The different documents analyzing the incidence of this type

⁷ Problems such as: (i) lack of financial statements on budget execution; (ii) expenses incurred without the corresponding tax credits; (iii) loans with private financial institutions without proper authorization; (iv) weaknesses in the DGI's IT system; and, (v) expenses incurred without supporting documentation. Nonetheless, a requirement that this activity be performed annually within the time frames stipulated in Law 550 is still pending.

of expenditure have emphasized the need for clear and transparent mechanisms to target these initiatives.⁸

- 1.18 In this regard, *the efficiency of social expenditure could be increased*, by creating programs with broader coverage and clear objectives that are not duplicated in other programs. In particular, according to the World Bank's 2007 Poverty Reduction Strategy (PRS), 47% of expenditure on poverty reduction benefits the nonpoor population. According to the PRS, the government has sufficient margin to reallocate budget resources to better targeted programs, reallocate specific program budgets to target the poorest beneficiaries, or else extend coverage to already established social programs for lower-income groups. To this end, it is desirable to use targeting tools that are associated with a greater degree of transparency in the allocation of expenditure on poverty (i.e., poverty maps).
- 1.19 This programmatic policy-based operation will give greater flexibility to decision making on reform in an institutional setting, which requires coordination between diverse institutions. In addition, measuring the effects of the first interventions makes it possible to orient more effectively subsequent policy reforms. The program will center on supporting some of the measures the government designed for the new 2007-2010 PEF on which there is consensus in the performance assessment matrix.⁹ The aim is to achieve greater effectiveness, efficiency, and transparency in fiscal policy management, for which immediate actions are established along with a critical path to make the new management methodologies and fiscal policies sustainable, thus expanding revenue collection and financing social spending on poverty reduction.
- 1.20 The first programmatic operation acknowledges the great strides that have been made to improve policy on planning, budget, revenue administration in fiscal 2007 and the first quarter of 2008, and the significant impact such actions have on reaching the goals of transparent and efficient governance. The second and third programmatic operations will help to consolidate these actions in 2009 and 2010.

H. Objective and components

- 1.21 **Objective.** The objective of this program is to improve fiscal and social management by increasing efficiency and transparency in both collection and expenditure, in order to contribute to sustained economic growth and poverty reduction.
- 1.22 **Program structure.** The general framework of the present operation is derived from the PAM based on a consensus reached with the government and Budget Support Group (BSG). The specific PAM actions the operation is underpinning are: (i) maintenance of a macroeconomic framework, (ii) increased revenue collection, (iii) performance of budget audits, (iv) improved public expenditure management,

⁸ See PER 2007 (published by the World Bank).

⁹ PAM.

- (v) increased spending on poverty, and (vi) advances in the use of the electronic procurement system under Law 323.
- 1.23 This programmatic policy-based loan consists of a sequence of three rapidly disbursing operations, the first of which is the present loan in the amount of US\$20 million. The first operation will support actions to help the Nicaraguan government implement the measures in its 2007-2010 economic-financial program (PEF), which has also served as a framework for the structural adjustments of the Poverty Reduction and Growth Facility (PRGF) agreed to with the International Monetary Fund (IMF). The first programmatic operation would improve policies in five areas, i.e.:
- a. **Maintain a stable macroeconomic environment.** The program will support the development of a macroeconomic policy consistent with the goals of the PRGF and the policy map. These goals include actions: (i) to increase tax revenue; and (ii) to maintain a balanced fiscal policy that reduces poverty rates.
 - b. **Improve the administrative management of the Nicaraguan Internal Revenue Service (DGI) and Customs Administration (DGA).** Here, the objective is to increase revenues through measures that strengthen the two collection agencies: DGI and DGA. The first operation will begin an updating of the RUC, with a commitment to successfully increase revenues from new taxpayers by at least 5% by May 2008 with respect to the baseline (December 2006). The RUC is one of the main issues that must be addressed by the tax administration, since it makes it possible to identify and learn about the main characteristics of all taxpayers. Another commitment made in this area is to begin an assessment of the tax information system. Regarding the DGA, meeting the customs revenues goals outlined in the 2007 National Budget (PGR) was incorporated as a trigger.
 - c. **Improve the management of results-oriented public expenditure.** The program objective is to support actions to achieve budget formulation based on medium-term investment planning and annual work plans in key sectors of public spending management, taking into account the clear prioritization of social expenditure. Accordingly, the program would *improve the quality of budget formulation and execution*, expanding the coverage of information, decentralizing the decision-making process, and setting strategies that create financial efficiency so that expenditure is focused on priority poverty reduction programs. The first programmatic operation will support the design and implementation of a medium-term budget framework methodology in 25 public institutions, in the 2008 budget.
 - d. **Promote the transparent management of government resources.** This first programmatic operation will verify that the government has begun the Financial and Compliance Audit of Budget Execution for 2006. Regarding the government's use of administrative procurement systems, this first operation

will promote improved transparency through an electronic procurement system available on the Internet, for 32 public entities, to permit greater participation and competitiveness in procurement.

- e. **Improve the efficiency of spending on poverty reduction.** The objective will be to ensure more resources are allocated to poverty reduction by the central government in 2007. In this way, the first programmatic operation acknowledges the current administration's efforts to increase central government allocations to poverty reduction as a percentage of GDP by at least 13.3% for 2007 as expressed in the PEF, which indicates a commitment to substantially higher spending on poverty reduction in 2007-2010 as a percentage of GDP. This commitment will be monitored using the program results matrix.

I. Outcome indicators and milestones for subsequent operations

- 1.24 Granting a second and third loan to support policy-based reform will depend on the attainment of specific milestones and would be aimed at completing the reforms undertaken with the proposed operation, as part of the continued reform of each sector. The milestones are:
 - a. **Maintain a stable macroeconomic environment.** This includes commitments regarding relatively low and stable levels of inflation, sustained GDP growth, and overall balance in the public sector, which is also stable.
 - b. **Improve the administrative management of the DGI and the DGA.** During the second tranche, with respect to the DGI, the trigger identified was verification of an increase in the registration of new taxpayers, specifically a 15% increase by May 2009 with respect to the baseline (December 2006). Regarding the commitment made in the Policy Matrix on conducting an assessment of the tax information system, this system is expected to be approved by the DGI in 2009; it would begin by implementing the recommendations for the third and last programmatic operation. Lastly, with respect to the DGA, the triggers included were attaining the 2008 customs revenue goals set out in the 2008 PGR, and implementing a new customs management IT system with 60% geographic and operational coverage in the last operation.
 - c. **Improve the management of results-oriented public expenditure.** The trigger for the second operation is related to implementation of the medium-term institutional expenditure framework (MGSMP) in at least 10 central government decentralized agencies. The trigger for the third operation will be to verify the government's commitment to integrating the physical and financial monitoring system for budget cycle investment projects. Lastly, for the final programmatic operation, the 2010 Budget is expected to be defined on the basis of information on costs, investment planning, and medium-term outcomes.

- d. **Promote the transparent management of government resources.** Having already started the Financial and Compliance Audit of Budget Execution for 2006 during the first operation, the trigger for the second operation will verify completion of the audit and publication of the results. The trigger for the third operation goes still further in seeking to capture the government's efforts to implement the 2006 Audit's recommendations in 21 central government agencies. As to government administrative procurement systems, the use of the electronic procurement system and its accessibility on the Internet will be verified in 50 public agencies in 2009 and 60 in 2010.
- e. **Improve the efficiency of expenditure on poverty reduction.** During the second and third operations, proposals to improve the composition of expenditure on poverty reduction will be promoted, where a higher percentage of resources is allocated to priority programs, based on their greater pro-poor impact, wider coverage of basic social services, and/or a closer relationship with the Millennium Development Goals (MDG). Also promoted will be proposed tools to target poverty reduction spending, so that priority programs go primarily to the most vulnerable social groups. More specifically, as a trigger for the second operation, the project would have a technical proposal to review expenditure on poverty reduction in order to allocate more resources to pro-poor programs, with extensive coverage of basic social services that are more closely aligned with the MDGs. At the same time, there should be a proposal to prioritize this expenditure on the most vulnerable population groups. This review of pro-poor expenditure entails the design of a proposed system for monitoring and evaluating pro-poor program expenditure, including establishment of baselines.¹⁰ The trigger for the third programmatic operation will be evidence that the proposals have been used to improve expenditure in terms of review and prioritization, along with an initial evaluation of the impact achieved. In addition, every effort will be made to ensure the monitoring and evaluation system is functioning in support of policy decisions on poverty expenditure.

J. Expected outcomes of the program

- 1.25 The medium-term outcomes of the program are expected, in principle, to translate into improvements in the country macroeconomic environment (high economic growth, low inflation, and overall public sector balance), thus contributing to economic growth and poverty reduction. Specifically, improvements will be seen in taxation and spending on poverty, including:
 - a. 15% increase in the number of taxpayers by 2010, through efforts to bring down tax evasion as a result of more efficient tax administration and more effective performance of functions involving the DGA (in parafiscal controls and their contribution to reducing the cost of commercial transactions).

¹⁰ One of the programs to be prioritized as part of the monitoring and follow-up system is the IDB-financed PAININ program.

- b. More efficient results-oriented public spending management and better operating efficiency through the implementation of a medium-term budget framework methodology in 10 decentralized public institutions, as well as a 50% increase in projects originating in the central government that have been evaluated by the end of the program.
- c. Increased transparency in the administration of government resources, through the inclusion of central government agencies (21) with audited budgets posted on the Internet. Significantly greater transparency will also be seen owing to an increase of more than 400% (from 14 to 60) in the number of public agencies using the electronic procurement system, with potential savings in procurement of as much as 5%.
- d. Increased expenditure on poverty from 12.2% to 15.5% by year-end 2009 as a percentage of GDP, with more effective allocation and targeting. With a view to meeting the social sector commitments assumed, social spending will take priority over public spending as a whole and every effort will be made to increase on a continuous basis as a proportion of GDP since this will have a more tangible impact on efforts to fight poverty and improve the quality of life.

II. FINANCIAL STRUCTURE AND PRIMARY RISKS OF THE PROGRAM

A. Financial tool

- 2.1 The programmatic modality selected by the Nicaraguan government and the project team draws on the tool's comparative advantages, since it facilitates dialog and continuous technical support throughout implementation of a reform agenda, and increases the impact of the proposed reforms. In particular, the flexibility of this tool is essential in scenarios like the one in Nicaragua which has a three-year program with the IMF, and a Budget Support Group that has reached a consensus on a three-year Budget Support Matrix underpinning the objectives of the government's Economic Financial Program. This programmatic policy-based loan in an estimated amount of US\$60 million (in three operations) is necessary for the three reasons:
- 2.2 **Implementation of the PEF and PRGF:** The objective of the PEF is to create conditions to significantly reduce poverty and ensure sustained economic growth, in a stable macroeconomic environment, with sustainable public finances and external accounts. In this context, the **three-year** IMF-backed program provides a macroeconomic framework centered on fiscal and monetary discipline and structural reform, with a view to increasing revenues and improving public resources management for poverty reduction. As a result, this operation will help create the fiscal space required by supporting measures to increase the collection of tax revenues, allocate resources for poverty reduction more efficiently, and optimize control and transparency.

- 2.3 **Consolidating progress towards public finance management:** The program has been structured to supplement and pursue the reform efforts backed by the Bank under the fiscal reform program. The program was also designed to produce an effect in what is considered to be a politically and institutionally viable setting, and would support the Nicaraguan government's sense of ownership of the reforms being implemented.
- 2.4 **Budget support and financial gap:** The government's budget depends largely on outside assistance. Budget support from multilateral and bilateral sources fundamentally helps to finance recurring and capital public expenditures. As a budget support program, this operation is essential for the continued achievement of structural goals, which, in conjunction with resources from other institutions and IMF program funding, will make it possible to channel more resources to investment and poverty reduction.
- 2.5 The first operation will be disbursed in a single tranche. This tranche of US\$20 million will be disbursed once the operation is approved and declared eligible, and the authorities submit the agreed documentation to the Bank, certifying fulfillment of the conditions in the policy matrix (Annex I). As a programmatic policy-based loan, the conditions precedent to the disbursement of the proposed operation are expected to be fulfilled prior to execution of the loan contract. Currently, all conditions have been met, and only the documents indicated in the policy matrix still need to be presented to the Bank. The second programmatic loan is expected to be prepared within 12 months after disbursement of the first loan. The progress of this second operation will depend on the rate at which the triggers are achieved.
- B. Coordination with other financial and cooperation agencies**
- 2.6 This operation is the result of a concerted effort by the donor community, and specifically the Budget Support Group, in which the Bank has been participating in the area of sector policy. The World Bank will provide additional support for the reforms proposed under the operation, in the form of a parallel loan to the Nicaraguan government.
- C. Social and environmental risks**
- 2.7 The program will have no direct negative effects, but will have direct social effects, since the measures to improve fiscal management will lead to increased spending on poverty reduction as a percentage of GDP, with more effective resource allocation.
- D. Other key issues and risks**
- 2.8 **Risk analysis.** During the program orientation mission, a risk analysis of the operation was performed with the participation of government authorities. The operation's most significant risk factors have to do with whether IMF financing will be available to complete the program since this will depend on whether the operation is approved (see electronic link).

III. IMPLEMENTATION AND MANAGEMENT PLAN

A. Summary of implementation arrangements

- 3.1 The borrower is the Republic of Nicaragua. The executing agency is the Ministry of Finance (MHCP), although there may be support for policy actions with respect to other institutions such as the Government Accounting Office [Contraloría General de la República] (CGR). The MHCP will have the following responsibilities: (i) deliver the reports, demonstrate the operation's conditions have been fulfilled, and produce such other reports as the Bank may request; (ii) promote actions to accomplish the program policy objectives, particularly the triggers for the second and third operations; and (iii) collect, file, and deliver to the Bank any information, indicators, and parameters that may help the government and the Bank monitor, gauge, and evaluate the outcomes of the program's three operations.

B. Summary of agreements for monitoring outcomes

- 3.2 The project team will monitor the program. The borrower and the Bank have agreed to supervise program execution through monitoring meetings to be scheduled by mutual agreement. Upon completion of the first operation, the project team will assess the progress of the program's proposed actions and its evaluation will be used as input in setting the policy conditions for the second operation, and in making any necessary adjustments to the trigger mechanisms proposed in the policy matrix (Annex I). The evaluation will include a measurement of the program indicators to determine progress made in attaining the indicators and implementing any necessary changes to achieve the program's medium-term goals. As programmatic operations are designed to produce results in the medium and long term, a full project completion report (PCR) will not be prepared until completion of the third operation. It will evaluate the impact of the program and the extent to which the objectives of the three operations have been fulfilled. The PCR will be prepared within six months after completion of the third programmatic operation. The borrower and the Bank previously agreed on the indicators and baseline for the final evaluation (see electronic link 1). The borrower will collect such data as are necessary for monitoring and evaluation. The authorities will cover the costs of collecting and processing this information, as part of the investments to be made with external financing in this sector. The indicators identified in the results matrix are mainly those the government is committed to follow based on its commitments for the investment programs or the PRGF with the IMF.

IV. POLICY LETTER

- 4.1 The Bank and the Nicaraguan government agreed on the macroeconomic and sector policies set out in the Policy Letter sent by the MHCP on 9 April (see link 1). The Letter describes the principal components of the government's strategy for this program, and reaffirms the government's commitment to implementing the reforms and activities agreed with the Bank.

PROGRAM TO SUPPORT FISCAL AND SOCIAL MANAGEMENT IMPROVEMENT (NI-L1011)

POLICY MATRIX

| Objectives | Actions taken | 2008 PBL Conditionalities | 2009 PBL Triggers | 2010 PBL Triggers | Medium-term outcomes |
|--|---|---|--|--|---|
| Preserve a stable macroeconomic environment based on the program objectives | Approval of the government's Economic-Financial Program [Programa Económico Financiero] (PEF) for 2007-2010 | Maintain a stable macroeconomic environment that is consistent with the program objectives | Maintain a stable macroeconomic environment that is consistent with the program objectives | Maintain a stable macroeconomic environment that is consistent with the program objectives | Fiscal and public debt sustainability |
| Improve the administrative management of the DGI and the DGA in order to increase tax revenues | <p>Implementation of the Tax Base Expansion Act, the Tax Census and the 2003 Audit Guarantee Plan</p> <p>Implementation of the Fiscal Equity Act and the Ministerial Agreement on Government Procurement, including the Master Taxpayer Register (RUC) for individuals or companies that participate in government competitive bidding or procurement processes in 2004</p> | <p>Update the Master Taxpayer Register, increasing the number of new taxpayers in the register by 5% by May 2008.</p> <p><i>Baseline: In December 2006, there were a total of 86,879 active taxpayers.</i></p> <p>Carry out the assessment of the tax information system.</p> | <p>Update the Master Taxpayer Register, increasing the number of new taxpayers in the register by 15%.</p> <p>Assessment of the tax information system approved by the DGI</p> | <p>Design and implement the tax collection system through banks, including medium-sized taxpayers.</p> <p>Begin implementing recommendations from the assessment of the tax information system approved by the DGI</p> | RUC working in accordance with international best practices |
| | Definition of a new customs management information system | Meet the revenue goals of the Customs Administration (DGA) set in the 2007 National Budget (PGR) | Meet the DGA's customs revenue goals set in the 2008 PGR | Implement the new customs management information system with 60% geographic and operational coverage. | <p>Revenues collected as a percentage of GDP is 19%, with cyclical adjustment.</p> <p>Greater efficiency in the management of the DGI and the DGA</p> |

| Objectives | Actions taken | 2008 PBL Conditionalities | 2009 PBL Triggers | 2010 PBL Triggers | Medium-term outcomes |
|---|--|--|--|---|---|
| Improve the management of results-oriented public expenditure | Enforcement of the Financial Administration and Budget Procedures Act [Ley de Administración Financiera y del Régimen Presupuestario] (Act 550) approved in 2005 | Institute the medium-term budget framework methodology in 25 public institutions in the formulation of the 2008 budget | Implement medium-term institutional expenditure frameworks in 10 decentralized public institutions. | <p>Integrate physical and financial monitoring systems for investment projects into the budget cycle by linking the central government's Public Investment Program registered in the National Public Investment System (SNIP) with the medium-term budget framework (interface between the SNIP and the Integrated Financial and Administrative Management System (SIGFA))</p> <p>Define the 2010 budget based on information on costs and investment planning, and establishment of medium-term outcomes</p> | <p>Greater efficiency and effectiveness in expenditure through the evaluation (ex ante) of at least 50% of the projects originated by the central government, which are registered in the SNIP for the budget year</p> <p>Monitoring reports on physical investment projects are issued annually for all projects in the SNIP</p> |
| Promote the transparent management of government resources | Bill on the Government Accounting Office (CGR) Act submitted to the National Assembly in February 2004 | Begin the 2006 Financial and Performance Audit of Budget Execution | <p>Complete the Financial and Performance Audit of Budget Execution for 2006 and publication of results</p> <p>Prepare the methodology and action plan for the institutionalization of operating audits (impact)</p> | Twenty-one (21) central government agencies have prepared action plans to implement the recommendations of the Financial and Performance Audit of Budget Execution for 2006 | <p>New control system on the management of the budget and public agencies, based on outcomes.</p> <p>Increased transparency in budget performance, through the publication of audit reports.</p> |

| Objectives | Actions taken | 2008 PBL Conditionalities | 2009 PBL Triggers | 2010 PBL Triggers | Medium-term outcomes |
|---|---|---|--|---|---|
| | Use of the electronic version of the Government Procurement System [Sistema de Compras y Contrataciones del Estado] (SISCAE) | Thirty-two (32) public agencies (included within the scope of Law 323) use the electronic procurement system and disseminate their procurement processes by Internet. Baseline: fourteen (14) public agencies use the system as of October 2007. | Fifty (50) public agencies (included within the scope of Law 323) use the electronic procurement system and disseminate their procurement processes by Internet (www.nicaraguacompra.gob.ni) | Sixty (60) public agencies (included within the scope of Law 323) use the electronic procurement system and disseminate their procurement processes by Internet (www.nicaraguacompra.gob.ni) Effective integration between the SISCAE and SIGFA | Greater efficiency and transparency in government purchasing and procurement. |
| Increase and improve the allocation of expenditure on poverty reduction | The Economic Financial Program establishes the commitment to increase expenditure on poverty reduction as a percentage of GDP and monitoring of social indicators in education, health and social welfare | At least 13.3% increase in the allocation of resources for central government expenditure on poverty reduction as a percentage of GDP for 2007 Baseline: central government expenditure on poverty reduction as a percentage of the GDP in 2006: 12.2% | Proposal to increase expenditure on poverty reduction, which allocates more resources to priority programs based on their greater pro-poor impact, greater coverage of basic social services, and/or closer relationship with the Millennium Development Goals (MDG) Proposed tools to prioritize expenditure on poverty reduction so that programs target primarily the most vulnerable population groups, taking into account the country's poverty map and other methodologies | Evidence of the impact of the new revised spending on poverty reduction (pro-poor, basic services coverage, and/or relationship with the MDG) Evidence of the use of prioritizing tools and their impact in terms of primarily favoring the most vulnerable population groups, taking into account the country's poverty map and other methodologies | Increased expenditure on poverty reduction and improved allocation |

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

PROPOSED RESOLUTION DE-___/08

Nicaragua. Loan ____/BL-NI to the Republic of Nicaragua. Program to
Support Fiscal and Social Management Improvement

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 Nicaragua, as Borrower, for the purpose of granting it a financing to cooperate in the execution of a program to support fiscal and social management improvement. Such financing will be for the amount of up to US\$10,000,000, from 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 Executive Summary of the Loan Proposal.

(Approved on ____ 2008)

LEG/SGO/CID/IDBDOCS#1573025
NI-L1011

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

PROPOSED RESOLUTION DE-___/08

Nicaragua. Loan ___/BL-NI to the Republic of Nicaragua. Program to
Support Fiscal and Social Management Improvement

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 Nicaragua, as Borrower, for the purpose of granting it a financing to cooperate in the execution of a program to support fiscal and social management improvement. Such financing will be for the amount of up to US\$10,000,000, from the resources of the Bank's Fund for Special Operations, and will be subject to the Financial Terms and Conditions and the Special Contractual Conditions of the Project Summary of the Loan Proposal.

(Approved on ____ 2008)

LEG/SGO/CID/IDBDOCS#1603777
NI-L1011