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ANNEX 2: LETTER OF DEVELOPMENT POLICY



República de Panamá
Ministerio de Economía y Finanzas
Departamento de Inversión de Economía

June 17, 2016
DdFP/NRI/706

Mr. Jim Yong Kim
President
The World Bank
1818 H Street NW
Washington D.C. 20433
United States of America

Ref: Letter of Development Policy for the
Second Shared Prosperity Development
Policy Financing

Dear Mr. Kim:

On behalf of the Government of Panama, I have the pleasure of submitting to you the letter of development policy for a Second Shared Prosperity Development Policy Financing (DPPF) in the amount of US\$300 million. This operation will support the Republic of Panama in continuing to pursue its ongoing reform program and will assist in sustaining the achievements made thus far.

This operation will enable our Government to advance three objectives: (1) strengthen the frameworks for international tax transparency, financial integrity, and fiscal management; (2) strengthen institutional arrangements to support social assistance and education; and (3) enhance the regulatory and financial sustainability framework of service delivery in the energy and water sectors.

I would like to express my gratitude for the World Bank's continued support to the reform process in Panama. Budget support operations, technical assistance projects, and knowledge activities continue to play a significant role in supporting the economic and social reforms undertaken by the Panamanian Government, amid what remains a turbulent and uncertain external environment. In particular, this operation supports strategic priorities of our Economic and Social Strategy 2015-2019, which aims to promote inclusion and increase the competitiveness of Panama's economy.

Macroeconomic Framework

Maintaining macroeconomic stability is a high priority for our Government. Since taking office in June 2014, our administration has aimed to strengthen the investment climate through a prudent management of public finances, while prioritizing social investment and boosting the competitiveness of the economy.

In the past few years, in spite of the uncertain external environment, Panama's economic fundamentals have remained strong. Our country recovered from the 2008 global financial crisis faster than other countries in the region and was able to realize higher rates of economic growth following the global crisis than preceding it. The average annual growth rate was close to 8 percent during 2009-2014, slowing to 5.8 percent in 2015 due to a moderation in investment activity, as major infrastructure projects including the expansion of the Panama Canal have been largely completed. Importantly, the high rates of economic growth have been accompanied by job creation and a significant reduction in the poverty rate, which fell from 26.2 percent in 2008 to 18.7 percent in 2014.

(using a poverty line of US\$4 per day). Inequality of income has also fallen, from a Gini coefficient of around 0.54 in 2008 to around 0.51 in 2014

Panama's fiscal position has also improved. The fiscal deficit of the non-financial public sector narrowed to 2.2 percent of GDP in 2015, down from 3.4 percent in 2014, and well below the initially-budgeted deficit of 3.7 percent of GDP. In the medium term, our Government is committed to stay within the deficit limit set forth in the Social and Fiscal Responsibility Law and reduce the fiscal deficit to 1.5 percent of GDP by end-2017. To this end, we are strengthening fiscal management, supported by the World Bank's OPF. In particular, we are enhancing public debt management, gradually pursuing fiscal decentralization, and improving public financial management and disaster risk management. At the same time, we are strengthening tax administration, reducing spending on electricity subsidies, and improving the targeting of social programs, all of which will support fiscal consolidation.

Going forward, we expect that the annual economic growth will stabilize at around 6 percent. Growth will be supported by the operations of the expanded Canal, an increase in copper exports with the start of operations of the Minera Panama copper mine, and strong public and private investment.

Strong macroeconomic fundamentals and sound policies have helped Panama withstand several waves of global market turbulence and paved the way for sustained economic growth and poverty reduction. Nonetheless, while benefiting from its trade and financial openness, Panama's economy continues to be exposed to external shocks and thus needs to further strengthen macroeconomic resilience through reforms in the areas supported by this OPF, notably: international tax transparency, financial integrity, fiscal management, social inclusion, and service delivery.

Objectives and Components of the Program

The reforms outlined below are designed to help safeguard economic growth and ensure that prosperity continues to be shared across society.

1. Strengthening the Frameworks for International Tax Transparency, Financial Integrity, and Fiscal Management

In order to strengthen the frameworks for international tax transparency and financial integrity, our Government is committed to implementing the automatic exchange of tax information and adhere to the Common Reporting Standards by 2018. This milestone is key for Panama, especially in the context of the recent leak of documents from one legal firm based in Panama. Furthermore, enhancing our country's institutional and legal frameworks for Anti-Money Laundering and Combating the Financing of Terrorism (AMF/CFT) is a high priority for us. We are committed to bring our AML/CFT regime in line with international standards of financial integrity and transparency. Significant achievements have been made thus far in the area. Our Government agreed with the Financial Action Task Force (FATF) on an AML/CFT Action Plan, which was fully completed in 2015. As a result, the Paris Plenary removed Panama from the observation list in February 2016. Panama was also able to move to Phase 2 of the Global Forum's peer review process, and our Government recently signed a tax information exchange agreement with the United States, and is currently negotiating double taxation agreements with Germany, Japan, and other countries. Building on the recent progress, our Government is determined to further strengthen the frameworks for international tax transparency and AML/CFT, and ensure their effective implementation. To this end, we will collaborate with international institutions to make sure that our reform efforts are well aligned with the internationally-accepted standards.

Improving fiscal management is also among the priorities of the Government. In this area, we have been advancing fiscal decentralization agenda, which aims to gradually reduce municipal governments' financial dependence on central government. The recent amendment to the Decentralization Law recognizes the importance of decentralizing responsibilities of the state to municipalities, while providing them with additional fiscal resources and legislative authority to be able to meet new requirements, especially in the area of public investment. Reforms to public finance information systems and public debt management through the integration of financial information management and debt systems are going to improve the overall debt management practices allowing Panama to service its debt electronically and recording its transactions transparently and in real time. Similarly, further advancements to implement Treasury Single Account and the new financial information management system ISTIAD will help Panama to overcome fragmentation of financial management systems for revenues and expenditures leading to improved process across the key functions of budget planning and execution, treasury management, accounting, and reporting. Over the medium term, the implementation of those reforms would improve the efficiency of public finance management, increase the transparency of government accounts, and ultimately create additional fiscal space. In addition, our Government is taking steps to haulate Panama's public finances from the financial implications of natural hazards. The multi-year action plan, prepared by the Directorate of Investment, Concessions, and Risks of the Ministry of Economy and Finance, provides a tool to operationalize the Government's strategic framework for Disaster Risk Management. The tool will allow us to make informed decisions on the best strategy to cover the costs associated to a natural hazard, including costs of recovery and reconstructions.

2. Strengthening Institutional Arrangements to Support Social Assistance and Education

Expanding inclusion and opportunities, through reforms strengthening institutional arrangements to support social assistance and education, is a critical component of our reform agenda. Supported by the World Bank's DPL program and technical assistance, our Government is committed to improve the social assistance system by expanding the coverage and improving the targeting of Red de Oportunidades, the flagship conditional cash transfer program in the country, as well as strengthening the institutional coordination of across the social assistance programs. As part of our collaboration with the World Bank, we have institutionalized periodical audits of social assistance beneficiaries to reduce the leakage in the system and at the same time expand coverage among the poorest segments of the society. We have also made institutional changes by establishing a new unit within our Ministry of Social Development to supervise all conditional cash transfer programs and coordinate the selection, enrollment, and payment systems across different schemes. To increase the financial transparency of the pay-out stage, our Government is advancing the use of the banking system to pay out the benefits of Red de Oportunidades. This reform targets beneficiaries of social assistance from urban areas and has been accompanied by a strong capacity building component for both beneficiaries and program managers.

In education policy, our efforts are geared towards improving educational outcomes of students and improving labor market prospects of young graduates. To this end, we have taken a multifaceted approach. We have been working on strengthening the system for monitoring and evaluation of education outcomes of Panamanian students through participation in international student test assessments (TERCE 2013, PISA 2016) and making the results publicly available. At the same time, we have taken steps to improve the quality of education services in Panama. With the creation of the Panama Bilingue Program, we are emphasizing the teaching of English across all age groups. We are also making an effort to improve labor market outcomes of young graduates by reforming the curricula for technical baccalaureates and through the roll-out of the ProJoven program.

3. Enhancing the Regulatory and Financial Sustainability Framework of Service Delivery in the Energy and Water Sectors

Our Government is also committed to improving public service delivery in the water and energy sectors by enhancing the regulatory framework and financial sustainability of service providers. We continue to reform the energy subsidy scheme by substituting the country-wide Energy Compensation Fund (FACIE) with the geographically-targeted Tariff Fund for the Occident al Region, a new fund created in 2015 that targets its resources to the western region. This reform is expected to improve the fiscal sustainability of the energy sector and going forward could allow for increased investment in environmentally sustainable power generation to improve service delivery.

In the water sector, we continue the coverage expansion with the "100/0" program which aims at providing reliable potable water 24 hours a day and eradicating the use of latrines. In addition, we have taken institutional steps to establish asset management practices between Ministry of Health and the National Water Supply and Sanitation Administration in order to improve sewerage service delivery and water quality in the Panama Bay area.

Conclusion

Our Government hereby reiterates its strong commitment to undertake necessary reforms actions to strengthen the framework for international tax transparency, financial integrity, and fiscal management; strengthen institutional arrangements to support social assistance and education, and enhance the regulatory and financial sustainability framework of service delivery in the energy and water sectors. The World Bank's support is a crucial impetus toward the fulfillment of the program's objectives.

In light of the prudent macroeconomic policy framework, the actions already carried out, and our commitment to advance further across all pillars of the DPF strategy, our Government requests the favorable consideration of its operation and the approval of the Second Shared Prosperity Development Policy Financing operation.

Yours sincerely,

Ivan A. Zúñiga
Vice Minister