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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROGRAM DOCUMENT FOR A PROPOSED

DEVELOPMENT POLICY FINANCING

IN THE AMOUNT OF US$300 MILLION

TO

THE REPUBLIC OF PANAMA

FOR THE

SECOND PROGRAMMATIC SHARED PROSPERITY
DEVELOPMENT POLICY FINANCING

July 19, 2016

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

REPUBLIC OF PANAMA
GOVERNMENT FISCAL YEAR
January 1 – December 31

CURRENCY EQUIVALENTS
(Exchange rate effective as of July 19, 2016)
PAB 1.00 = US$1.00

WEIGHTS AND MEASURES
Metric System

ABBREVIATIONS AND ACRONYMS

AML	Anti-Money Laundering
CCT	Conditional Cash Transfer
CFT	Combating the Financing of Terrorism
CGO	Comptroller's General Office
CRS	Common Reporting Standards
DICRE	Directorate of Investments, Concessions, and Risks of the State
DPF	Development Policy Financing
DRM	Disaster Risk Management
DSA	Debt Sustainability Analysis
FACE	Energy Compensation Fund
FATF	Financial Action Task Force
FDI	Foreign Direct Investment
FTO	Tariff Fund for the Occidental Region
GDP	Gross Domestic Product
IBRD	International Bank for Reconstruction and Development
IDB	Inter-American Development Bank
IDAAN	National Water Supply and Sanitation Administration
IFC	International Finance Corporation
IMF	International Monetary Fund
ISTMO	Integration and Technological Solutions of the Operational Management Model
LAC	Latin America and the Caribbean
MEDUCA	Ministry of Education
MEF	Ministry of Economy and Finance
MIDES	Ministry of Social Development
MINSA	Ministry of Health
PISA	Program for International Student Assessment
PFM	Public Financial Management
OECD	Organization for Economic Co-operation and Development
SEDLAC	Socio-Economic Database for Latin America and the Caribbean
SFRL	Social and Fiscal Responsibility Law
SIASAR	Rural Water and Sanitation Information System
SIGADE	Debt Management and Financial Analysis System
SINIP	National Planning and Public Investment System
TERCE	Third Regional Comparative and Explanatory Study
TSA	Treasury Single Account
US	United States
WB	The World Bank

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REPUBLIC OF PANAMA
SECOND PROGRAMMATIC SHARED PROSPERITY
DEVELOPMENT POLICY FINANCING
TABLE OF CONTENTS

FINANCING AND PROGRAM SUMMARY

I. INTRODUCTION AND COUNTRY CONTEXT 1
II. MACROECONOMIC POLICY FRAMEWORK 3
RECENT ECONOMIC DEVELOPMENTS 3
MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY 9
III. THE GOVERNMENT'S PROGRAM 11
IV. THE PROPOSED OPERATION 12
OPERATION DESCRIPTION AND LINK TO GOVERNMENT PROGRAM 12
PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS 13
LINK TO CPF, OTHER BANK OPERATIONS, AND THE WBG STRATEGY 29
CONSULTATIONS, COLLABORATION WITH DEVELOPMENT PARTNERS 30
V. OTHER DESIGN AND APPRAISAL ISSUES 30
POVERTY AND SOCIAL IMPACT 30
ENVIRONMENTAL ASPECTS 34
PUBLIC FINANCIAL MANAGEMENT, DISBURSEMENT AND AUDITING ASPECTS ... 36
MONITORING, EVALUATION AND ACCOUNTABILITY 37
VI. SUMMARY OF RISKS AND MITIGATION 37
ANNEX 1: POLICY AND RESULTS MATRIX 41
ANNEX 2: LETTER OF DEVELOPMENT POLICY 45
ANNEX 3: IMF RELATIONS NOTE 49
ANNEX 4: POVERTY AND SOCIAL IMPACT ANALYSIS 52
ANNEX 5: COMPARISON OF THE DPF 2 INDICATIVE TRIGGERS AND DPF 2 PRIOR ACTIONS 65

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SUMMARY OF PROPOSED FINANCING AND PROGRAM
REPUBLIC OF PANAMA
SECOND PROGRAMMATIC SHARED PROSPERITY DEVELOPMENT POLICY FINANCING

Borrower	Republic of Panama
Implementation Agency	Ministry of Economy and Finance
Financing Data	*IBRD Loan.* *Terms:* USD denominated, commitment-linked, IBRD Flexible Loan with a variable spread, with customized repayments on May 15 and November 15 of each year, with 2 years of grace period and 20.5 years final maturity, with all conversions options selected and the Front-end Fee paid by the Borrower. *Amount:* US$300 million.
Operation Type	Single tranche Development Policy Financing (DPF); second in a series of three operations.
Pillars of the Operation and Program Development Objectives	The Program Development Objectives of the DPF series are to support the Government of Panama's efforts to (i) strengthen the frameworks for international tax transparency, financial integrity, and fiscal management; (ii) strengthen institutional arrangements to support social assistance and education; and (iii) enhance the regulatory and financial sustainability framework of service delivery in the energy and water sectors.
Result Indicators	• Panama complies with CRS requirements related to the availability of tax information, ensuring that (i) ownership and identity information is available for all relevant entities; and (ii) reliable accounting records are kept for all relevant entities (Baseline 2014: No; Target 2017: Yes) • Number of Banks supervised (on-site and off-site) in a year using the new anti-money laundering supervision procedures (Baseline 2014: 0; Target 2017: 50) • Share of investments by local governments that follow SINIP (*Sistema Nacional de Inversiones Públicas*) norms and procedures (Baseline 2014: 0 percent; Target 2017: 70 percent) • Share of central government debt that is paid electronically (Baseline: 2014: 0 percent; Target 2017: 100 percent) • Number of available disaster financial protection instruments of the Panama's DRM Strategic Framework that underwent a cost-benefit analysis (Baseline 2014: 0; Target 2017: 2) • Share of central government funds channeled through a Treasury Single Account (Baseline 2014: 0 percent; Target 2017: 90 percent) • Percentage of the extreme poor benefiting from at least one social assistance program (Baseline: 2014: 37 percent; Target: 2017: 60 percent) • Percentage of total funds from social assistance programs transferred through the social card *(Clave Social)* (Baseline 2014: 0 percent; Target 2017: 30 percent) • Number of reports prepared by MEDUCA based on the results of international student assessments (Baseline 2014: 0; Target 2017: 2) • Number of teachers participating in the International Teacher Training of *Panama Bilingüe* (Baseline 2014: 0; Target 2017: 1,500) • Public expenditures on electricity subsidies are reduced by at least 50 percent in nominal terms relative to their level in 2014 (Baseline 2014: US$320 million; Target 2017: US$160 million). • Number of Rural Water Management Boards connected to the standardized

	information system for improving the monitoring of water management in rural areas (SIASAR) (Baseline 2014: 400; Target 2017: 1,400)
Overall Risk Rating	Substantial
Operation ID	P154819

PROGRAM DOCUMENT FOR A SECOND PROGRAMMATIC SHARED PROSPERITY DEVELOPMENT POLICY FINANCING TO THE REPUBLIC OF PANAMA

I. INTRODUCTION AND COUNTRY CONTEXT

1. **The proposed Development Policy Financing (DPF) is the second operation in a programmatic series of three, aimed at accompanying Panama's efforts to advance the country's shared prosperity agenda.** The operation supports reforms in three main areas of the Government's Economic and Social Strategy 2015-19: (i) international tax transparency, financial integrity, and fiscal management; (ii) social inclusion; and (iii) water and energy service delivery. The proposed operation, for an amount of US$300 million, is consistent with the World Bank (WB) Group's Country Partnership Framework for 2015-2018 (Report No. 932425).

2. **Over the past 15 years, sound macroeconomic and structural policies have contributed to remarkable economic growth and poverty reduction in Panama.** In 2015, GDP expanded by 5.8 percent, compared to a contraction of 0.1 percent in the Latin American and the Caribbean (LAC) region. More generally, over the 2008-15 period, Panama grew by 6.9 percent on average, outpacing the LAC average (2.6 percent) and that of emerging and developing economies (5.2 percent). High economic growth helped to reduce the poverty rate (US$4 per day poverty line) from 26.2 percent in 2008 to 18.7 percent in 2014 (Figure 1). Moreover, growth was widely shared, with the income of the bottom 40 percent of the population growing faster than that of the national average (Figure 2). As a result, Panama's Gini coefficient in 2014 (0.51) was 2.5 percentage points lower than in 2008. Nonetheless, challenges in social inclusion persist. Notably, extreme poverty continues to be concentrated in certain areas of the country. Moreover, the Panamanian youth, with limited education and low attainment rates, is facing significant challenges in accessing the labor market, and is vulnerable to crime and violence. Finally, large inequalities remain in access to basic services, including electricity, water, and sanitation.

Figure 1: Poverty in Panama was reduced substantially *(Poverty headcount rates, US$4 per day)*

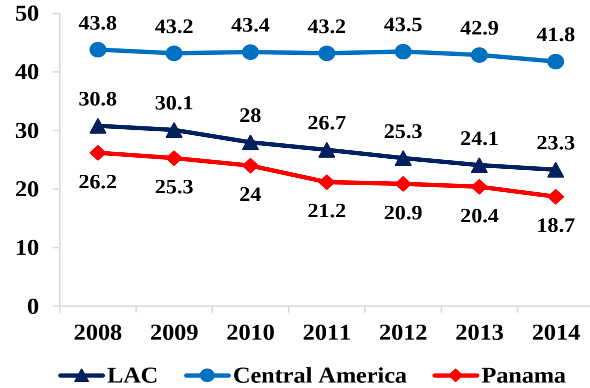
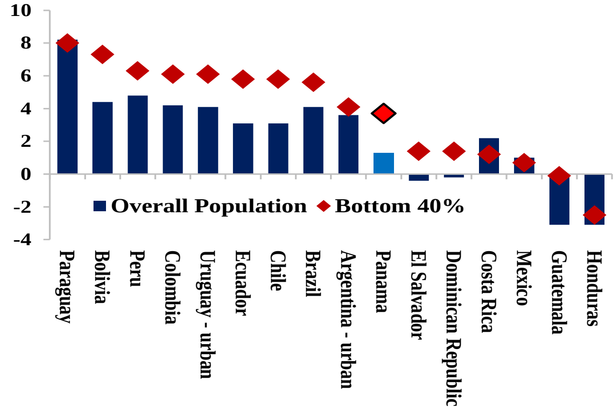


Figure 2: Growth was broadly shared during 2009-2014 *(Income growth of the poorest 40 percent & average income growth)*



Source: WB Staff calculations based on Center for Distributive, Labor and Social Studies (SEDLAC) and the WB. The US$4 per day poverty rates are based on 2005 purchasing power parity.

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

4. **The scope of the proposed operation has been enhanced to support reforms in the areas of international tax transparency and financial integrity, while continuing to support the reform agenda to improve fiscal management, inclusion, and service delivery.** The program has been revised to support policy measures aimed at bringing Panama's legal frameworks on AML/CFT and international tax transparency in line with global standards, and ensuring their effective implementation. And in line with the original design of the series, the operation continues to support mutually reinforcing efforts to: (i) improve fiscal management systems; (ii) strengthen institutional arrangements to support social assistance and education; and (iii) enhance the regulatory and financial sustainability framework of service delivery in the energy and water sectors.

5. **The risk assessment of the DPF series is substantial and has increased since DPF 1** (see Section VI). The broadening of the scope of the DPF program increases the risks to the achievement of the program development objectives, particularly in the new areas of international tax transparency and financial integrity. Panama has made progress in strengthening legislation on Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT), and in February 2016, was removed by the inter-governmental Financial Action Task Force

(FATF) from its “Grey List” of countries with inadequate legal provisions on these matters. Similarly, in October 2015, the Organization for Economic Co-operation and Development’s (OECD) Global Forum on Transparency and Exchange of Information for Tax Purposes accepted Panama into Phase 2 of the tax information exchange process. However, recent events have highlighted the need to bring the framework for international tax transparency closer to accepted international standards and ensure the effective implementation of the recently-adopted AML/CFT legal regime. In April 2016, 11.5 million documents were leaked from a private legal firm based in Panama regarding operations through off-shore shell structures by over 200,000 entities from all over the world. Notwithstanding recent progress, existing weaknesses in the AML/CFT implementation and shortcomings in the area of international tax transparency will likely create challenges for the October 2016 Global Forum review of the country’s progress under Phase 2, and the forthcoming assessments by both FATF and the OECD in mid-2017 of the country’s transparency and financial integrity frameworks.

II. MACROECONOMIC POLICY FRAMEWORK

RECENT ECONOMIC DEVELOPMENTS

6. **Panama’s high growth rates have been accompanied by a significant reduction in the poverty rate.** This was the result of the economy’s capacity to create jobs. The employed labor force in Panama increased by 70 percent between 2001 (when it was 1.0 million) and 2015 (1.7 million), more than doubling employment growth in LAC (34 percent). Panama’s exceptional growth performance over the past decade stems partly from an open, competitive, and diversified economy. The country’s continuous improvements in structural policies and infrastructure have also allowed it to consolidate its position as the most competitive economy in Central America and second after Chile in LAC, according to the 2015-16 Global Competitiveness Report.

7. **Panama’s growth performance in 2015 has remained solid, supported by low oil prices and the gradual recovery of the US economy.** GDP growth was 5.8 percent in 2015, driven by robust domestic consumption and a strong contribution from net trade (Table 1). From the sectoral side, growth was led by construction, commerce and financial intermediation. While growth rates in 2014 and 2015 were below the post-crisis boom period, the recent trend shows a gradual return to the medium-term potential growth rate of the economy, which is currently estimated at 6 percent. The slowdown in economic activity in the Colon Free Zone[1], triggered by Venezuela’s weak economic standing and the imposition of tariffs by Colombia for re-exports of Chinese textiles and footwear, reduced Panama’s merchandise export demand, but this decline was fully compensated by strong growth in the exports of services.

8. **The Panama Canal has been supporting economic growth, despite the recent softening in the global trade flows**. In 2015, the Panama Canal continued to serve over 3

[1] The Colon Free Zone operates as an autonomous body within Panama and currently ranks as the world's second-largest low-tax port after Hong Kong. Some 2,500 firms are located in the Zone, and are principally involved in the import and re-export of goods, such as electronics, pharmaceuticals, textiles and clothing, and jewelry. Transport, banking and commercial infrastructure support these activities.

percent of the world's trade with traffic through the Canal growing by 2.1 percent compared to 2014. The increase in transported freight stood at 3.4 percent in 2015. In addition, exports of services provided by the Panama Canal Authority represent 4.7 percent of GDP, having grown by 6.6 percent in 2015 (2 percentage points higher than in the previous year), and revenues from tolls continued to grow, reaching almost US$2 billion in 2015 (an increase of 3.5 percent as compared to 2014). The operations of the Panama Canal benefited from the ongoing recovery of the US economy, as the US-originating freight has been by far the largest destination for the Panama Canal (at 160.7 million tons) followed by China (48.4 million tons), Chile (29.5 million tons) and Japan (22 million tons). The expansion of the Canal, which benefited from IFC investment and support from other partners, opened on June 26, 2016. The expanded Canal accommodates a new generation of container ships, thereby enhancing Panama's role as a global logistics and trade hub.

9. **The current account deficit narrowed in 2015 to 6.5 percent of GDP from 9.8 percent in 2014, and was fully financed by FDI.** The merchandise trade deficit has hovered at around 20 percent of GDP over the past five years, mainly explained by large investment-related imports. In addition, an income account deficit, related to profit expatriation of foreign companies, contributed to the elevated current account deficit in Panama over the past few years. In 2015, the current account deficit narrowed by 3.3 percentage points of GDP as compared to 2014 as a result of a large decline in merchandise imports, which reflected the completion of major investment projects and the decline in oil prices. Merchandise export activity declined as well, explained by a fall in re-exports from the Colon Free Zone, but was fully compensated by strong performance of services exports, which resulted in a trade account surplus of 0.6 percent of GDP. Robust FDI inflows of US$4.5 billion (8.6 percent of GDP) fully financed the current account deficit. FDI has flowed into a large range of sectors, with an emphasis on services, predominantly commerce, transport and logistics, communications, and financial services, and more recently, the mining sector. Although foreign exchange reserves amounted to US$3.9 billion in 2015, and imports-coverage is relatively low (about 2 months), the use of the US dollar as the legal tender mitigates convertibility and transfer risks.

10. **The inflation rate declined in 2015.** The decline in the inflation rate (to 0.2 percent) reflects the impact of lower commodity prices, particularly oil (Panama is a net importer), the appreciation of the US dollar, and the Government's effort to tame price hikes on basic food items. The decline in the inflation rate is due to the fall of prices in the Housing, Water, Electric and Gas category of the Consumer Price Index, despite the increases in electricity tariffs introduced in January 2015. In addition, the prices of food products recorded a significant decline, as the authorities introduced temporary controls over 22 food items in July 2014.

11. **The fiscal deficit declined to 2.3 percent of GDP in 2015, reflecting moderate declines in public capital spending.** The fiscal consolidation initiated in mid-2014 helped to contain the fiscal deficit. In 2015, the fiscal deficit declined to around 2.3 percent of GDP, in line with the SFRL, well below the initially budgeted level of 3.7 percent of GDP (Table 2).[2] This

[2] Panama's SFRL has undergone multiple adjustments since its creation in 2002. The 2012 amendment introduced the concept of "adjusted balance" and linked the SFRL with the Sovereign Fund of Panama Law. The adjusted fiscal balance considers the budgetary contributions of the Canal Authority. Starting in 2015, a new methodology was applied to estimate the adjusted budget

decline was supported by a decrease in the capital expenditures from 7.8 percent of GDP in 2014 to 6.8 percent of GDP in 2015, reflecting the completion of major public infrastructure projects. At the same time, current expenditures declined from 16.2 percent of GDP in 2014 to 15.7 percent of GDP in 2015, reflecting lower expenditures of the Central Government, in particular on goods and services. Revenues declined slightly from 20.8 percent of GDP in 2014 to 20.2 percent of GDP in 2015, reflecting lower economic growth and institutional changes within the revenue administration.

12. **Panama's financial sector is largely sound and resilient.** The banking sector is well capitalized and profitable. It is comprised by 96 banks of which two are state-owned, 49 have a general license, 28 have an international license, and 17 have a representation license. Credit to the private sector grew by 11.6 percent in 2015, while deposits of the private sector grew by 5.2 percent, resulting in an 86.4 percent loan to deposits ratio. All financial institutions exceeded the Basel III required minimum capital-adequacy ratio of 8 percent, with a significant margin (around 15 percent in December 2015) and the liquidity ratio is high (at 60.9 percent in May 2016). Despite strong lending activity over the past few years, the loan portfolio remained sound, with a share of non-performing loans at 1.2 percent of total loan portfolio as of December 2015. Going forward, the global phenomenon of de-risking (i.e., closing correspondent accounts due to increased capital requirements in source countries and the complex and expensive due diligence procedures) can affect Panama's financial sector and restrict access to finance.

Box 1. Recent Measures related to AML/CFT in Panama

In June 2014, as part of its on-going review of compliance with the AML/CFT standards, FATF listed Panama as a country with AML/CFT deficiencies (FATF's "Grey List"). Previously in February 2014, the International Monetary Fund (IMF) had published a Detailed Assessment Report on AML/CFT which identified Panama as a country vulnerable to money laundering and not fully compliant with FATF's 40+9 Recommendations.

To address the identified deficiencies, the Government developed an action plan with FATF.
Measures implemented by Panama included the establishment of:

- an adequate legal framework that criminalizes money laundering and terrorist financing;
- an adequate legal framework for freezing terrorist assets;
- effective measures for customer due diligence in order to enhance transparency;
- regulations for Bearer Shares;
- an independent Financial Intelligence Unit;
- a Superintendence of Supervision and Regulation of Non-Financial Subjects;
- regulations related to suspicious transaction reporting requirements for all financial institutions and

deficit limit. Specifically, in case annual Canal contributions fall short of 3.5 percent of GDP, the fiscal deficit target can be increased by the difference. The budget deficit limit for 2015 is 3.5 percent of GDP. Since Canal contributions to the budget were 2 percent of GDP and the budget deficit target was 2 percent of GDP, then the budget deficit limit for 2015 is 3.5 percent of GDP (i.e. 2 percent of GDP + (3.5 minus 2 percent of GDP)).

Designated Non-Financial Businesses and Professions; and

- regulations supporting effective mechanisms for international co-operation on AML/CFT.

Law 46 of 2013, and Laws 10, 18, 23, and 34 of 2015 underpinned the legal basis for these reforms. Within 20 months, Panama successfully addressed the issues highlighted by FATF, and in February 2016 the country was removed from the “Grey List”.

13. **The authorities are working to strengthen the AML/CFT framework, but further reforms and effective implementation are needed to address weaknesses in this area (Box 1).** In June 2014, FATF publicly identified Panama among the countries with strategic AML/CFT deficiencies. In mid-2014, the authorities and FATF agreed on a plan to address a number of these deficiencies, including laws and regulations. Box 1 summarizes the policy actions that allowed the country to be removed from the FATF “Grey List” in February 2016 in recognition of its progress. It should be noted, however, that the assessment was prepared based on the previous FATF standards (from 2003) and Panama is scheduled to undergo an assessment against the prevailing 2012 FATF standard in mid-2017.[3] As further discussed in Section IV, the Government remains committed to advance reforms in this area and bring AML/CFT regulatory frameworks closer to international standards and best practices and ensure their effective implementation.

14. **In May 2016, against the backdrop of sanctions imposed by the US on a Panamanian conglomerate, the Superintendence of Banks of Panama took control over a small bank linked to the conglomerate.** The liquidation of the bank is proceeding as planned without significant spillover effects to the financial sector. In addition, these recent allegations triggered the opening of criminal investigations. The authorities also took control of a local brokerage house and begun extraordinary inspections of nonfinancial entities.

15. **The fallout from the recent leak of documents related to offshore companies emphasized the importance of strengthening international tax transparency and facilitating exchange of information between Panama and the rest of the world.** The assessment by the OECD’s Global Forum on Transparency and Exchange of Information for Tax Purposes from 2010 concluded that Panama had an inadequate legal framework for international collaboration on tax matters and had no involvement in international cooperation on these issues (Phase 1 assessment).[4] The April 2014 assessment pointed to several improvements in Panama’s legal framework, but concluded that further progress was necessary before Panama could qualify for a Phase 2 review. Finally, in October 2015, Panama was accepted into Phase 2 of the information exchange process, yet the assessment report flagged important shortcomings in the legal framework that require attention before subsequent assessments. In addition to those underpinning weaknesses, the recently leaked documents from a private legal firm may

[3] The mid-2017 review will focus on the effective implementation of the AML/CFT framework. The prevailing 2012 FATF standards place greater emphasis on a risk-based approach whereby countries are expected to analyze and understand how the money laundering/terrorism financing risks they identify affect them and take appropriate measures to mitigate and manage those risks. The 2012 FATF standards include tax crimes as predicate offences to money laundering.
[4] The Global Forum peer reviews occur in two Phases: Phase 1 reviews assess the quality of a jurisdiction’s legal and regulatory framework for the exchange of information, while Phase 2 reviews look at the practical implementation of that framework.

constitute challenges not only for the October 2016 Global Forum review of Panama's progress under Phase 2, but also for the upcoming FATF and OECD assessments of the country's transparency and financial integrity frameworks (both assessments are scheduled for mid-2017). As further discussed in Section IV, the Government is committed to advance the tax transparency reform agenda by adhering with the Automatic Exchange of Information, following the path of implementation of the CRS, supported by this DPF series. In addition, in July 2016 Panama decided to sign the Multilateral Convention on Mutual Administrative Assistance in Tax Matters. The ratification of the Convention will be a significant step forward in implementing its commitment to tax transparency.

Table 1: Panama—Key Economic Indicators, 2011-2018

	2011	2012	2013	2014	2015	2016	2017	2018
Real sector	Annual percentage change, unless otherwise indicated							
Real GDP	11.8	9.2	6.6	6.1	5.8	6.0	6.1	6.2
Per Capita Atlas GNI (In US$)	8,350	9,510	10,530	11,430	12,050	12,769	13,554	14,395
Contributions:								
Consumption	2.5	2.9	2.4	2.6	2.1	2.2	2.1	2.1
Investment	7.8	7.2	7.9	4.3	-1.0	2.5	2.6	2.7
Net exports	1.5	-0.9	-3.7	-0.8	4.7	1.3	1.4	1.5
GDP deflator	106.3	106.4	105.3	103.4	101.5	101.3	101.1	101.4
CPI (average)	5.9	5.7	4.0	2.6	0.2	1.0	2.0	2.0
Fiscal Accounts	Percent of GDP, unless otherwise indicated							
Revenues and grants	22.6	22.6	22.2	20.8	20.2	20.1	20.2	20.2
Expenditures	24.6	23.9	24.5	24.0	22.5	22.8	22.0	21.7
Overall balance	-2.0	-1.4	-2.3	-3.2	-2.3	-2.7	-1.9	-1.5
Selected Monetary Accounts	Annual percentage change, unless otherwise indicated							
Credit to non-financial private sector	15.2	13.6	10.4	11.7	11.6	--	--	--
Balance of Payments	Percent of GDP, unless otherwise indicated							
Current account balance	-14.5	-8.8	-9.8	-9.8	-6.5	-6.4	-6.1	-6.0
Merchandise exports, f.o.b. (annual percentage change)	33.5	7.9	-6.6	-10.1	-16.6	3.0	9.8	11.8
Merchandise imports, f.o.b (annual percentage change)	40.2	16.6	-5.5	-3.3	-12.5	-0.4	1.9	5.6
Foreign direct investment (millions of US$)	2,956	3,254	3,612	3,980	4,511	4,872	5,182	5,268
Gross reserves (months of imports)	1.8	1.5	1.9	2.5	2.7	2.8	2.5	2.4
External public debt	31.7	27.0	27.3	29.2	29.6	27.4	25.5	23.5
Terms of trade (annual percentage change)	-0.7	-0.1	1.4	-1.3	2.4	0.3	-1.2	-0.8
Memoranum items								
GDP nominal in US$ billion	34.4	40.0	44.9	49.2	52.8	56.7	60.8	65.5
Public sector debt (in percent of GDP)	37.3	35.7	35.0	37.1	38.3	39.0	38.4	38.0

Source: Panamanian authorities, IMF, and WB staff estimates and projections.
Notes: All ratios to GDP are presented with a base year of 2007.[5]

[5] In the second half of 2010, the authorities initiated the process of revising the methodology for GDP calculation. The revision changed the base year from 1996 to 2007 and updated the calculation methodology in line with the standards set out in the new 2008 System of National Accounts. The new approach benefitted from the updated analysis of prices and a better coverage of the economy, for example in the construction sector, transport, and agriculture. As a result, nominal GDP was revised upwards

Table 2: Panama—Fiscal Accounts of the Non-Financial Public Sector, 2011-2018

	2011	2012	2013	2014	2015	2016	2017	2018
Non-financial public sector, percent of GDP								
Revenues	**22.6**	**22.6**	**22.2**	**20.8**	**20.2**	**20.1**	**20.2**	**20.2**
Current revenue	22.1	21.7	21.3	20.1	19.5	19.7	19.7	19.8
Central Govt	15.7	15.9	14.9	14.1	13.3	13.6	13.6	13.6
Taxes	10.8	11.7	10.8	10.2	9.5	9.7	9.7	9.8
Direct	5.0	6.2	5.8	5.2	4.9	5.0	5.0	5.0
Indirect	5.8	5.5	5.0	5.0	4.7	4.7	4.8	4.8
Non-tax revenue	4.9	4.1	4.0	3.9	3.8	3.9	3.8	3.8
o/w: Panama Canal contributions	2.2	2.6	2.3	2.1	2.0	1.9	2.3	2.5
Social Security Agency	5.9	5.5	6.0	5.7	5.8	5.8	5.8	5.8
Consolidated Agencies	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Public enterprises' operating balance	0.4	0.3	0.3	0.2	0.2	0.2	0.2	0.2
Non-consolidated agencies	0.0	0.4	0.2	0.3	0.4	0.2	0.2	0.2
Capital revenue	0.1	0.1	0.4	0.2	0.1	0.0	0.0	0.0
Expenditure	**24.6**	**23.9**	**24.5**	**24.0**	**22.5**	**22.8**	**22.0**	**21.7**
Current Expenditures	16.8	16.1	15.5	16.2	15.7	16.2	16.2	16.1
Central Govt	8.4	8.5	7.9	8.9	8.3	8.5	8.3	8.3
Wages and salaries	4.1	4.0	3.9	4.0	4.1	4.3	4.2	4.2
Goods and services	1.2	1.3	1.1	1.4	1.0	1.0	1.0	1.0
Other current expenditures	3.1	3.2	2.8	3.4	3.1	3.1	3.1	3.1
Social Security Agency	5.7	5.2	5.4	5.2	5.2	5.6	5.8	5.8
Consolidated Agencies	0.6	0.5	0.4	0.4	0.5	0.5	0.5	0.5
Interest	2.2	1.9	1.8	1.7	1.8	1.7	1.6	1.6
Capital	7.9	7.9	9.0	7.8	6.8	6.6	5.9	5.6
Balance	**-2.0**	**-1.4**	**-2.3**	**-3.2**	**-2.3**	**-2.7**	**-1.9**	**-1.5**
Memorandum items:								
Non-financial public sector plus Panama Canal Authority, percent of GDP								
Revenue and grants	24.4	25.8	25.3	23.7	23.6	23.4	23.1	--
Expenditure	29.7	28.9	29.4	28.3	27.7	26.9	24.8	--
Overall balance	-5.2	-3.1	-4.1	-4.6	-4.1	-3.5	-1.7	--

Source: Panamanian authorities, IMF, and WB staff estimates and projections.
Notes: (i) The non-financial public sector does not include the operations of the Panama Canal Authority. (ii) All ratios to GDP are presented using the amended GDP figures, which are in line with the 2008 System of National Accounts. The Program Document of the First Shared Prosperity DPF was using the old GDP methodology.

between 5.6 to 8.2 percent depending on the year. All ratios presented in the Program Document use the nominal GDP numbers according to the new methodology.

Table 3: Panama—Balance of Payments Financing Requirements and Sources, 2013-18

	2013	2014	2015	2016	2017	2018
Financing requirements (US$ million)	**13,547**	**15,930**	**16,207**	**16,832**	**16,479**	**16,758**
Current account deficit	4,396	4,798	3,455	3,652	3,714	3,931
Medium and long-term debt amortization	9,151	11,132	12,753	13,179	12,766	12,827
Financing sources (US$ million)	**13,547**	**15,930**	**16,207**	**16,832**	**16,479**	**16,758**
Capital grants	28	24	26	10	9	9
FDI and portfolio investments (net)	4,145	4,977	3,556	5,390	5,535	5,722
Medium and long-term debt disbursements	9,780	12,130	12,337	12,099	11,993	12,042
Change in reserves (+ decrease)	-406	-1,202	289	-667	-1,058	-1,014

Source: Panamanian authorities, IMF, and WB staff estimates and projections.

MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

16. **Panama's growth outlook is expected to remain solid over the medium-term.** Real GDP growth is projected at 6.0 percent in 2016 and to increase gradually to 6.2 percent by 2018. The expanded Panama Canal, which opened on June 26, 2016, will continue to support growth and fiscal revenues, together with the copper mine project Minera Panama, which is planned to start production by 2018. Growth will also be supported by strong investment, albeit at lower levels than in the boom years (some large projects in the next years include the expansion of the Panamerican highway, the construction of a new bridge to connect the West Panama area, the construction of the second metro line in Panama City, and the Colón urban renewal project). Growth is expected to continue to be driven by construction, financial intermediation, transport, communication and logistics, and wholesale and retail trade. The macroeconomic impact associated with the recently leaked documents is expected to be limited—legal services account for a small share of value added (around 0.7 percent of GDP)—however, the reputational risks have increased and may affect other sectors.

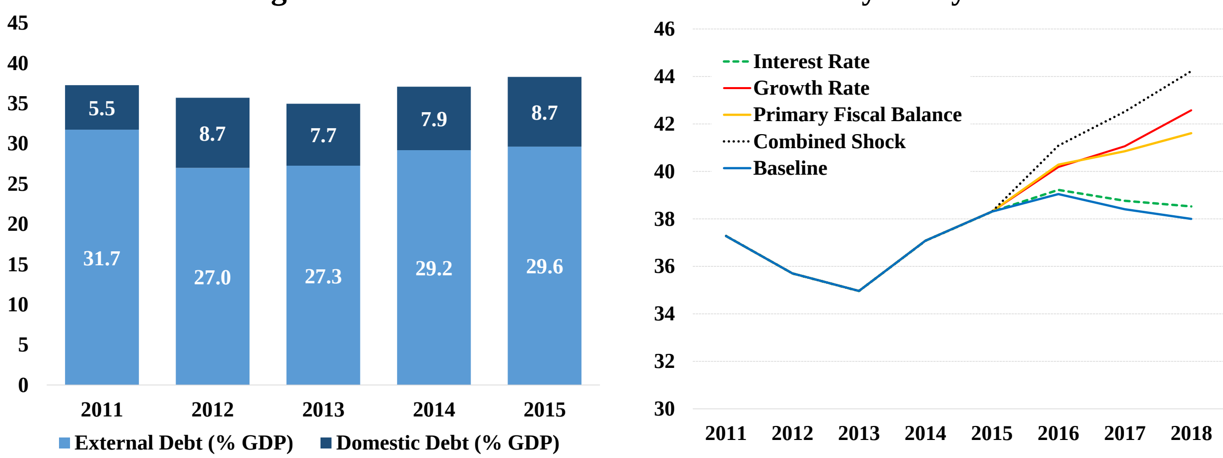
17. **The current account deficit is expected to narrow gradually to around 6 percent of GDP by 2018 and continue to be financed by FDI during the projected period.** The reduction in the current account deficit is expected to be driven by projected improvements in the merchandise trade balance. Imports growth will further slow in line with gradual decreases in infrastructure investment activity relative to the levels of the boom years. At the same time, exports are projected to accelerate due both to the expanded Canal and the expected increase in copper exports from the new mining project during 2017-2018, although this would be more visible towards the end of the projection period. Exports of services are expected to remain sizeable (supported by the expanded Canal) and will contribute to the narrowing of the current account deficit. Robust FDI inflows, including in the mining, commerce, logistics and energy sectors, are projected to continue to finance the current account balance.

18. **Inflation is projected to remain low, while monetary conditions will tighten following the expected gradual normalization in US monetary policy.** The inflation rate is projected to accelerate slightly from the historically low level in 2015, and remain at around 2 percent over the medium-term. The normalization of monetary policy in the US, in the context of the fully dollarized Panamanian economy, will result in higher interest rates over the medium-term.

19. **The headline fiscal deficit of the non-financial public sector is projected to decline gradually to 1.5 percent by the end of 2018.** The fiscal forecast assumes adherence to the targets set by the SFRL (i.e., the forecasted headline deficit of 1.5 percent of GDP in 2018 is below the target of 0.5 percent of GDP adjusted for 1 percentage point of GDP difference between 3.5 percent and the Canal contributions). Fiscal consolidation will come mainly from the expenditure side, as public investment levels return to the levels seen in the pre-boom period. A reduction of electricity subsidies will also support fiscal efforts. Government reforms, supported as part of the DPF program in the area of fiscal management—e.g. improvements in public debt management as well as introduction of the Treasury Single Account (TSA) and the Integration and Technological Solutions of the Operational Management Model (ISTMO)—are likely to result in the reduction in administrative costs and support more efficient use of public resources. In addition, fiscal revenues are projected to increase slightly supported by improvements in tax administration. Specifically, in late 2015, the General Revenue Directorate (*Dirección General de Ingresos*) initiated forced collection by freezing debtors' banking assets until tax debts are settled and by increasing the number of tax audits. Other initiatives include the introduction of a value added tax withholding mechanism for the largest 160 taxpayers in the country in January 2016 in order to increase revenue collection in intermediate transactions.

20. **Panama's public debt levels are resilient to adverse economic shocks, and the country's risk of public external debt distress is considered to be low.** Under the baseline scenario (Tables 1, 2, and 3), the public debt-to-GDP ratio is expected to peak at about 39.5 percent of GDP in 2016 and decrease gradually thereafter to 38 percent of GDP by 2018. A debt sustainability analysis conducted by the World Bank indicates resilience to different economic shock scenarios (see Figure 3). For example, a slowdown in the GDP growth rate starting in 2016 to around 4 percent annually would result in an increase in the debt-to-GDP ratio to 42.6 percent by 2018. Under a combined shock scenario—which assumes permanent 1/4 standard deviation shocks applied to the real interest rate, the growth rate, and the primary fiscal balance—Panama's debt-to-GDP ratio would stabilize at around 44.3 percent of GDP.

Figure 3: Panama—Public Debt Sustainability Analysis



Source: Panamanian authorities, IMF, and WB staff estimates and projections.
Notes: Individual shocks represent scenarios in which a permanent 1/4 standard deviation shock is applied to the real interest rate, growth rate, and fiscal primary balance. The combined shock represents a scenario in which a similar shock is applied to all variables (i.e., interest rate, growth rate, and fiscal primary deficit) at the same time.

21. **Panama's macroeconomic policy framework is sustainable and adequate for the proposed operation.** Growth is projected to remain high over the medium-term, with low inflation, and improvements in the fiscal and external balances. These outcomes are underpinned by prudent macroeconomic management and the implementation of structural reforms, some of which are supported by the DPF series. Nonetheless, the outlook is vulnerable to some downside risks. Being a small, open and well-integrated economy, Panama is vulnerable to external shocks. Uncertain global market conditions and slow growth in world trade could reduce Panama service exports and FDI inflows. In particular, the slowdown in China, the world's major driver of demand for exports, may result in the adjustment in the volumes of global trade, thus affecting the freight crossing the Canal. The decline in cargo tonnage and consequently, vessel traffic, may translate to lower toll revenues affecting Panama's fiscal position and ultimately, the Government's ability to fund public investment and social programs, leading to slower output growth. Moreover, an economic slowdown in trading partners could amplify the negative effect of Venezuelan and Colombian policies on the Colon Free Zone exports. The mitigating factors for the slowdown in global trade include the expanded Panama Canal, which can accommodate larger ships and therefore make transportation of liquefied petroleum and gas financially viable, which is expected to capture traffic between North America and Asia. In addition, the completion of the Minera Panama copper mine is expected to support exports growth starting in 2018. The pacing of the US normalization of monetary policy poses a risk, particularly as the higher interest rates are internalized by the local financial system, with potential spillover effects on the local economy. Moreover, the appreciation of the US dollar may affect Panama's competitiveness and lead to deceleration in the exports. In particular, a loss of correspondent banking relations by several banks could have contagion effects on the whole financial sector and impact economic growth. Limited progress in this area could also affect the performance of Panama's offshore banking sector, resulting in lower employment and potentially additional spillover effects on FDI, tourism flows, and infrastructure investment. In addition, there is some risk that the fiscal balance could deteriorate, especially over the medium-term, due to unfunded liabilities of the pension system and contingent liabilities related to turnkey projects, which could limit room for maneuver in the presence of negative shocks, given the lack of monetary policy.

IMF Relations

22. **The Government maintains an ongoing dialogue with the IMF on macroeconomic policy in Panama**. On May 23, 2016, the IMF's Executive Board concluded the last Article IV Consultation, highlighting Panama's robust macroeconomic performance and continued solid economic growth. The IMF Board noted the importance of improving the quality of institutions in the areas of international tax transparency and AML/CFT, fiscal management, education, healthcare, and skills to support inclusive growth (see the IMF Relations Note in Annex 3).

III. THE GOVERNMENT'S PROGRAM

23. **The DPF series is fully aligned with the Government's Economic and Social Strategy 2015-2019.** The strategy's key priorities include actions aimed at promoting inclusion (social strategy) and increasing the country's competitiveness (economic strategy) along six areas: (i) economic development, by promoting productivity and economic diversification through boosting sectors such as logistics, agriculture, tourism and mining; (ii) social

development, to increase quality of life by improving water and sanitation services, urban cleanliness, housing, urban transportation and health; (iii) human development, to reinforce human capacity by enhancing basic education and technical training; (iv) infrastructure, to boost connectivity through roads, ports, airports and energy infrastructure; (v) environmental sustainability, by advancing on land and environmental management; and (vi) governance, to strengthen institutions by bolstering the National Planning and Public Investment System (SINIP), establishing a program-based budget, enhancing internal control mechanisms, improving civil service, promoting decentralization, and ensuring justice and safety for all Panamanians. In 2016, the Government plans to focus on advancing the provision of basic services in water, education and health sector, improving transport infrastructure and public safety, and continuing to improve the quality of institutions. Furthermore, issues related to financial integrity and international tax transparency have gained more importance and the authorities are taking steps to accelerate reforms in these areas.

IV. THE PROPOSED OPERATION

OPERATION DESCRIPTION AND LINK TO GOVERNMENT PROGRAM

24. **The Program Development Objectives of the DPF series are to support the Government of Panama's efforts to (i) strengthen the frameworks for international tax transparency, financial integrity, and fiscal management; (ii) strengthen institutional arrangements to support social assistance and education; and (iii) enhance the regulatory and financial sustainability framework of service delivery in the energy and water sectors.** These three pillars complement and reinforce each other. First, a stronger framework for international tax transparency and financial integrity will improve investor confidence and support economic growth, while the strengthening of fiscal management will support the adherence to the SFRL and help ensure fiscal sustainability. Second, improved transparency and better targeting of social protection systems will help direct resources to those that need them the most, while improved quality of education will contribute to advancing opportunities, particularly for vulnerable youth, and supporting the competitiveness agenda to boost long-term productivity growth. Finally, an enhanced regulatory and financial sustainability framework of water and energy service delivery will help increase the fiscal space needed to safeguard social assistance and education programs.

25. **The policies supported in the DPF series are fully aligned with the Government's program**. In particular, the program supports objectives (ii), (iii), (iv), and (vi) of the Social and Economic Strategy 2015-2019 described in Section III. The proposed second operation consolidates progress achieved under the first operation, and lays the groundwork for future policy dialogue in additional reform areas, including international tax transparency and AML/CFT, fiscal decentralization, debt management, and public investment management. In addition, the measures supported by this DPF in the areas of disaster risk management and energy are aligned with the Government's priorities for climate change mitigation and adaption, as reflected in Panama's

commitment to the United Nation's Framework Convention on Climate Change (April 2016) which sets forth a Nationally Determined Contribution to the global response to climate change.[6]

26. **The design of the proposed operation builds on lessons learned from previous DPFs in Panama and the WB's experience in other middle-income countries.** Key lessons include supporting government-led initiatives to obtain ownership of reform, as illustrated by previous operations in Panama. The legal and regulatory framework underpinning the reform program was initiated and developed by the Administration, with technical inputs from the WB and other development partners. Additional lessons include the need for strong analytical underpinnings, and consolidation and continuity of the reform agenda. For example, under the previous programmatic DPF series, the Government achieved important advancements in the area of public debt management, and through a renewed emphasis on fiscal management, the current DPF series continues to support reforms in this area.

PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS

27. **The scope of the DPF series has been strengthened in existing areas, and has been broadened to support measures on international tax transparency, financial integrity, and fiscal management in response to emerging risks.** Overall, the prior actions in DPF 2 reflect a more ambitious program than that envisaged by the triggers included in DPF 1. Out of nine indicative triggers identified under DPF 1, three were converted to prior actions (the language of the prior actions was adjusted to better capture their legal form), four were strengthened (i.e., the scope of the action was broadened), and two were dropped due to a change in the timeline of the Government's reform agenda. In turn, three prior actions were added, reflecting the authorities' commitment to strengthening the frameworks for international tax transparency and financial integrity, and improving fiscal decentralization and debt management practices. All of these new measures are crucial for Panama to build resilience given the lack of monetary policy to respond to external shocks. The indicative triggers that were removed from the Policy Matrix relate to the institutionalization of the National Council of Indigenous People and the planned reforms in the water sector. The removal of the indicative trigger in the area of Indigenous People was due to a changed timeline of the reform agenda, as the Council requires operational strengthening and capacity building activities before it can be fully operational. Steps are being taken in this regard, including the establishment of an Indigenous People Roundtable in 2015 to serve as a consultation platform between the Government and the Indigenous People until the Council is formalized by law. The WB is providing technical assistance to support the inclusion of Indigenous People, and is currently preparing an Investment Project Financing operation to provide further support to this area. Similarly, the indicative trigger in the water sector was removed, reflecting a change in the Government's reform timeline. Nevertheless, the DPF program continues to support reforms in the water sector through policy actions planned for DPF 3. The triggers for DPF 3 and the results indicators were also revised to make them more ambitious relative to what was originally proposed under DPF 1. Annex 4 presents a comparison of the DPF 2 indicative triggers and the DPF 2 prior actions.

[6] See: "Contribución Nacionalmente Determinada a la Mitigación del Cambio Climático (NDC) de la Republica Panamá ante la Convención Marco de Naciones Unidas sobre Cambio Climático (CMNUCC)", April 2016 (available at: http://www4.unfccc.int/Submissions/INDC/Published%20Documents/Panama/1/Panama_NDC.pdf).

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

Prior Action 1: *The Borrower, through the Ministry of Foreign Affairs, has taken initial actions aimed at conforming with the Common Reporting Standards for Automatic Exchange of Financial Account Information in Tax Matters (CRS) through its commitment to adhere to the CRS by 2018, as evidenced by Notification D.S.-MIRE-2016-25092, dated May 9, 2016.*

28. **A key priority for Panama is to strengthen the framework for international tax transparency and ensure its effective implementation.** In October 2015, following assessments by the OECD's Global Forum on Transparency and Exchange of Information for Tax Purposes, Panama was officially accepted into Phase 2 of the Peer Review process, which evaluates the status of the country's compliance with international standards of transparency and exchange of information.[7] Panama has made notable progress in bringing its legal framework closer to international standards, especially through: (i) an amendment to the Commercial Code obliging all legal entities to keep updated share registries; (ii) a modification to the legislation introduced in 2013 to immobilize bearer shares, which reduced the grace period for conversion of bearer shares to nominal shares or designation of a custodian, and prohibited banks from opening accounts to bearer shares companies (Law 18 of April 2015); and (iii) the expansion of the network of countries with which Panama can exchange tax information. Despite this progress, in its report the OECD highlighted the need to address important shortcomings in Panama's legal framework, especially with respect to the availability of information on the identity of beneficiaries of private foundations, the availability of reliable accounting records for relevant entities registered in Panama (irrespective of their place of operations), and regarding the timeliness and effectiveness of existing agreements for the exchange of information. As part of its commitment to strengthen international tax transparency, in April 2016 the Government established a Committee of Independent Experts to review Panama's current practices in international tax transparency and financial integrity, and provide recommendations and best practices. The Government has set a six-month deadline for the Committee to perform its review, which will presented at the International Anti-Corruption Conference to be held in Panama in December 2016.

29. **In May 2016, Panama issued a notification with the government's decision and commitment to adhere to the CRS for Automatic Exchange of Financial Account Information in Tax Matters developed by the Global Forum on Transparency and Exchange of Information for Tax Purposes (DPF 2 Prior Action 1).** As of June 7, 2016, 101 member jurisdictions have committed to implementing the CRS by 2017 or 2018. Panama's commitment is a significant milestone for adherence to the global standards on international tax transparency. This decision by the Government locks Panama into an institutional and policy reform process, which includes legislative, technical, and operational actions that would need to

[7] The peer review process evaluates jurisdictions' compliance with the international standard of transparency and exchange of information on request. The Global Forum Terms of Reference break down the standard in ten essential elements, divided into three main parts: A – availability of information, B – access to information, C – exchange of information. Peer reviews take place in two phases: Phase 1 reviews examine the legal and regulatory framework; and Phase 2 reviews assess the implementation of the framework in practice.

be completed within the timeline established by the Global Forum (2018) and are expected to result in the adherence to the CRS by 2018. In particular, the adherence to the CRS involves four key steps: (i) translating the reporting and due diligence requirements into domestic law through amendments to existing legislation as well as new legal acts; (ii) selecting a legal basis for the exchange of information (automatic exchanges on bilateral or multilateral basis); (iii) putting in place the administrative and information technology infrastructure to collect and exchange information within the Competent Authority; and (iv) protecting confidentiality and data safeguards.

30. **The triggers for DPF 3 aim to follow up on specific reforms needed to adhere to CRS, as well as on measures for an effective implementation of the new AML/CFT framework.** The DPF 3 triggers in these area support (i) the enactment of new legislation in line with Panama's commitment to adhere to the CRS for Automatic Exchange of Financial Account Information in Tax Matters; and (ii) the completion of a semi-annual report on the implementation of the new supervision procedures aligned with the AML legislation provisions on bearer shares and beneficial owners adopted in April 2015. The first trigger aims to prepare the country's legislation for the adherence to CRS by 2018. The second trigger seeks to institutionalize the process of supervision activities related to the implementation of the revamped AML/CFT framework. In particular, the Superintendence of Banks of Panama will start issuing semi-annual reports starting in 2017 on the basis of the updated AML/CFT supervision procedures that relate to bearer shares and beneficial owners. The ultimate goal of this action would be to serve as an effective tool to assess the status of the implementation of the new legal framework. In addition, Panama's decision to adopt the Multilateral Convention on Mutual Administrative Assistance in Tax Matters, announced in July 2016, will be a significant step forward in implementing its commitment to tax transparency and exchange of information.

31. **Expected results**: Panama's reforms in the area of international tax transparency and AML/CFT framework are critical to safeguard the country's role as an international financial center. The supported measures are expected to result in Panama's compliance with CRS requirements related to the availability of tax information, ensuring that (i) ownership and identity information is available for all relevant entities; and (ii) reliable accounting records are kept for all relevant entities by 2017. These were key outcomes of implementation where Panama fell significantly short in the last Global Forum's review. In addition, the country is expected to increase the number of banks that are supervised (on-site and off-site) in a year using the new AML supervision procedures, from 0 in 2014 to 50 by end-2017 (in 2015 there were 96 banks in Panama).

Prior Action 2: *The Borrower has amended the Decentralization Law which, inter-alia: (i) establishes a mechanism to distribute property taxes to municipalities, (ii) establishes a municipal public investment program, and (iii) creates the National Secretariat for Decentralization to supervise and coordinate the decentralization process, as evidenced by Law 66, dated October 29, 2015, duly published in the Borrower's official gazette dated October 30, 2015.*

32. **Panama is one of the most centralized countries in LAC, with local governments playing only a minor role.** The bulk of public investment and service provision responsibilities and resources to address the needs of the population are concentrated in central government and are exercised by line ministries. While there have been several attempts in the past to advance the decentralization agenda,[8] little notable reform has been undertaken. As a result, by 2015 local governments in Panama continued to play a rather minor role in supporting local development, including performing strategic planning functions or designing and implementing investments. Until recently, the legal framework regulating local government functions and intergovernmental relations did not provide a clear division of responsibilities between local governments and the central government. In addition, the expenditures by local governments were small: total annual spending executed at the subnational level in Panama is around 0.5 percent of GDP, the lowest share in LAC.

33. **In late 2015, the Government took an important step to promote fiscal decentralization with the enactment of an amendment to the Law on Decentralization which aims to gradually reduce municipal governments' financial dependence on central government (DPF 2 Prior Action).** The Law recognizes the importance of decentralizing responsibilities, while providing municipalities with additional fiscal resources and legislative authority for them to be able to meet new requirements. In particular, the Law establishes a mechanism to distribute the property tax, taking into account: (i) the need to create incentives for municipalities to expand tax bases (thus, a part of the distribution depends on the origin of the collected tax—i.e., tax-compliant properties in the municipal territory); (ii) spending needs (thus, part of the distribution of resources depends on the municipality's population); and (iii) the principle of a basic level of service provision (the distribution formula ensures that all municipalities receive at least US$500,000 per year, an amount to be updated every two years). The Law aims to improve the coordination of investment projects between the central government and municipalities, by earmarking 90 percent of the property tax revenues to finance investments and social development. It also stipulates the creation of a Municipal Public Investment Program, and requires it to be aligned with SINIP. In order to ensure the proper coordination of the decentralization process, the Law mandates a creation of the National Secretariat for Decentralization, which will start its operations in 2018.

34. **The trigger for DPF 3 supports the adoption of a Law for Public Investment.** Despite having one of the largest shares of public investment spending to GDP in LAC, Panama lacks a comprehensive legal framework governing public investment. The planned Law for Public Investment will set common rules for planning, allocation, and implementation of public investments, and will facilitate more efficient management of SINIP.

35. **Expected results**: With a gradual decentralization process, local governments are expected to make more efficient use of their resources, introduce mechanisms to better align spending decisions with local needs, support greater citizen participation in local development issues, and strengthen local governance. The compliance with SINIP procedures will ensure that

[8] Panama Country Report, Trends in Decentralization, Municipal Strengthening, and Citizen Participation in Central America, 1995–2003, June 2004, prepared for the Regional Sustainable Development Office, the Bureau for LAC, US Agency for International Development.

investments by local governments comply with the established standards and guidelines aimed at improving the quality of spending. By end 2017, 70 percent of all local investment projects are expected to be rigorously evaluated by SINIP procedures.

Prior Action 3: *The Borrower, through MEF, has signed an agreement with the Comptroller General to define tasks and responsibilities for public debt servicing, including to allow for the use of the integrated SIGADE-ISTMO platform, as evidenced by "Acuerdo Interinstitucional para la Implementacion de la Interfaz SIGADE-ISTMO", dated January 21, 2016.*

36. **The Government remains committed to strengthening institutional arrangements for debt management and in recent years, has taken a series of measures in this area.** In particular, supported by the previous DPF series (2011-2013), the Government: (i) created a domestic debt market to increase the range of available debt instruments and reduce risks for Government funding; (ii) aligned the organizational structure of the Directorate of Public Financing with international best practices; and (iii) completed and published a medium-term debt management strategy. The debt management strategy is the result of a cost-risk analysis of alternative debt strategies under different scenarios, taking into account market and macroeconomic constraints. Its outcome is a debt portfolio with an optimal cost-risk profile. It also guarantees consistency of debt management operations across time and increases transparency, with the ultimate aim of reducing interest costs over the long-term.

37. **Further steps to strengthen debt management include the clarification of operational and audit functions between Ministry of Economy and Finance (MEF) and the Comptroller's General Office (CGO), and the integration of the public financial and debt systems (DPF 2 Prior Action).** A sound organizational structure is a prerequisite for efficient debt management. Historically the CGO has been responsible for both the management of debt payments and the audit/oversight of debt management functions in Panama. In 2016, MEF and the CGO signed an agreement that transferred the responsibility for debt payment functions from the CGO to MEF, while the CGO retains its oversight and audit functions, in line with best international practices. As a result of this agreement, for the first time, MEF will be able to make electronic debt payments. Furthermore, MEF has integrated its Debt Management and Financial Analysis System (*Sistema de Gestión y Análisis de la Deuda*, SIGADE), the country's debt information system, with the new ISTMO, the country's integrated financial management information system (see below for a description of ISTMO). By linking the SIGADE with ISTMO, MEF has integrated budgetary and debt functions, thereby allowing the country to service its debt electronically and recording its transactions transparently and in real time. Going forward, the Government plans to complete its first government-led debt sustainability analysis in 2016 (including forecasts of real, monetary, external, and fiscal variables, and contingent liabilities) and update it on an annual basis, which will allow for regular assessments of the sustainability of the fiscal position and its sensitivity to changes in the economic environment.

38. **Expected results:** The supported measures would allow MEF to increase the share of central government debt that is paid electronically from 0 percent in 2014 to 100 percent by 2017.

Prior Action 4: *The Borrower, through MEF, has adopted a medium-term disaster risk management operational plan to strengthen the Borrower's disaster risk management framework, as evidenced by Ministerial Resolution 001-DICRE, dated March 2, 2016.*

39. **Safeguarding public finances from the financial implications of natural hazards is a key challenge for Panama given its geographical location.** As noted in the Systematic Country Diagnostic, Panama is ranked in 14th place among the countries most exposed to multiple natural hazards that represent an important fiscal contingency. Around 15 percent of the country's total area and 13 percent of its population is vulnerable to two or more perils. The main threats include long lasting and heavy rainfall, storms, strong lightning, floods, forest fires, waterspouts, earthquakes, tsunamis, and episodes of the El Niño-La Niña phenomena. In the case of an extreme event (the likelihood of which is once every century), the country could incur large losses as percent of GDP. In November 2012, for instance, heavy rains caused floods and landslides in Colon and across the western Caribbean region of Panama, causing estimated damages of US$123 million, prompting the Government to declare a state of national emergency and approve a waiver to exceed the deficit ceiling.

40. **To improve the management of fiscal risks related to natural hazards, the Government has issued a resolution defining operational guidelines for disaster risk management (DRM) (DPF 2 Prior Action).** This resolution approves a medium-term plan that builds directly on the Strategic Framework for the Financial Management of Disaster Risk, which was approved by the Government and endorsed by DPF 1.[9] The multi-year action plan, prepared by the Directorate of Investment, Concessions, and Risks (DICRE) of MEF provides a thorough and exhaustive tool to operationalize the DRM Strategic Framework. The approval of this resolution represents an important regulatory milestone that strengthens the DRM Strategic Framework, and more broadly supports the country's climate change objectives. This resolution establishes key outputs under each strategic pillar; identifies sequential actions to achieve each of the outputs; identifies the primary responsible institutions; and establishes a timetable for the completion of each action. The resolution also outlines an annual evaluation and monitoring process to assess progress in implementation of the DRM Strategic Framework, with activities including (i) conducting probabilistic studies in a metropolitan area of Panama; (ii) establishing the GeoNode system (a web-based platform for developing geospatial information systems) within DICRE; and (iii) estimating the level of uncovered risks and identifying appropriate contingency financing instruments using cost-benefit analysis. Furthermore, the resolution envisages the development of domestic private insurance market for disaster risks.

41. **The trigger for DPF 3 supports the adoption of regulations for the operational functions of the State Insurance Committee (*Comisión de Seguros del Estado*).** The Committee will be vital for fostering development of insurance market, which is a key milestone from the Strategic Framework for the Financial Management of Disaster Risk.

[9] This strategy puts special emphasis on (i) the identification, quantification, and understanding of fiscal risks due to natural disasters; (ii) incorporation of disaster risk analysis in the planning of public investments; (iii) formulation of components for developing and implementing risk retention and transfer instruments; (iv) development of the domestic insurance market; and (v) strengthening of DICRE.

42. **Expected results:** The development of the Strategic Framework for the Financial Management of Disaster Risk and the approval of the operational action plan put Panama at the global frontier in the area of DRM. The application of cost-benefit analysis to existing and new financial instruments (at least 2 by end 2017) for contingent fiscal risks would enable the country to make informed decisions on the best strategy to finance the costs associated to a natural hazard, including costs of recovery and reconstruction. In addition, technical capacity would be built within DICRE to undertake future financial dynamic analysis for assessments of other financial tools against different risk scenarios, thus setting the basis for a continued strengthening of the DRM Strategic Framework in the medium and long-term.

Prior Action 5: *The Borrower, through MEF, has: (a) expanded the application of the new financial information management system ISTMO to central government entities, as evidenced by Letter DNC-N-No. 036-16, dated April 20, 2016; and (b) integrated 23 budgetary accounts of central government entities under the Treasury Single Account; as evidenced by Letter Nota No. 900-01-333-DT, dated April 27, 2016.*

43. **Integrating financial management systems under a TSA will help address Panama's fragmentation of financial management systems for revenues and expenditures (DPF 2 Prior Action).** Law 56-2013 and Law 19-2014 created the National Treasury System and the TSA. This new system is based on two principles: (i) cash unity and (ii) centralized administration of public funds by the National Treasury Department. In 2015, MEF embarked on the integration of institutional bank accounts under the TSA, with the aim of unifying the administration of over 5,800 bank accounts of the central government and public sector entities. In early 2016, MEF began channeling funds for 23 budgetary accounts of fifteen central government entities through the TSA. The use of the TSA improves transparency and accountability in the use of public financial resources by smoothing the allocation of resources through improved cash management, avoiding idle funds and reducing unnecessary financing costs.

44. **The creation of the TSA is complemented with the development of an integrated system for Government resource planning, ISTMO (DPF 2 Prior Action).** The newly launched ISTMO seeks to strengthen and integrate, through information technology solutions, the core functions of budget planning and execution, treasury management, accounting, and reporting. The use of both the TSA and ISTMO will improve the efficiency of public finance management, increase the transparency of government accounts, and ultimately create additional fiscal space. To this end, MEF has developed an interface between the TSA and ISTMO to automatically record transactions in the TSA and align them with accounting module of ISTMO. This process is expected to facilitate a reliable reconciliation of banking accounts with the Government's accounting information. Also, the links created between ISTMO with the revenue collection and debt management systems will support the consolidation of cash management systems.

45. **The trigger for DPF 3 supports the completion of the integration of all budgetary accounts of central government entities under the TSA and the roll-out of ISTMO across all central government entities.**

46. **Expected results:** The consolidation of financial management functions under ISTMO, the integration of cash management through the TSA, and the linkage of the revenue collection and debt management systems are expected to enhance the transparency of public resources and put Panama on the path towards international best practices. Improved cash management through the TSA would enable more effective and efficient use of government resources during the budget execution, channeling available cash to priority objectives and improving the timeliness of payments. It is expected that by 2017, at least 90 percent of central government funds will be channeled through TSA. The use of ISTMO would allow for the automatic generation of financial statements for budget execution in central government entities, which will enhance the quality of monitoring of national programs and execution of projects.

Pillar 2: Strengthening Institutional Arrangements to Support Inclusion in Social Assistance and Education

47. **Progress on the inclusion front will require addressing challenges related to the efficiency of the social assistance system and the quality of education.** Social protection programs, including Conditional Cash Transfer (CCT) programs, have helped to reduce poverty in recent years, but additional progress can be made to refine their targeting. Moreover, improving the quality of education services, especially in secondary schooling and vocational training, remains key to improving access to opportunities and boosting the competitiveness of the economy.

48. **This pillar supports actions to advance (i) the efficiency and transparency of social assistance programs; and (ii) the quality of education services.**

Prior Action 6: *The Borrower, through MIDES, has completed an audit of beneficiaries of the conditional cash transfer program "Red de Oportunidades" to improve the coverage and targeting of beneficiaries, while reducing fiscal leakage in the program, as evidenced by the official notification from MIDES to MEF, dated February 3, 2016.*

Prior Action 7: *The Borrower, through MIDES, has signed an agreement with a regulated financial institution to channel payments to beneficiaries of all conditional cash transfer programs through said financial institution, as evidenced by "Convenio Clave Social 14-15" between MIDES and the National Bank of Panama, dated June 15, 2015.*

49. **CCTs have been the main policy vehicle to reduce extreme poverty in Panama.** The Ministry of Social Development (MIDES) is responsible for the design and the implementation of three CCT programs: (i) the flagship *Red de Oportunidades* (Opportunities Network) program, aimed at providing income support to the extreme poor; (ii) *120 a los 65* program, which targets poor and vulnerable elderly; and (iii) the *Ángel Guardián* program for extreme poor individuals with disabilities. Launched in 2006, *Red de Oportunidades* has been serving over 70,000 households. Beneficiary families receive US$50 per month in exchange for their children's school attendance and regular primary health care visits. They are selected by estimating per capita family consumption using a proxy means test, adjusted for urban and rural areas. Targeting in the indigenous *comarcas* is purely geographical, meaning that all households in the selected *comarcas* are eligible for the program. The *120 a los 65* program (originally *100 a*

los 70) has been operational since 2009 and provides a benefit of US$120 per month to individuals over 65 years of age who do not receive a contributory pension and are considered vulnerable. This payment is contingent upon health checkups and participation in counseling and medical guidance talks, courses, and seminars. The expansion of this program from *100 a los 70* to *120 a los 65* was a prior action supported by DPF 1. Finally, the *Ángel Guardián* program supports disabled individuals living in extreme poverty. Overall, these CCT programs represent around 0.7 percent of GDP annually, and have contributed to reducing extreme poverty and improving social indicators, such as rates of school enrollment, medical check-ups, and pregnant woman screenings.

50. **Improving the efficiency of CCT programs is a key priority for the Government.** Key challenges relate to weak targeting mechanisms, gaps in coverage, leakage of benefits that lead to losses of fiscal resources, and lack of coordination between social assistance support schemes within MIDES. Proxy means testing targeting criteria are not used across all CCT programs and the lack of a single/master registry of beneficiaries does not allow for the regular monitoring of beneficiaries. Furthermore, the absence of rules for periodic recertification leads to fiscal leakages and inclusion errors, affecting coverage for the extreme poor. According to the latest household survey data, over 50 percent of beneficiaries of *120 a los 65* program are not poor, whereas an audit of beneficiaries of *Red de Oportunidades* revealed that roughly 15 percent of beneficiaries were not eligible for social assistance. Moreover, the dispersed staffing structure of MIDES as well as the weak mechanisms facilitating intra-ministerial coordination of the social assistance agenda creates duplications of functions, which affects the efficiency and effectiveness of the country's social assistance system.

51. **The Government is taking measures to improve the coverage and targeting of *Red de Oportunidades* within the same fiscal envelope (DPF 2 Prior Action).** In 2015 MIDES completed an audit of beneficiaries of the *Red de Oportunidades* program that led to the identification and exclusion of nearly 10,000 households (out of about 70,000 households) that did not qualify for the program. In exchange, MIDES included a similar number of extreme poor families, mainly living in indigenous *comarcas* (70 percent of the new beneficiaries), thereby reducing the extreme poor coverage gap in a fiscally neutral manner. This audit helped to improve the coverage and targeting of beneficiaries, while reducing fiscal leakage in the program. In order to institutionalize the gains from the audit, the authorities amended the Operational Manual of the *Red de Oportunidades* program to mandate the regular update of the registry of beneficiaries and prioritize poor and vulnerable households. In addition, to strengthen the management of social programs, a Social Development Directorate was created within MIDES to supervise all CCT programs and coordinate the selection, enrollment, and payment systems across different CCT schemes.

52. **In parallel, the Government is advancing the use of the banking system to pay out the benefits of *Red de Oportunidades* (DPF 2 Prior Action) with a view to enhance access**. In 2014, all CCT programs were being paid out in cash through a network of decentralized social workers. Such a scheme lacked financial transparency, was administratively expensive and prone to errors, and resulted in leakages. In order to reduce administrative costs and facilitate the financial inclusion of the poor, MIDES has signed an agreement with *Banco Nacional*, Panama's national bank, to allow for the channeling of CCT payments through the banking sector. To this

end, MIDES has begun implementing training programs on financial inclusion to beneficiaries of *Red de Oportunidades*.

53. **A trigger for DPF 3 supports the enactment of a Law on Social Protection.** The Law, expected to be adopted in 2016, would mandate the creation of a single registry of beneficiaries for all CCT programs to monitor potential overlaps and conduct cross-checks with other administrative databases. The registry would also serve as a tool for the identification and characterization of the socioeconomic situation of low income families. It would also create a Unique Registry Form that includes ethnicity information, in order to better monitor and evaluate the social programs for specific groups (e.g. the indigenous population).The Law would also regulate the automatic re-certification of beneficiaries across all CCT programs to reduce inclusion errors and leakage problems.

54. **Two additional DPF 3 triggers in this area include: (i) the introduction of proxy means testing formula for "*120 a los 65*" program; and (ii) the introduction of a new payment modality e-Wallet for *Red de Oportunidades*.** First, the proxy means testing formula for "*120 a los 65*" program will be consistent with the formula used for *Red de Oportunidades*, to improve the program's targeting and reduce its administrative costs. Second, the e-Wallet payment system will facilitate the payment of CCT benefits through a system of points of sales, located in hard to reach areas, with the objective of reducing transportation costs for beneficiaries and improving the security of the payment collection process.

55. **Expected results:** These actions are expected to improve the targeting and coverage of CCT programs in Panama within the same fiscal envelope. Regular updates to the registry of beneficiaries, and improvements in the targeting formulas are expected to increase the number of extreme poor and vulnerable people benefitting from social assistance. The usage of the social card (*Clave Social*) for the payment of benefits is likely to lead to an increase in the percentage of *Red de Oportunidades* funds transferred more securely and transparently using the banking system (from 0 percent in 2014 to 30 percent in 2017), and at the same time, is expected to promote financial inclusion for low income beneficiaries. The Law for Social Programs is expected to strengthen MIDES management, reduce inclusion errors, and improve the coverage and targeting of social assistance schemes. As a result, the percentage of the extreme poor benefiting from at least one social assistance program is expected to increase form 37 percent in 2014 to 60 percent in 2017.

Prior Action 8: *The Borrower, through MEDUCA, has: (a) taken initial actions aimed at participating in the Program for International Student Assessment (PISA), through the issuance of an official notification to the OECD informing of its participation in the 2018 PISA, as evidenced by Letters from MEDUCA to the OECD (DM-280-2015, dated February 3, 2015; DM-2561-2015, dated November 26, 2015, and DM-082-2016, dated January 11, 2016); and (b) completed and published the microdata of the 2013 Third Regional Comparative and Explanatory Study (TERCE).*

Prior Action 9: *The Borrower has: (a) established and regulated the implementation of the program "Panama Bilingüe", as evidenced by Executive Decree 148, dated April 1, 2016; and (b) approved the curricula for the new technical baccalaureates, which includes the development* *of non-cognitive skills, as evidenced by Executive Decree 149, dated April 12, 2016.*

56. **Panama has made important progress in improving educational outcomes in recent years, however, the quality of education services and the large drop-out rate at the secondary level remain a concern.** While the country has an almost universal coverage of primary education (91 percent in 2012) and the net enrollment ratio in secondary education comparable to the regional average (76 percent in 2012), the survival rate to the last grade of lower-secondary education is well below regional standards (77 percent in Panama versus 84 percent in LAC). The quality of education services also remains a challenge, as evidenced by Panama's weak performance in the 2009 PISA. Furthermore, the results of the 2013 Third Regional Comparative and Explanatory Study (TERCE) confirmed that the average performance of Panamanian children remains below the regional average and there is a substantial degree of variation in the results within the country. In addition, there is a broad perception that the education system in Panama is not well aligned with the needs of the labor market, translating into relatively high unemployment rates for the youth (at 8.1 percent in 2013 as compared to 2.1 percent for the group aged 25-54 years old).[10]

57. **Improving Panama's educational outcomes requires a focus on strengthening monitoring and evaluation systems.** In the past, Panama participated in standardized student assessments sporadically and on an ad hoc basis (e.g., in the 2009 PISA). As a result, policymakers lack readily available standardized student learning assessments to design evidence-based policies. Similarly, there has been very little evidence regarding the efficiency and effectiveness of student support programs, including the flagship initiative *Beca Universal* (Universal Scholarship), which provides cash benefits to over 600,000 students.

58. **To better track the performance of Panamanian students, the Government completed the 2013 TERCE process and published its results, and committed to taking part in the 2018 PISA (DPF 2 Prior Action).** The publication of the 2013 TERCE results on the website of the Ministry of Education (MEDUCA), along with the full documentation on the data, will allow the Government, think-tanks, and international experts to conduct diagnostics on student learning outcomes and benchmark Panama's performance. This effort is expected to promote society's engagement in the challenges of the education sector as well as the formulation of evidence-based policies. Going forward, the Government intends to systematically participate in international student assessments, starting with an official notification to the OECD committing to participate in the 2018 PISA.

59. **The Government aims to improve labor market prospects for the youth by improving the quality of English teaching and adopting new curricula for technical baccalaureates (DPF 2 Prior Action).** In 2016, the Government issued a decree to launch the program *Panama Bilingüe* to foster English language education at the pre-school and school levels through the training of current and future language teachers. Under the pilot program,

[10] In 2009, when the international crisis took place, the unemployment rate increased to 6.6 percent but since then, has been declining and stood at 4.1 percent in 2013 (Panama Social Sector Expenditure Review, WB, forthcoming.) Despite recent improvements, unemployment is still high among the youth and among those with secondary education. For instance, the youth unemployment rate reached 8.1 percent, more than twice the national rate. Unemployment is also concentrated in urban areas reaching 3.7 percent in contrast with 2.2 percent in rural areas.

implemented in 2015, more than 13,000 students from over 50 schools participated in the pre-school component, about 6,000 students in the after-school scheme, and over 500 teachers of English participated in courses held in the universities in the US, the United Kingdom, and Australia.

60. **The triggers for DPF 3 include: (i) the completion of an evaluation of *Beca Universal* and the approval of a corresponding strategy to implement its recommendations; and (ii) the national roll-out of the *ProJoven* and *Panama Bilingüe* programs.** First, to rigorously assess impact of *Beca Universal* on educational outcomes of Panamanian students, in 2016, the Government will conduct the first evaluation of the program and based on its findings will prepare an action plan to implement its recommendations. Second, building on the achievements of the pilot phase of *ProJoven* implemented in 2015 (around 48 percent of interns were offered a job, of which 70 percent stayed in the companies for more than six months), the authorities plan to institutionalize the program and scale it up nationally over the course of 2016. The Government also plans to roll out *Panama Bilingüe* nationally, and conduct an evaluation of its outcomes.

61. **Expected Results:** The actions supported by the operation are aimed at supporting medium- and long-term improvements in Panama's education system, the improved assessment of student skills and facilitate the school-labor market transition of the youth. Specific results indicators include improved understanding of key challenges related to the quality of education services in Panama demonstrated by the increase in the number of diagnostic reports, prepared by MEDUCA, and based on the results of international student assessments, from 0 in 2014 to 2 by the end of 2017, and increase in the number of teachers who participated in the International Teacher Training as part of *Panama Bilingüe*, from 0 in 2014 to 1,500 teachers in 2017.

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

62. **Inclusion challenges also impact public service delivery in Panama.** Among LAC countries, Panama has the lowest level of electricity coverage among vulnerable population groups, such as the indigenous. In addition, and partly due to an inefficient institutional set-up, access to potable water and sanitation services remains low in rural areas in comparison to regional standards.

63. **This pillar supports actions to advance public service delivery by securing financially-sustainable and reliable energy provision through the reduction of subsidies and the promotion of efficiency standards within the energy sector.** The DPL program also supports the enhancement of regulatory arrangements and management practices within the water sector.

Energy

Prior Action 10: *The Borrower has reduced electricity tariff subsidies through the replacement of the nation-wide Fund for Energy Compensation (FACE) with a geographically-targeted Fund for the Occidental Region (FTO), as evidenced by Cabinet Resolutions No. 59 and No.60, both dated June 23, 2015 and Cabinet Resolution No.2, dated January 5, 2015.*

64. **The energy sector in Panama has not been able to keep pace with the growing demand that has arisen due to the outstanding performance of the Panamanian economy in the last decade**. The modest increase in the power generation capacity and slow progress on diversification of power generation over the last decade have not matched the accelerated increase in demand. The total installed capacity in Panama is approximately 2,500 MW, and is comprised primarily of hydropower (60 percent) and fossil fuel-based generation (40 percent), exposing the Panamanian power system to droughts and oil price volatility and making it vulnerable to energy shortages. For example, during 2013 and 2014, the Government was forced to introduce emergency response measures to reduce electricity demand and prevent power outages, including restrictions on the use of air conditioning. In addition, in the absence of electricity price adjustment mechanisms, energy shortages have put tremendous pressure on the costs of energy generation, as these required the use of less efficient and more expensive emergency power generation plants, threatening the financial sustainability of the sector.

65. **To improve the fiscal sustainability of the power sector, the Government has reformed the electricity subsidy mechanisms (DPF 2 Prior Action).** Supported by the previous DPF series, the Government has undertaken reforms to diversify the power generation mix towards renewable energy, promoting new solar and wind generation projects. In addition, as part of DPF 1, the Government increased tariffs in December 2014 by 10.3 percent to address the fiscal cost of energy. Supported by DPF 2, the Government has improved the targeting of electricity tariff subsidies by substituting the country-wide Energy Compensation Fund (*Fondo de Compensación Energética – FACE*) with the geographically-targeted Tariff Fund for the Occidental Region (*Fondo Tarifario de Occidente – FTO*), a new fund created in 2015 targeting resources to the western region of Chiriquí, which bears higher structural electricity costs. The elimination of FACE amid low international oil prices has resulted in a 74 percent reduction in transfers from the Government to end-consumers through distribution companies (from over US$240 million in 2014 through FACE to US$62 million in 2015 through FTO).

66. **The trigger for DPF 3 is the adoption of a Construction Code and the regulation of energy efficiency labeling standards for consumer products.** First, the Construction Code aims to reduce electricity demand, particularly during peak hours, by setting minimum energy-efficiency standards for new construction and alterations to existing buildings. Second, the Government plans to issue a decree that introduces labeling standards to allow consumers to compare the energy consumption of similar products (e.g. household appliances), and factor electricity costs into their purchasing decisions. This regulation seeks to promote energy efficiency and more responsible use of energy by consumers to prevent pollution and excessive greenhouse gas emissions. The trigger is fully aligned with Panama's nationally determined contribution to the global response to climate change in the area of climate change mitigation, as agreed during the 21st session of the Conference of the Parties in Paris in December 2015.

67. **Expected results:** Measures supported are expected to improve the fiscal sustainability of the energy sector, which is fundamental for providing reliable, affordable and continuous access to electricity. As a result, by 2017 expenditures related to electricity subsidies are expected to be reduced by at least 50 percent in nominal terms relative to their level in 2014 (US$320 million, about 0.7 percent of GDP).

Water

68. **In recent years, the Government has improved the provision of water and sanitation services, but access is still inequitable and challenges related to quality remain.** According to the 2010 national census, 93 percent of Panamanians have access to potable water, and 95 percent to sanitation services. In rural areas, however, coverage levels drop dramatically: 78 percent of the rural population has access to potable water and 85 percent to sanitation services. These numbers drop even further for indigenous populations, where potable water coverage is only 28 percent and sanitation coverage is 6 percent. Although coverage levels are high in urban areas, the quality of water and sanitation services provided by the National Water Supply and Sanitation Agency, the *Instituto de Acueductos y Alcantarillados Nacionales* (IDAAN), continues to be a problem, in particular in poor urban and peri-urban areas.

69. **While its legal framework has recently been updated, the water and sanitation sector still faces a number of challenges, including unclear roles among the different sector actors, a lack of coordinated investment, weak regulatory capacity, and limited operational and financial autonomy of IDAAN.**[11] The Government has made water and sanitation services a priority in its policy agenda by initiating the "100/0" program (supported by DPF 1) which seeks to provide reliable potable water 24 hours a day and eradicate the use of latrines. DPF 1 also supported strengthening the Rural Water and Sanitation Information System (SIASAR) to monitor the development and performance of rural water supply and sanitation services. Despite the progress, several challenges lay ahead. In particular, lack of established division of roles and responsibilities of different actors in the water and sanitation sector, coupled with poor urban planning and regulation enforcement, have resulted in poor management of assets in the sector and increased risks for floods in urban areas, particularly in Panama City and Colon. To address these issues in the Panama Bay area, the Ministry of Health (MINSA) will gradually transfer the assets of the "Panama Sanitation Program" to IDAAN**.** While MINSA will still be responsible for the operation and maintenance of the infrastructure built by the Panama Sanitation Program, this gradual transfer of assets will help improve the administrative organization of the sector, clearly assigning asset management responsibilities and ultimately contributing to strengthening the capacity of IDAAN over the medium-term.

[11] Four main state entities are responsible for policy setting, coverage expansion, and service provision in the water sector: (i) the Ministry of Health through the Directorate of Water and Sanitation is responsible for sector policy, coordination and long-term planning, and water provision to smaller towns and rural areas; (ii) the National Council for Sustainable Development within the Secretariat of Presidential Goals (*Secretaria de Metas Presidenciales*) is in charge of the basic sanitation plan "100/0" (100 percent access to drinking water and 0 latrines) aimed at improving quality of life by providing reliable water 24 hours a day and eliminating the use of latrines; (iii) IDAAN is responsible for water provision to urban areas and rural communities with over 1500 inhabitants; and (iv) the National Authority for Public Services, supervises and regulates service provision in urban areas. Other actors such as the National Authority for Environment and the Panama Canal Authority also play important roles in the water sector by supervising water quality and selling bulk water to IDAAN, respectively.

70. **The trigger for DPF 3 is the approval of an institutional action plan to strengthen IDAAN and the establishment of operational guidelines for the Inter-institutional Committee for Water and Sanitation.** These actions would restore IDAAN's autonomy and financial sustainability, as well as initiate the move towards a clearer and more transparent way to allocate subsidies to the national utility. It also aims at revamping IDAAN's human resources capacity, modernizing its information systems, accelerating procurement process, and putting in place a more effective organizational structure. The Government also aims to improve water sector management with the creation of an Inter-Institutional Committee for Water and Sanitation, which will be responsible for, among others, the elaboration of a water quality monitoring plan.

71. **Expected results:** The measures supported by the DPF program will strengthen the institutional framework in the water and sanitation sector. Specifically, the number of Rural Water Management Boards connected to the standardized information system for improving the monitoring of water management in rural areas is expected to increase from 400 in 2014 to 1,400 in 2017, out of a total of 2,824 rural water boards.

Analytical Underpinnings

72. **The DPF series is underpinned by extensive analytical work conducted by the World Bank Group.** It includes the 2015 Panama Systemic Country Diagnostic, the Panama Public Expenditure Review, and the Panama Social Expenditure Review, which together with analytical work by other institutions, provided the basis for an ongoing policy dialogue with the Government. Table 4 links the proposed prior actions to specific analytical work.

Table 4: DPF Prior Actions and Analytical Underpinnings

Prior Actions	Analytical Underpinnings Key Findings
Pillar 1: Strengthening the Frameworks for International Tax Transparency, Financial Integrity, and Fiscal Management	
Prior Action 1: The Borrower, through the Ministry of Foreign Affairs, has taken initial actions aimed at conforming with the Common Reporting Standards for Automatic Exchange of Financial Account Information in Tax Matters (CRS) through its commitment to adhere to the CRS by 2018, as evidenced by Notification D.S.-MIRE-2016-25092, dated May 9, 2016. **Prior Action 2:** The Borrower has amended the Decentralization Law which, inter-alia: (i) establishes a mechanism to distribute property taxes to municipalities, (ii) establishes a municipal public investment program, and (iii) creates the National Secretariat for Decentralization to supervise and coordinate the decentralization process, as evidenced by Law 66, dated October 29, 2015, duly published in the Borrower's official gazette dated October 30, 2015. **Prior Action 3:** The Borrower, through MEF, has signed an agreement with the Comptroller General to define tasks and responsibilities for public debt servicing, including to allow for the use of the integrated SIGADE-ISTMO platform, as	• Panama Systematic Country Diagnostic (WB 2015) • OECD: Phase 1 Peer Review Report and Supplementary Reports (2010, 2014, 2015) on Panama's Legal and Regulatory Framework on Tax Transparency • IMF: Panama: Detailed Assessment Report—FATF Recommendations for Anti-Money Laundering and Combating the Financing of Terrorism (IMF, 2014) • IMF Article IV reports • Decentralized Service Delivery for the Poor (WB 2006) • Panama Public Expenditure and Financial Accountability Assessment (WB, IDB, and Government of Panama 2012) • Strengthening Public Expenditure Management in Panama: A Basis for Better Government Performance (WB 2014) • Panama – Disaster Risk Management

Prior Actions	Analytical Underpinnings Key Findings
evidenced by *"Acuerdo Interinstitucional para la Implementacion de la Interfaz SIGADE-ISTMO"*, dated January 21, 2016. **Prior Action 4:** The Borrower, through MEF, has adopted a medium-term disaster risk management operational plan to strengthen the Borrower's disaster risk management framework, as evidenced by Ministerial Resolution 001-DICRE, dated March 2, 2016. **Prior Action 5:** The Borrower, through MEF, has: (a) expanded the application of the new financial information management system ISTMO to central government entities, as evidenced by Letter DNC-N-No. 036-16, dated April 20, 2016; and (b) integrated 23 budgetary accounts of central government entities under the Treasury Single Account; as evidenced by Letter Nota No. 900-01-333-DT, dated April 27, 2016.	Development Policy Loan with a Catastrophe Deferred Drawdown Option No. 60719 (WB 2011)
Pillar 2: Strengthening Institutional Arrangements to Support Inclusion in Social Assistance and Education	
Prior Action 6: The Borrower, through MIDES, has completed an audit of beneficiaries of the conditional cash transfer program *"Red de Oportunidades"* to improve the coverage and targeting of beneficiaries, while reducing fiscal leakage in the program, as evidenced by the official notification from MIDES to MEF, dated February 3, 2016. **Prior Action 7:** The Borrower, through MIDES, has signed an agreement with a regulated financial institution to channel payments to beneficiaries of all conditional cash transfer programs through said financial institution, as evidenced by *"Convenio Clave Social 14-15"* between MIDES and the National Bank of Panama, dated June 15, 2015. **Prior Action 8:** The Borrower, through MEDUCA, has: (a) taken initial actions aimed at participating in the Program for International Student Assessment (PISA), through the issuance of an official notification to the OECD informing of its participation in the 2018 PISA, as evidenced by Letters from MEDUCA to the OECD (DM-280-2015, dated February 3, 2015; DM-2561-2015, dated November 26, 2015, and DM-082-2016, dated January 11, 2016); and (b) completed and published the microdata of the 2013 Third Regional Comparative and Explanatory Study (TERCE). **Prior Action 9:** The Borrower has: (a) established and regulated the implementation of the program *"Panama Bilingüe"*, as evidenced by Executive Decree 148, dated April 1, 2016; and (b) approved the curricula for the new technical baccalaureates, which includes the development of non-cognitive skills, as evidenced by Executive Decree 149, dated April 12, 2016.	• Panama Systematic Country Diagnostic (WB 2015) • Panama Social Sector Expenditure and Institutional Review (WB 2015) • *Red de Oportunidades*: Conditional cash transfer evidence from Panama (Arraiz, S. Rozo 2011) • Review of Social Assistance programs and Recommendations for Priorities and the Way Forward; and Social Protection Responses to the triple wave of crises in Central America and Panama (Marques 2009, 2010) • Technical Vocational Education and Training: Mapping Institutions and Policies (WB 2014) • Evaluation of training for the unemployed in Mexico: learning by comparing methods (Delajara et al. 2013) • *Mejores Empleos en Panamá: El Rol del Capital Humano* (WB 2012) • School subsidies for the poor: Evaluating the Mexican Progresa Program (Schultz 2004)
Pillar 3: Enhancing the Regulatory and Financial Sustainability Framework of Service Delivery in the Energy and Water Sectors	
Prior Action 10: The Borrower has reduced electricity tariff subsidies through the replacement of the nation-wide Fund for	• Panama Systematic Country Diagnostic (WB 2015)

Prior Actions	Analytical Underpinnings Key Findings
Energy Compensation (FACE) with a geographically-targeted Fund for the Occidental Region (FTO), as evidenced by Cabinet Resolutions No. 59 and No.60, both dated June 23, 2015 and Cabinet Resolution No.2, dated January 5, 2015.	• *Política energética: Diagnostico y propuestas, Fundación para el desarrollo económico y social de Panamá* (Primola et al. 2013) • *Dossier energético Panamá,* Inter-American Development Bank (Espinosa et al. 2013)

LINK TO CPF, OTHER BANK OPERATIONS, AND THE WBG STRATEGY

73. **The proposed DPF is fully consistent with the Country Partnership Framework for 2015-2018.** The proposed DPF plays an instrumental role in influencing outcomes in the three pillars of the Country Partnership Framework: (i) promoting social inclusion and increasing social opportunities, which is a precondition for ensuring the benefits of growth reach poor and marginalized groups; (ii) expanding service provision and increasing access to reliable services for the bottom 40 percent; and (iii) streamlining institutional development, in particular strengthening fiscal management to reduce fiscal risks and improve the efficacy of public expenditures.

74. **The proposed DPF builds on the enhancements in the areas of social inclusion and fiscal management supported by previous DPF series, as well as other WB operations**. As noted in Section IV, the DPF series aims to consolidate reforms supported by previous DPFs, particularly in the areas of fiscal management and social protection. Prior actions also complement ongoing activities supported by the International Finance Corporation (IFC) in the energy and education sectors. The IFC has joined forces with the WB to support energy efficient facilities, with a focus on financing renewable energy generation plants. The IFC is also promoting the expansion of private health and education services in Panama. The WB's active portfolio comprises five lending operations in the areas of social protection, rural development and environment, water and sanitation, disaster risk management, and public financial management, and the objectives of relevant operations are linked to the objectives of the proposed DPF 2.

75. **The proposed DPF is fully consistent with the World Bank's Group strategy aimed at eradicating extreme poverty and promoting shared prosperity.** The PDOs are directly linked with specific priorities of the Government's reform program. In addition, as noted in Section V, the DPL program is likely to have positive effects for poverty reduction and shared prosperity. The program aims to improve social assistance, education, as well as service delivery in water and energy sectors. At the same time, the program aims to safeguard macroeconomic stability and resilience, which are key preconditions for sustained poverty reduction.

76. **Analytical and advisory activities complement the DPF program.** In terms of social protection, the proposed DPF 2 seeks to strengthen policy coordination to ensure the greatest possible impact of public expenditures in terms of poverty reduction and shared prosperity. Ongoing technical assistance on social protection supports the strengthening of the institutional functions for enhanced coverage of social programs. Analytical work supplements the DPF. The 2015 Systemic Country Diagnostic identifies challenges and priority areas to advance social

inclusion, service delivery, and fiscal sustainability. The 2015 assessment of social spending for Central American countries, including Panama, analyzes the fiscal sustainability and effectiveness of social programs, providing recommendations for the short- and medium-term. Furthermore, the WB and the IFC are providing advisory services to simplify business regulations, and improve the transparency of the country's tax system, and promote the exchange of tax information to meet the standards of the Global Forum.

CONSULTATIONS, COLLABORATION WITH DEVELOPMENT PARTNERS

77. **The design of the proposed DPF was informed by consultation processes among various sectors of the Panamanian society.** The measures supported by the operation are aligned with the Government's strategy *Plan El Pueblo Primero*. This document has been subject to consultations with different levels of Government, private sector, and civil society. During round table sessions, the Government, private sector, academia, think thanks, Indigenous Peoples, Afro Panamanian groups, civil society and non-governmental organizations discussed the country's development priorities and challenges, such as expanding inclusion and opportunities, improving service delivery, and modernizing fiscal management. As a result of these participatory consultations, the Government has launched sectoral strategies, some of which the WB is supporting as part of this DPF series to reduce poverty and boost shared prosperity. For instance, the Ministry of Education and the Ministry of Labor have established an alliance with private companies in Panama to pilot an apprenticeship program for graduate students to access job opportunities and strengthen their skills and capacity for the labor market demand.

78. **The proposed program represents a coordinated engagement with development partners.** This DPF series has been prepared in close consultation with the IMF and the IDB as part of a coordinated effort to support sound macroeconomic management and structural reforms. The WB's support to issues related to international tax transparency and AML/CFT is coordinated with the IMF and the OECD's Global Forum on Transparency and Exchange of Information for Tax Purposes.

V. OTHER DESIGN AND APPRAISAL ISSUES

POVERTY AND SOCIAL IMPACT

79. **This DPF supports actions that are expected to have largely neutral or positive effects on poverty reduction and income distribution in the short-term, and overall positive effects over the medium- and long-term.** Annex 4 summarizes the analysis carried out on the potential effects of the reforms supported under the operation, which suggests a positive or neutral impact on poverty and social development indicators (Table 5). While some measures may have immediate implications on household income (i.e., reforms of social transfers and electricity subsidies), the majority of actions are of an institutional nature and will be broadly neutral for poverty in the short-term. Stronger institutions, an enhanced regulatory framework, and improved procedures within the public administration, are all expected to support poverty reduction and boost shared prosperity over the medium- and long-term.

80. **Measures aimed at strengthening international tax transparency, financial integrity and fiscal management are expected to have positive effects on the poor over the medium-term, while the short-term effects are expected to be largely neutral.** With the exception of the Decentralization Law and the Operational Plan for DRM, the prior actions under the Pillar 1 are institutional in nature and expected to be neutral for the poor. Prior actions related to international tax transparency, debt management, and financial information management systems are related to administrative processes expected to increase confidence in, and improve the efficiency of, the state. However, they are not expected to have an impact on welfare and income distribution in the short-term.

81. **Directing property tax revenues to local governments and earmarking the funds for local investment and social development initiatives is likely to have a positive, but difficult to quantify, effect on the poor**. The New Decentralization Law uses an allocation formula proportional to the revenue collection and the estimated population of each municipality, implying a lower allocation of funds to poor municipalities. The Law also guarantees a minimum allocation of US$500,000 through a "solidarity transfer" from richer municipalities. In addition, 90 percent of the allocation will be earmarked to infrastructure and social investment likely to benefit the poor and vulnerable. It should also be noted that the potential benefits to the poor and vulnerable will depend on the inclusiveness and transparency of local institutions who will be in charge of prioritizing local investments under the new framework. However, given the absence of data at the municipal level on overall spending and the local capacity to implement projects, the poverty impact of the Law is difficult to quantify.

82. **The operationalization of the DRM strategy will have positive effects on the poor.** The exposure of the population and the economy to natural disasters in Panama is large. The areas with the poorest populations, such as the indigenous *comarcas* and the provinces of Bocas del Toro and Darien, historically tend to be significantly more vulnerable to natural disasters.[12] At the same time, the growing urban nature of the country is increasing risks. The Metropolitan Area of Panamá, which concentrates 43 percent of the country's population and generates about 68 percent of the GDP, has seen increasing floods, with estimated losses of over US$135 million in the last decade. The operationalization of the DRM framework will bolster the resilience of public finances to contingent fiscal risks stemming from natural hazards, and will protect the social spending from emergency cuts related to the increased spending on disaster relief programs.

83. **Measures aimed at strengthening institutional arrangements in social assistance programs are expected to have positive poverty and distributional effects.** The recent audit carried out by MIDES of the *Red de Oportunidades*, supported by the DPF, indicated a leakage of around 13 percent and led to the removal of just under 9,200 ineligible households (of 69,524). In exchange, MIDES identified a new group of extreme poor households (largely from *comarcas*), which entered the program. A simulation exercise suggests that the reallocation of resources as a result of the audit would lower the extreme poverty rate by 0.9 percentage points (representing a 9 percent decline). Further regular updates to the registry of beneficiaries are

[12] Gordón C, Guardia R, Osorio, K, 2012: Análisis de la vulnerabilidad ante desastres naturales en Panamá. 1990-2009. XIII, Congreso de Ciencia y Tecnología, APANAC. Panamá, 2012.

expected to help address remaining leakage challenges in *Red de Oportunidades*.[13] In addition, the creation of a new Directorate of Inclusion is expected to lead to better coordination of social programs within MIDES, although the poverty effects of this organizational change are hard to quantify. Finally, the introduction of a new payment method for CCTs through the banking sector is expected to have neutral effects on poverty as long as the authorities are committed to maintaining the availability of other payment methods for populations with limited access to bank branches and ATMs. The introduction of the new payment method may potentially reduce transaction costs for beneficiaries as they can remove funds more safely and at their convenience.

84. **While not expected to immediately influence poverty, reforms in the area of education (publication of TERCE results, participation in PISA, initiation of the *Panama Bilingüe* program, and introduction of new curricula for technical schools), are likely to yield improvements in the quality of educational services over the medium- and long-term.** International evidence suggests that the comparative data from international education testing can provide important incentive for improving the quality of educational service and the educational outcomes, including among the poor, thus improving welfare. As evidenced by the TERCE results, Panama has been successful in expanding access to schooling (the country has the highest social inclusion index across the region), but the performance of Panamanian students is still below the LAC average. The publication of data on learning outcomes and Panama's participation in other international assessments will help the system to move from a focus on coverage to a focus on quality, and provide useful inputs for the new programs around bilingual education and technical training.

85. **The elimination of the electricity subsidy fund FACE and its replacement with the geographically-targeted FTO is expected to have limited effects on poverty in the short-term.** While the removal of the FACE subsidy will increase the costs of electricity for a relatively small share of residential consumers in the country (18 percent), those households that consume up to 350 kWh per month will continue to be directly subsidized by the Rate Stabilization Fund (*Fondo de Estabilización Tarifaria*). Notably, data from the electricity companies shows that residential clients that will be affected by increased costs of electricity due to the elimination of FACE are characterized by their ownership of a wide range of energy consuming appliances, not owned by the extremely poor nor even the bulk of the poor in Panama. For that reason, it is unlikely that the elimination of the FACE will have any significant effect on poverty. However, in an unlikely event for those poor with access to electricity and who use more than 350 kWh per hour, improving the targeting of *Red de Oportunidades* (supported by the operation) will provide additional income which can offset some of the increase in electricity costs. It is also worth mentioning that the new subsidy fund (FTO), targeted to the Chiriquí province, will be distributed to all consumers above the 350 kWh threshold in this region. Chiriquí is ranked 8th out of 13 provinces and *comarcas* in terms of poverty level, and thus there remains scope for improving the progressivity of electricity subsidies in Panama. However, it should be noted that the replacement of FACE by the FTO is expected to generate fiscal space of over US$180 million, part of which can be used to offset the

[13] According to an analysis of the household survey data, fiscal leakage from *Red de Oportunidades* is estimated to be around 25 percent.

potential impact of the subsidy removal on the poorest households through the existing targeted social programs. It may also lead to increased investment in energy sector to reduce transmission costs and expand the electricity grid to remote areas with the poorest households.

Table 5: Likely Poverty and Social Effects of the Prior Actions

Prior Actions under DPF 2	Groups most affected	Short-Term Effects on Poverty / Distribution
Pillar 1: Strengthening the Frameworks for International Tax Transparency, Financial Integrity, and Fiscal Management		
Prior Action 1: The Borrower, through the Ministry of Foreign Affairs, has taken initial actions aimed at conforming with the Common Reporting Standards for Automatic Exchange of Financial Account Information in Tax Matters (CRS) through its commitment to adhere to the CRS by 2018, as evidenced by Notification D.S.-MIRE-2016-25092, dated May 9, 2016.		Neutral / Neutral
Prior Action 2: The Borrower has amended the Decentralization Law which, inter-alia: (i) establishes a mechanism to distribute property taxes to municipalities, (ii) establishes a municipal public investment program, and (iii) creates the National Secretariat for Decentralization to supervise and coordinate the decentralization process, as evidenced by Law 66, dated October 29, 2015, duly published in the Borrower's official gazette dated October 30, 2015.	Population in poor municipalities	Positive / Positive
Prior Action 3: The Borrower, through MEF, has signed an agreement with the Comptroller General to define tasks and responsibilities for public debt servicing, including to allow for the use of the integrated SIGADE-ISTMO platform, as evidenced by *"Acuerdo Interinstitucional para la Implementacion de la Interfaz SIGADE-ISTMO"*, dated January 21, 2016.		Neutral / Neutral
Prior Action 4: The Borrower, through MEF, has adopted a medium-term disaster risk management operational plan to strengthen the Borrower's disaster risk management framework, as evidenced by Ministerial Resolution 001-DICRE, dated March 2, 2016.	The poor living in disaster prone areas	Neutral / Neutral
Prior Action 5: The Borrower, through MEF, has: (a) expanded the application of the new financial information management system ISTMO to central government entities, as evidenced by Letter DNC-N-No. 036-16, dated April 20, 2016; and (b) integrated 23 budgetary accounts of central government entities under the Treasury Single Account; as evidenced by Letter Nota No. 900-01-333-DT, dated April 27, 2016.		Neutral / Neutral
Pillar 2: Strengthening Institutional Arrangements to Support Inclusion in Social Assistance and Education		
Prior Action 6: The Borrower, through MIDES, has completed an audit of beneficiaries of the conditional cash transfer program *"Red de Oportunidades"* to improve the coverage and targeting of beneficiaries, while reducing fiscal leakage in the program, as evidenced by the official notification from MIDES to MEF, dated February 3, 2016.	Households living in extreme poverty	Positive / Positive
Prior Action 7: The Borrower, through MIDES, has signed an agreement with a regulated financial institution to		Neutral / Neutral

Prior Actions under DPF 2	Groups most affected	Short-Term Effects on Poverty / Distribution
channel payments to beneficiaries of all conditional cash transfer programs through said financial institution, as evidenced by "*Convenio Clave Social 14-15*" between MIDES and the National Bank of Panama, dated June 15, 2015.		
Prior Action 8: The Borrower, through MEDUCA, has: (a) taken initial actions aimed at participating in the Program for International Student Assessment (PISA), through the issuance of an official notification to the OECD informing of its participation in the 2018 PISA, as evidenced by Letters from MEDUCA to the OECD (DM-280-2015, dated February 3, 2015; DM-2561-2015, dated November 26, 2015, and DM-082-2016, dated January 11, 2016); and (b) completed and published the microdata of the 2013 Third Regional Comparative and Explanatory Study (TERCE).	Students living in vulnerable households	Positive / Neutral
Prior Action 9: The Borrower has: (a) established and regulated the implementation of the program *"Panama Bilingüe"*, as evidenced by Executive Decree 148, dated April 1, 2016; and (b) approved the curricula for the new technical baccalaureates, which includes the development of non-cognitive skills, as evidenced by Executive Decree 149, dated April 12, 2016.		Neutral / Neutral
Pillar 3: Enhancing the Regulatory and Financial Sustainability Framework of Service Delivery in the Energy and Water Sectors		
Prior Action 10: The Borrower has reduced electricity tariff subsidies through the replacement of the nation-wide Fund for Energy Compensation (FACE) with a geographically-targeted Fund for the Occidental Region (FTO), as evidenced by Cabinet Resolutions No. 59 and No.60, both dated June 23, 2015 and Cabinet Resolution No.2, dated January 5, 2015.	Households living in extreme poverty	Negative / Negative

ENVIRONMENTAL ASPECTS

86. **The measures supported under the proposed DPF are not expected to have significant effects on the environment, forests or other natural resources.** Pillars 1 and 2 of this DPF are primarily institutional in nature and thus, unlikely to have significant effects on the environment.

- Prior Action 1 is aimed at improving the international tax transparency and AML/CFT frameworks in Panama in order to bring them closer in line with international standards and best practices, with no expected impact on the environment, forests or other natural resources.
- Prior Action 2, supporting fiscal decentralization and the municipal investment program is aimed at increasing the responsiveness of public investment to local needs, with continued support of the country's existing monitoring and evaluation systems. It is not expected to have significant impacts on the environment, forests or other natural resources.

- Prior Actions 3 and 5 in the area of fiscal management are expected to lead to a more efficient use of public resources, particularly through enhanced budgeting systems and more resilient public finances.
- Prior Actions 7, 8, and 9 in the area of social assistance and education aim to improve the targeting and coverage of social assistance programs as well as improving the quality of education services in Panama. As such, these prior actions are not expected to have significant environmental impacts.

87. **Improved management of fiscal risks stemming from natural hazards is expected to have positive, albeit difficult to quantify, effects on the environment (Prior Action 4).** The medium-term disaster risk management operational plan should be seen as a component of Panama's adaptation to climate change. According to the Intergovernmental Panel on Climate Change[14], an increase of greenhouse gases in the atmosphere is likely to increase risks associated with natural hazards. Global climate change models indicate that Panama will undergo severe changes in its weather patterns, with heat waves, droughts, heavier rainfall, more frequent storms, and rising sea levels. These events are already causing major economic losses and affecting the livelihood of the poorest and the most marginalized sectors of the population. In this context, Panama's DRM operational plan is an important tool for effective disaster risk management and proactive strategy towards adaptation to extreme climate events.

88. **Reducing electricity tariff subsidies could have both positive and negative environmental effects (Prior Action 10)**. This reform can lead to positive effects given that it will incentivize increased energy efficiency among consumers, thus contributing to better utilization of energy resources, in line with the country's climate change objectives. However, the increase in electricity tariffs could also potentially lead to fuel substitution by the most vulnerable groups to cheaper traditional fuel, in particular firewood, thus contributing to higher household air pollution and deforestation. This reform, however, has been designed to mitigate social and environmental risks. Electricity will remain directly subsidized for households that use less than 350 kWh per month, i.e. the poorest consumers and those who could potentially switch to firewood. In addition, the design of the reform takes into account the higher structural costs of energy generation in the western region of the country and will continue to subsidize consumers in this region. Overall, this measure is aligned with Panama's nationally determined contribution to the global response to climate change in the area of climate change mitigation, as agreed during the 21st session of the Conference of the Parties in Paris in December 2015.

89. **At the same time, measures aimed at improving the targeting of *Red de Oportunidades* (Prior Action 6) can help further mitigate the potential negative environmental effects of Prior Action 10.** Improving the targeting of *Red de Oportunidades* will lead to an increase in the household income of recipient families in extreme poverty. For those with access to electricity and who use more than 350 kWh per hour, this additional income can offset some of the increase in electricity costs.

[14] See: Intergovernmental Panel on Climate Change, Climate Change 2014, Synthesis Report.

PUBLIC FINANCIAL MANAGEMENT, DISBURSEMENT AND AUDITING ASPECTS

90. **Panama's public financial management (PFM) and public procurement systems are sound.** Panama has no Central Bank and uses the US dollar as currency. The budget is published promptly after its approval in the official gazette. The published budget and data on budget execution are publicly available online. According to the latest Public Expenditure and Financial Accountability Assessment conducted jointly by the WB and the IDB and published in July 2013, Panama's PFM systems are characterized by: (i) a timely review and approval of the national budget by the National Assembly; (ii) good and timely public debt management and reporting; (iii) readily accessible information on government expenditure to the public; and (iv) permanent reconciliation of payroll registries management. At the same time, several PFM areas would benefit from further improvement, particularly in relation to budget preparation and execution: (i) budget credibility and predictability is affected by significant and numerous budget modifications throughout the year; (ii) predictability of the availability of funds for commitment of expenditures is uneven; (iii) a mechanism for the proper control of payment arrears should be put in place; (iv) quality and comprehensiveness of budgetary reports and annual financial statement could improve; and (v) a strengthened internal and external audit functions and internal control framework is required.

91. **The Government has been making further progress in strengthening its PFM system.** The Government is implementing a set of key reforms to strengthen and modernize planning and budgeting, the financial management system, the financial control framework, and procurement systems. The WB has been supporting the Government in the improvement of PFM through the previous DPF series, as well as the Enhanced Public Sector Efficiency Technical Assistance Loan. Notably, with support from this DPF series, the Government has introduced ISTMO, which aims at providing a modern platform that integrates accounting, budgetary, and treasury functionalities in 21 central government entities during the first phase of its implementation. To support ISTMO, Panama is pursuing reforms in public accounting through the gradual implementation of International Public Sector Accounting Standards and the expansion of the TSA, which has already integrated 23 budgetary accounts of central government entities. As a result, Panama would improve the quality of its financial statements, thereby enhance the efficiency and effectiveness of public programs, and the transparency and accountability of public resources. A challenge ahead to better support the country's efforts is to put in place a new control and asset management frameworks, through implementation of International Standards of Supreme Audit Institutions.

92. **The WB will disburse the loan proceeds into the US dollars TSA of the MEF once the loan is approved and becomes effective**. Upon its deposit, DPF disbursement will become available to finance budgeted expenditures. The account is denominated in US dollars, which is legal tender in the country, and is held at the National Bank of Panama, a state-owned bank and the Government's financial agent. A WB review of an audit report on the 2014 financial statements of the National Bank of Panama and external audit reports as well as the WB's experience with special designated accounts indicates that the banking control environment into which the loan proceeds will flow is adequate. On this basis, no audit will be required for the deposit account, and no additional fiduciary arrangements are considered necessary at this time. Upon IBRD's request, the Borrower will provide written confirmation that the amount of the

loan has been credited to an account available to finance budgeted expenditures. Such confirmation will be sent to the Bank within 30 days after the deposit. If the proceeds of the loan are used for excluded expenditures as defined in the Loan Agreement, IBRD will require the Borrower to refund an amount equal to the amount of said payment to IBRD promptly upon notice from IBRD. Amounts refunded to IBRD upon such notice, shall be cancelled from the Loan.

MONITORING, EVALUATION AND ACCOUNTABILITY

93. **MEF is responsible for the implementation of the program supported by the DPF.** As the main implementing agency, MEF will coordinate with other Government agencies involved in the implementation of the DPF, including *Metas Presidenciales*, MIDES, MINSA, the Energy Secretariat, and IDAAN. Together with MEF and the National Statistics and Census Institute, these institutions will collect the necessary data to assess implementation progress and evaluate results. The technical capacity of these institutions is adequate to perform regular monitoring of the indicators and outcome measures shown in the monitoring and results framework of the policy matrix (Annex 1).

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

VI. SUMMARY OF RISKS AND MITIGATION

95. **The overall risk of this operation is considered to be substantial.** The recent revelations from the leaked documents of a private legal firm based in Panama underscore the need to strengthen the frameworks for international tax transparency and financial integrity. This situation has prompted the broadening of the engagement under the DPF series to include reforms in these areas. This has also increased the risks to the achievement of the revised Program Development Objectives. The most relevant risks defined for this operation are political risks and the risks related to institutional capacity for implementation of the added measures and results. Macroeconomic risks, risks associated with sector strategies and policies, technical design of the program, as well as risks associated with stakeholders are considered moderate.

Risk Categories	Rating
1. Political and governance	Substantial
2. Macroeconomic	Moderate
3. Sector strategies and policies	Moderate
4. Technical design of project or program	Moderate
5. Institutional capacity for implementation and sustainability	Substantial
6. Fiduciary[15]	Moderate
7. Environment and social[16]	Moderate
8. Stakeholders	Moderate
9. Other	Not applicable
Overall	**Substantial**

96. **Risks associated with political environment are substantial.** Political disagreement or legislative gridlock could threaten the pace of the reform agenda, particularly with regard to the agenda on international tax transparency and AML/CFT. These risks are also relevant for reforms focused on strengthening: (i) the institutional framework for social protection and education; (ii) service delivery in electricity and water, and (iii) fiscal decentralization and public investment. The authorities are fully aware of this risk and are utilizing a continuous consultation process and raising awareness on key policy measures. The authorities have thus far demonstrated credible commitment to the reform program and there is consensus among the major political parties on the need to improve tax transparency and financial integrity, advance social inclusion, and modernize fiscal management. This consensus has enabled the passage of a number of important legislative reforms. The WB, in coordination with development partners, is conducting dialogue with the Panamanian authorities to support consensus on the importance of the reform program.

97. **Risks associated with institutional capacity for implementation are substantial.** In particular, the effectiveness of reforms in tax transparency and AML/CFT will depend on the ability of the Government to apply and enforce new provisions, and build capacity in new regulatory agencies. Similarly, the success of the reforms in social protection, education, and in the electricity sectors will depend on the effective implementation of new regulations. In addition, in a number of DPF-supported areas, the progress in reform implementation depends on smooth collaboration and coordination between multiple actors. For example, in the education sector, the implementation of the program requires the strengthening of technical capacity of the MEDUCA and the Institute for the Development of Human Resources (IFAHRU), which is responsible for the implementation of *Beca Universal*. The authorities have taken steps to mitigate these risks, such as the reorganization of key sectoral units to improve program implementation, and the establishment of supervisory arrangements across policy areas, including the creation of *Metas Presidenciales*. Moreover, reform implementation across all pillars of this operation is being supported by advisory activities and technical assistance from the WB, IMF, IDB, OECD, and other development partners. WB support focuses on

[15] Fiduciary risks are considered moderate. The detailed discussion on fiduciary risks is included in section Public Financial Management, Disbursement and Auditing Aspects of the Program Document.
[16] Environmental and social risks are considered moderate. The detailed discussion on environmental risks is included in section Environmental Aspects of the Program Document.

strengthening tax transparency, social protection, and education systems, strengthening energy and water sector management, and improving fiscal management. To further mitigate institutional capacity risks, the Government is building capacity, for instance by training staff and hiring of consultants to support the implementation of key measures, including the preparation of new legislation to adhere to the CRS, the rollout of ISTMO, and the improvement of targeting mechanisms for social protection programs.

98. **Macroeconomic risks are moderate.** Risks to the macroeconomic situation stem from external conditions and domestic factors. On the external side, global economic uncertainties could affect global trade flows and in turn, traffic in the Panama Canal. Likewise low oil prices could incentive shipping boats to take longer routes that avoid the Panama Canal. Given the centrality of the Canal for the economy and fiscal balance, this in turn could endanger the Government's program. However, even if these risks were to materialize, they would likely be offset by the positive impact on traffic expected from the Canal expansion. Domestically, there are risks associated with fiscal performance, related to the lack of adherence to fiscal targets outlined in the SFRL. In addition, lower revenue collection might compromise the financing needs of the programs supported by this operation and reduce the country's ability to absorb domestic and external shocks. This is a particularly important risk, given Panama's fully dollarized economy, where the fiscal policy becomes a primary tool to cope with external shocks. Finally, a delay in the implementation of the legal framework for improved financial and tax transparency could potentially undermine foreign investor confidence and constrain access to foreign capital. However, these risks are considered moderate given Government's progress in reducing fiscal imbalances and the political commitment of the new Administration to adhere to the deficit path laid out in the SFRL (the 2015 headline fiscal deficit was in line with the limit of the SFRL, adjusted for the Canal contributions). Fiscal consolidation measures, including through savings from reduced energy subsidies, as well as improvements in the public fiscal management (TSA, ISTMO, public investment management, and public debt management reforms supported in the proposed operation) are also expected to support fiscal consolidation efforts. Furthermore, the authorities are committed to adhering to CRS and Automatic Exchange of Tax Information, supported by technical assistance from the WB, IMF, OECD, and other partners.

99. **Risks associated with sectoral strategies and policies are moderate.** The Government's sectoral strategy for social protection, in particular with regards to targeting vulnerable groups including Indigenous Peoples, the youth, and the elderly, is currently not well articulated. The Government aims to mitigate this risk by supporting the necessary institutional measures to enhance the management, coverage, and targeting of social programs. The lack of a long-term vision, clear leadership, and a weak institutional and legal framework in the energy and water sectors also pose risks to the operation. The WB is engaging with the Government in these sectors to identify key governance challenges and elaborating an action plan to resolve these.

100. **Stakeholders' risks are moderate.** These risks relate to the socially-sensitive reform agenda. For example, fiscally neutral adjustments to the *Red de Oportunidades* will lead to redistribution of resources within the program, which could be opposed by some beneficiaries. Energy sector reforms, including the reduction of electricity subsidies, might be resisted by

customers. The authorities are aware of these risks and are utilizing a consultation process with the stakeholders, including through the implementation of a communication strategy for more effective outreach to the broader society.

ANNEX 1: POLICY AND RESULTS MATRIX

Prior Actions under DPF 1	Prior Actions under DPF 2	Indicative Triggers for DPF 3	Results Indicators
Pillar 1: Strengthening the Frameworks for International Tax Transparency, Financial Integrity, and Fiscal Management			
	Prior Action 1: The Borrower, through the Ministry of Foreign Affairs, has taken initial actions aimed at conforming with the Common Reporting Standards for Automatic Exchange of Financial Account Information in Tax Matters (CRS) through its commitment to adhere to the CRS by 2018, as evidenced by Notification D.S.-MIRE-2016-25092, dated May 9, 2016.	**Trigger 1:** The Government has enacted legislation in line with its commitment to adhere to the Common Reporting Standards for Automatic Exchange of Financial Account Information in Tax Matters. **Trigger 2:** The Superintendence of Banks has completed a semi-annual report on the implementation of the new supervision procedures on bearer shares and beneficial owners (beyond the custodian) in alignment with the amended anti-money laundering legislation.	Panama complies with CRS requirements related to the availability of tax information, ensuring that (i) ownership and identity information is available for all relevant entities; and (ii) reliable accounting records are kept for all relevant entities Baseline 2014: No Target 2017: Yes Number of Banks supervised (on-site and off-site) in a year using the new anti-money laundering supervision procedures Baseline 2014: 0 Target 2017: 50
	Prior Action 2: The Borrower has amended the Decentralization Law which, inter-alia: (i) establishes a mechanism to distribute property taxes to municipalities, (ii) establishes a municipal public investment program, and (iii) creates the National Secretariat for Decentralization to supervise and coordinate the decentralization process, as evidenced by Law 66, dated October 29, 2015, duly published in the Borrower's official gazette dated October 30, 2015.	**Trigger 3**: A Law for Public Investment Management has been enacted, which establishes rules for planning, allocation, and implementation of public investments.	Share of investments by local governments that follow SINIP *(Sistema Nacional de Inversiones Públicas)* norms and procedures: Baseline 2014: 0 percent Target 2017: 70 percent
	Prior Action 3: The Borrower, through MEF, has signed an agreement with the Comptroller General to define tasks and responsibilities for public debt servicing, including to allow for the		Share of central government debt that is paid electronically: Baseline: 2014: 0 percent Target 2017: 100 percent

Prior Actions under DPF 1	Prior Actions under DPF 2	Indicative Triggers for DPF 3	Results Indicators
	use of the integrated SIGADE-ISTMO platform, as evidenced by *"Acuerdo Interinstitucional para la Implementacion de la Interfaz SIGADE-ISTMO"*, dated January 21, 2016.		
Prior Action 1: The Government has approved a policy for managing fiscal risks related to natural disasters which includes the identification and evaluation of fiscal risk from disasters; the integration of disaster risk analysis into public investment planning; and the design of risk retention and risk transfer tools.	**Prior Action 4:** The Borrower, through MEF, has adopted a medium-term disaster risk management operational plan to strengthen the Borrower's disaster risk management framework, as evidenced by Ministerial Resolution 001-DICRE, dated March 2, 2016.	**Trigger 4:** The Government has regulated the operational functions of the State Insurance Technical Committee to foster development of the insurance market.	Number of available disaster financial protection instruments of the Panama's DRM Strategic Framework that underwent a cost-benefit analysis: Baseline 2014: 0 Target 2017: 2
Prior Action 2: The Government has (a) approved the introduction of the Treasury Single Account; and (b) channeled all funds of the treasury and MEF through the Treasury Single Account.	**Prior Action 5:** The Borrower, through MEF, has: (a) expanded the application of the new financial information management system ISTMO to central government entities, as evidenced by Letter DNC-N-No. 036-16, dated April 20, 2016; and (b) integrated 23 budgetary accounts of central government entities under the Treasury Single Account; as evidenced by Letter Nota No. 900-01-333-DT, dated April 27, 2016.	**Trigger 5:** The Government, through MEF, has (a) completed the integration of all budgetary accounts of central government entities under the Treasury Single Account; and (b) rolled out the ISTMO system in all central government entities.	Share of central government funds channeled through a TSA: Baseline 2014: 0 percent Target 2017: 90 percent

<table>
<tr><th>Prior Actions
under DPF 1</th><th>Prior Actions
under DPF 2</th><th>Indicative Triggers
for DPF 3</th><th>Results Indicators</th></tr>
<tr><td colspan="4">Pillar 2: Strengthening Institutional Arrangements to Support Inclusion in Social Assistance and Education</td></tr>
<tr><td rowspan="2">Prior Action 3: The Government has expanded the coverage and the benefits of the social protection program for the elderly without pension (120 a los 65 program) to provide 120 B/ monthly.</td><td>Prior Action 6: The Borrower, through MIDES, has completed an audit of beneficiaries of the conditional cash transfer program “Red de Oportunidades” to improve the coverage and targeting of beneficiaries, while reducing fiscal leakage in the program, as evidenced by the official notification from MIDES to MEF, dated February 3, 2016.</td><td>Trigger 6: A Law for Social Programs has been enacted, which (i) creates a master/single registry of beneficiaries of conditional cash transfer programs; (ii) establishes procedures for a re-certification of beneficiaries, and (iii) creates a Unique Registry Form for social assistance programs that specifies ethnicity information.

Trigger 7: The Government, through MIDES, has established proxy means testing to improve the targeting of the 120 a los 65 program.</td><td>Percentage of the extreme poor benefiting from at least one social assistance program:
Baseline: 2014: 37 percent
Target: 2017: 60 percent</td></tr>
<tr><td>Prior Action 7: The Borrower, through MIDES, has signed an agreement with a regulated financial institution to channel payments to beneficiaries of all conditional cash transfer programs through said financial institution, as evidenced by “Convenio Clave Social 14-15” between MIDES and the National Bank of Panama, dated June 15, 2015.</td><td>Trigger 8: The Government, through MIDES, has introduced a new payment modality (e-Wallet) to facilitate payments of Red de Oportunidades for beneficiaries in remote areas.</td><td>Percentage of total funds from social assistance programs transferred through the social card (Clave Social):
Baseline 2014: 0 percent
Target 2017: 30 percent</td></tr>
<tr><td>Prior Action 4: The Government has increased payment incentives to the beneficiaries of the Beca Universal program differentiated by schooling level (primaria, pre-media, media cycles).</td><td>Prior Action 8: The Borrower, through MEDUCA, has: (a) taken initial actions aimed at participating in the Program for International Student Assessment (PISA), through the issuance of an official notification to the OECD informing of its participation in the 2018 PISA, as evidenced by Letters from MEDUCA to the OECD (DM-280-2015, dated February 3, 2015; DM-2561-2015, dated November 26, 2015, and DM-082-2016, dated January 11, 2016); and (b) completed and published the microdata of the 2013 Third Regional Comparative and Explanatory Study (TERCE).</td><td>Trigger 9: The Government, through MEDUCA, has completed an evaluation of Beca Universal program and approved a corresponding resolution to implement its recommendations.</td><td>Number of reports prepared by MEDUCA based on the results of international student assessments:
Baseline 2014: 0
Target 2017: 2</td></tr>
</table>

Prior Actions under DPF 1	Prior Actions under DPF 2	Indicative Triggers for DPF 3	Results Indicators
Prior Action 5: The Government has (a) piloted a vocational training program *ProJoven* that provides on the job training to graduates of the technical branch of secondary education; and (b) legally created a new set of baccalaureates, including the creation of curricula consistent with labor market demands.	**Prior Action 9**: The Borrower has: (a) established and regulated the implementation of the program *"Panama Bilingüe"*, as evidenced by Executive Decree 148, dated April 1, 2016; and (b) approved the curricula for the new technical baccalaureates, which includes the development of non-cognitive skills, as evidenced by Executive Decree 149, dated April 12, 2016.	**Trigger 10:** The Government, through MITRADEL, has (a) initiated the implementation of the social assistance program *ProJoven* nationally; and (b) through MEDUCA, has rolled out *Panama Bilingüe* nationally and completed an evaluation of the program.	Number of teachers participating in the International Teacher Training of *Panama Bilingüe*: Baseline 2014: 0 Target 2017: 1,500
Pillar 3: Enhancing the Regulatory and Financial Sustainability Framework of Service Delivery in the Energy and Water Sectors			
Prior Action 6: The Government has approved (a) a resolution for the adjustment of electricity tariff subsidies; and (b) a law establishing a regime of incentives to increase the share of renewable energy in the power generation matrix.	**Prior Action 10:** The Borrower has reduced electricity tariff subsidies through the replacement of the nation-wide Fund for Energy Compensation (FACE) with a geographically-targeted Fund for the Occidental Region (FTO), as evidenced by Cabinet Resolutions No. 59 and No.60, both dated June 23, 2015 and Cabinet Resolution No.2, dated January 5, 2015.	**Trigger 11:** The Government has (a) regulated energy efficiency standards for residential and commercial construction through the adoption of a Construction Code; and (b) regulated energy efficiency labeling standards for consumer products.	Public expenditures on electricity subsidies are reduced by at least 50 percent in nominal terms relative to their level in 2014: Baseline 2014: US$320 million Target 2017: US$160 million
Prior Action 7: The Government has (a) created a management unit within the *Secretaria de Metas Presidenciales* to carry out a basic sanitation plan to provide 100 percent access to drinking water and 0 latrines; and (b) launched a standardized information system for improving the monitoring of water management in rural areas.		**Trigger 12:** (a) A decree that approves an institutional action plan to strengthen IDAAN has been issued; (b) a decree that establishes operational guidelines for the Inter-institutional Committee for Water and Sanitation has been issued.	Number of Rural Water Management Boards connected to the standardized information system for improving the monitoring of water management in rural areas (SIASAR): Baseline 2014: 400 Target 2017: 1,400

ANNEX 2: LETTER OF DEVELOPMENT POLICY

República de Panamá
Ministerio de Economía y Finanzas
Despacho del Viceministro 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 (DPF) 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 DPF. 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 DPF, 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 this 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 **ISTMO** 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 insulate 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 2018) and making the results publically available. At the same time, we have taken steps to improve the quality of education services in Panama. With the creation of the Panama Billingue 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 (FACE) with the geographically-targeted Tariff Fund for the Occidental 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 within 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 frameworks 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 towards 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 this DPF series, 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. Zarak A.
Viceminister

ANNEX 3: IMF RELATIONS NOTE

IMF Executive Board Concludes 2016 Article IV Consultation with Panama

IMF Press Release No. 16/276
June 10, 2016

On May 23, 2016, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Panama.

Panama has had the highest average growth in the region over the past decade and is expected to continue to have one of the strongest growth rates in Latin America, set against a backdrop of low inflation, a stable financial system, and a declining current account deficit. GDP grew by 5.8 percent in 2015, and growth is projected to remain around 6 percent in 2016 and over the medium term. The economy will be supported by the expected opening of the expanded canal and lower fuel prices, which will counterbalance the effects of slowing global growth and U.S. dollar appreciation. Over the medium term, the increase in canal transit, a dynamic service sector, and investments in the energy, mining, and logistics sectors should help maintain vibrant growth. Inflation is expected to remain subdued in 2016.

The overall fiscal deficit fell to 2.8 percent of GDP in 2015 and is expected to consolidate to 1.2 percent of GDP over the medium term. Public debt is projected as sustainable. Debt of the Non-Financial Public Sector was 39 percent of GDP in 2015 and is projected to fall below 35 percent of GDP over the medium term. The current account deficit, which declined significantly in 2015 to 6.5 percent of GDP, is expected to fall to 3 percent of GDP in the medium term, financed by broad-based foreign direct investment inflows.

Since the Financial Action Task Force (FATF) included Panama in the list of countries with strategic deficiencies in the area of Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) in June 2014, the authorities implemented an action plan agreed with the FATF. The FATF recognized the progress by removing Panama from the list in February 2016. Going forward, Panama is scheduled to undergo an assessment against the prevailing 2012 FATF standard in mid-2017, where the focus will be on the effective implementation of the AML/CFT regime. In addition, after the leak of the documents from the law firm Mossack Fonseca in April 2016, the government has announced the creation of an independent commission of international experts to evaluate the practices of the Panamanian financial center and propose measures to strengthen transparency of the financial and legal systems. The government has also committed to the bilateral Automatic Exchange of Information related to tax matters, following the OECD's Common Reporting Standards by 2018. In May 2016, the U.S. imposed sanctions under the U.S. Foreign Narcotics Kingpin Designation Act on the Waked Money Laundering Organization for laundering narcotics and other illicit proceeds. This action prompted Panama's Superintendent of Banks subsequently to take operating control of a local bank that was designated by the U.S. authorities as part of that organization, and also triggered the opening of criminal investigations, taking control of a local brokerage house, and beginning extraordinary inspections of nonfinancial entities by the Panamanian authorities.

Strong integration with the global trade and financial system brings substantial benefits to Panama, but increases the country's vulnerability to external shocks. A weakening of global growth could dampen canal revenues and precipitate weaker capital inflows. Tighter and/or more volatile global financial conditions would quickly feed into the local financial system. However, the strong fundamentals of the banking sector and the room to implement a countercyclical fiscal response would help mitigate the impact of either shock on the domestic economy. Evolving business models for banks, changes in capital regulations, concerns over compliance with international standards on financial integrity and transparency, and increased due diligence by foreign banks have curtailed some smaller Panamanian banks' access to correspondent banks; the risk could be more extensive going forward.

Executive Board Assessment

Directors commended Panama's dynamic macroeconomic performance, set against the backdrop of low inflation and unemployment, and a declining current account deficit. While the medium-term outlook remains favorable, Directors noted that the uncertain external environment poses downside risks. Against this background, they encouraged further efforts to enhance financial transparency, strengthen the fiscal framework, build larger buffers, and promote inclusive growth.

Directors stressed the importance of strengthening the AML/CFT framework in line with international standards and ensuring its effective implementation, especially in light of recent revelations. While noting Panama's removal from the FATF list of countries with strategic deficiencies in AML/CFT, they called on the authorities to improve financial integrity and transparency, which would place Panama in a strong position ahead of the next FATF assessment and safeguard Panama's role as an international financial hub. Directors welcomed the authorities' commitment to the automatic exchange of tax information and urged them to expand these agreements with other jurisdictions. Measures to mitigate the impact of de-risking were encouraged, but will require greater international efforts to fully address.

Directors underlined the need to continue strengthening the transparency and accountability of the fiscal framework. They encouraged the authorities to introduce mechanisms to enhance incentives for compliance with fiscal rules and promptly detect and correct slippages. Directors welcomed the authorities' openness to introduce a multi-year budgeting process, establish an independent fiscal council, and safeguard capital spending. Pension reform is encouraged, given large unfunded future liabilities, and to preserve space for other components of public spending. Welcoming the authorities' efforts to modernize revenue administration, Directors underscored the need to broaden the tax base, develop appropriate incentives for tax compliance, and refrain from tax amnesties.

Directors noted that Panama's financial sector is generally healthy, while certain areas require greater vigilance. In the absence of a lender of last resort, they emphasized the need to develop contingency plans to address systemic shocks and to ensure larger liquidity buffers, including through an alignment of the liquidity regulation with the Basel III framework and the establishment of a temporary liquidity facility for banks. Directors encouraged the authorities to fully implement FSAP recommendations, enhance cross-border supervision and systemic risk monitoring, and strengthen supervision of nonbank financial institutions.

Directors highlighted that human capital enhancements are essential for sustaining high and inclusive growth and encouraged the authorities to move forward with the envisaged measures to improve education quality, reduce skills shortages, and strengthen productivity. They welcomed the significant poverty reduction over recent years, while underlining that social assistance will be essential to address the needs of the indigenous and other socially-vulnerable groups for achieving more inclusive growth.

ANNEX 4: POVERTY AND SOCIAL IMPACT ANALYSIS

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

Prior Action 1: The Borrower, through the Ministry of Foreign Affairs, has taken initial actions aimed at conforming with the Common Reporting Standards for Automatic Exchange of Financial Account Information in Tax Matters (CRS) through its commitment to adhere to the CRS by 2018, as evidenced by Notification D.S.-MIRE-2016-25092, dated May 9, 2016.

Prior Action 2: The Borrower has amended the Decentralization Law which, inter-alia: (i) establishes a mechanism to distribute property taxes to municipalities, (ii) establishes a municipal public investment program, and (iii) creates the National Secretariat for Decentralization to supervise and coordinate the decentralization process, as evidenced by Law 66, dated October 29, 2015, duly published in the Borrower's official gazette dated October 30, 2015.

Prior Action 3: The Borrower, through MEF, has signed an agreement with the Comptroller General to define tasks and responsibilities for public debt servicing, including to allow for the use of the integrated SIGADE-ISTMO platform, as evidenced by "*Acuerdo Interinstitucional para la Implementacion de la Interfaz SIGADE-ISTMO*", dated January 21, 2016.

Prior Action 4: The Borrower, through MEF, has adopted a medium-term disaster risk management operational plan to strengthen the Borrower's disaster risk management framework, as evidenced by Ministerial Resolution 001-DICRE, dated March 2, 2016.

Prior Action 5: The Borrower, through MEF, has: (a) expanded the application of the new financial information management system ISTMO to central government entities, as evidenced by Letter DNC-N-No. 036-16, dated April 20, 2016; and (b) integrated 23 budgetary accounts of central government entities under the Treasury Single Account; as evidenced by Letter Nota No. 900-01-333-DT, dated April 27, 2016.

1. **Measures aimed at improving public debt management, international tax transparency, financial integrity, and fiscal management in Panama are expected to have a neutral direct effect on poverty and inequality reduction.** However, to the extent that they reduce economic volatility and protect the fiscal space necessary to preserve public spending targeted to help the most vulnerable segments of the population, these measures are important for long-term and sustainable poverty reduction. The measures undertaken under Pillar 1 in the operation will improve the transparency, quality and enforcement of public sector budgets and financial management, with the expected result of improving long-term fiscal sustainability while increasing trust in public and private institutions. Full compliance with the global standards against money laundering and terrorist financing, as well advances in tax transparency are likely to be largely neutral for poverty over the short-term. However, in the long-term, increased foreign private investment will improve growth prospects thereby benefiting the poor.

2. **Directing property tax revenues to local government and earmarking them for local investment and social development initiatives under the new Decentralization Law is likely to have positive, but difficult to quantify, effects on the poor.** The Decentralization Law modifies the allocation to the municipalities of the fiscal resources received from property taxes. Half of these resources will be allocated proportionally to the amount of taxes collected by each municipality and the other half will be proportional to the estimated population based on the last census. While the allocation of property taxes proportional to amounts collected means that poorer municipalities will have less funds, a minimum amount of at least B/ 500,000 will be

guaranteed to each municipality, through a 'solidarity transfer' thereby protecting those municipalities that do not collect enough revenues and thus would not able to make social development investments. To allocate this minimum amount, a transfer will take place from the richer municipalities to the poorer ones. The Law emphasizes that municipal investments should take into account both: a respect for traditional cultures of indigenous peoples, and social equity. Thus the Law appears to favor investments that are pro-poor and inequality-reducing. It should also be noted that the potential benefits to the poor and vulnerable will depend on the inclusiveness and transparency of local institutions who will be in charge of prioritizing local investments under the new framework. However, given the absence of data at the municipal level on overall spending, capacity and investment, it remains unclear what the net effect of the new Law will be on overall poverty.

3. **The operationalization of the DRM strategy is expected to have positive effects on the poor.** The exposure of the population and the economy to natural disasters in Panama is large. The indigenous *comarcas* and the provinces of Bocas del Toro and Darien show historically significant levels of vulnerability to natural disasters.[17] These are the areas with the poorest populations. At the same time the increasingly urban nature of the country is increasing risks. The Metropolitan Area of Panamá, which concentrates 43 percent of the country's population and generates about 68 percent of the GDP, has seen increasing floods of higher impacts in the last decade. More than ten national emergency declarations have been issued since 2005, with serious landslides and flooding affecting Panama and Colon, with estimated losses at over US$135 million. The operationalization of the DRM framework will bolster the resilience of public finances to contingent fiscal risks stemming from natural hazards and will protect the social spending from emergency cuts related to the increased spending on disaster relief programs.

Pillar 2: Strengthening Institutional Arrangements to Support Inclusion in Social Assistance and Education

Prior Action 6: The Borrower, through MIDES, has completed an audit of beneficiaries of the conditional cash transfer program *"Red de Oportunidades"* to improve the coverage and targeting of beneficiaries while reducing fiscal leakage in the program, as evidenced by the official notification from MIDES to MEF, dated February 3, 2016.

Prior Action 7: The Borrower, through MIDES, has signed an agreement with a regulated financial institution to channel payments to beneficiaries of all conditional cash transfer programs through said financial institution, as evidenced by *"Convenio Clave Social 14-15"* between MIDES and the National Bank of Panama, dated June 15, 2015.

Prior Action 8: The Borrower, through MEDUCA, has: (a) taken initial actions aimed at participating in the Program for International Student Assessment (PISA), through the issuance of an official notification to the OECD informing of its participation in the 2018 PISA, as evidenced by Letters from MEDUCA to the OECD (DM-280-2015, dated February 3, 2015; DM-2561-2015, dated November 26, 2015, and DM-082-2016, dated January 11, 2016); and (b) completed and published the microdata of the 2013 Third Regional Comparative and Explanatory Study (TERCE).

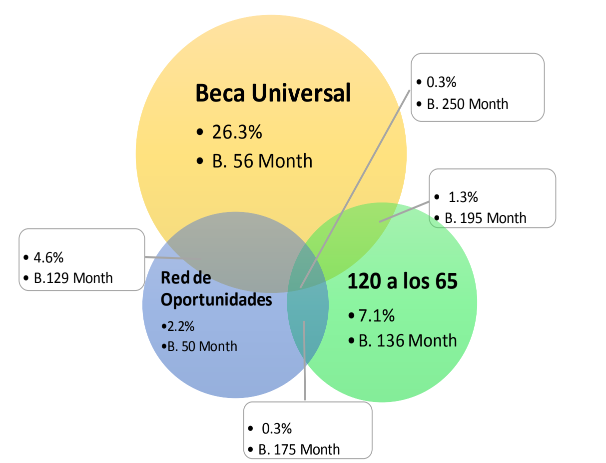
[17] Gordón C, Guardia R, Osorio, K, 2012: Análisis de la vulnerabilidad ante desastres naturales en Panamá. 1990- 2009. XIII, Congreso de Ciencia y Tecnología, APANAC. Panamá, 2012.

Prior Action 9: The Borrower has: (a) established and regulated the implementation of the program *"Panama Bilingüe"*, as evidenced by Executive Decree 148, dated April 1, 2016; and (b) approved the curricula for the new technical baccalaureates, which includes the development of non-cognitive skills, as evidenced by Executive Decree 149, dated April 12, 2016.

Social Assistance

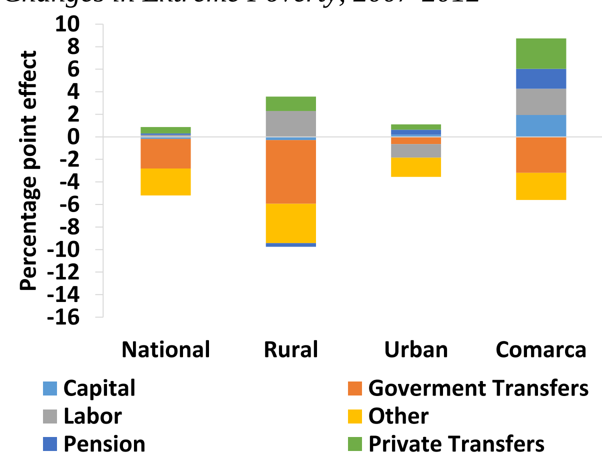
4. **Public transfers under Panama's social programs have been an important source of poverty reduction.** The three main social transfer programs—the CCT program *Red de Oportunidades*, the non-contributory pension program *120 a los 65*, and the school scholarship program *Beca Universal*, a cash transfer program contingent on school attendance and minimum grade level—support more than a third of all households in Panama (Figure A.1). One in four households (26.3 percent) benefits from the *Beca Universal* and no other program, while 2.2 percent and 7.1 percent of households are recipients only of either *Red de Oportunidades* or *120 a los 65*, respectively. In total, 6.6 percent of households are beneficiaries of more than one of these programs with, the greatest overlap being between *Red de Oportunidades* and *Beca Universal*. The impact of these transfer programs on poverty reduction has been strong. More than half of the reduction in extreme poverty in the 2007 to 2013 period was associated with public transfers (Figure A.2). These effects were particularly strong in rural areas and in *comarcas*.

Figure A.1: One in three households benefit from public transfers
Share of Households Receiving Public Transfers and Average Amount Received, 2015



Source: World Bank staff estimates based on the *Encuesta de Propósitos Múltiples*, March 2015.

Figure A.2: Public transfers are linked to strong poverty reduction
Contribution of Different Income Sources to Changes in Extreme Poverty, 2007-2012



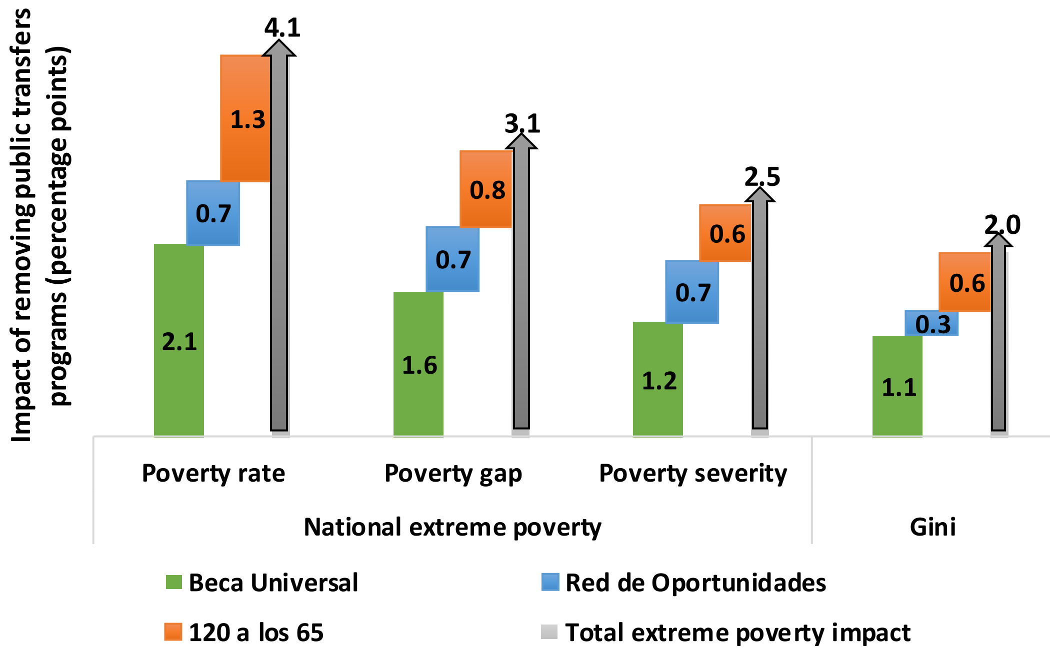
Source: Panama Systemic Country Diagnostic.[18]

5. **In the absence of these social assistance programs, poverty would have been higher (Figure A.3)**. A simple simulation exercise of the impact of removing these three social

[18] "Locking in Success: Panama Systematic Country Diagnostic", Koehler-Geib, Friederike, Kinnon Scott, Ayat Soliman and Humberto Lopez, 2015.

assistance programs shows that extreme poverty would rise by 4.1 percentage points, i.e., more than 30 percent. *Beca Universal* would have the most impact, followed by *120 a los 65* and then *Red de Oportunidades* (although this does not include the value of the non-cash benefits of *Red de Oportunidades*). Clearly a simple simulation overestimates the impact of removing transfers as the public transfers may have crowded out private ones, but the exercise gives an insight to the importance of these benefits for welfare in Panama. Importantly, inequality, which is already high in Panama, would rise by 2.0 percentage points to 52.8 percent in the absence of these three programs.

Figure A.3: Poverty would increase if social assistance programs were removed
Simulation exercise of the hypothetical impact of removing key social assistance programs in Panama (expected increase in the poverty rate, in percentage points)



Source: World Bank Staff estimates based on the *Encuesta de Propósitos Múltiples*, March 2015
Note: This represents an upper bound effect as secondary effects of changes in private transfers or labor market activities, not included in this calculation, might be able to somewhat mitigate the negative effects of a change in benefits.

6. ***Red de Oportunidades* has contributed to reduce poverty in Panama, and improving its targeting mechanism would further enhance its positive impact.** Despite being explicitly targeted to the poorest households, the effect of *Red de Oportunidades* on poverty has been hindered due to program leakage. As seen in Figure A.3, in the absence of the program extreme the poverty rate would be 0.7 percentage points higher and, both the poverty gap (the average distance from the poverty line) and poverty severity would also be higher (they would increase from 4.1 to 4.6 percent for the former and from 2.3 to 2.7 percent for the latter). *Red de Oportunidades* uses a proxy means test to identify households in extreme poverty. However, as the recent audit of the program's beneficiaries carried out by MIDES showed (Prior Action 1), there has been significant leakage in the program in recent years. The audit found that the inadequate use of household registration data had led to the inclusion of ineligible households,

households with a proxy means' test score above the cutoff level. The review of household eligibility indicated a leakage level of around 13 percent. The audit led to the removal of just under 9,200 households (of 69,524) from the program roster (Table A.1). A new group of eligible households (9,600) were then enrolled, and the inclusion of these new households was fiscally neutral, i.e. financed by the resources freed-up by removing ineligible households. The decrease in beneficiaries (removal) was most common in the richer provinces and the newly enrolled households are more likely to be from the poorest provinces or *comarcas*, providing prima facie evidence that the audit improved the program's targeting.

Table A.1: Changes in Number and Distribution of Beneficiary Households due to the Audit of *Red de Oportunidades*

	Jan-Feb	May-June	Sept-Oct	% Change Jan-May	% Change May-Sept	Ext. Poverty Ranking
Bocas del Toro	4807	3878	5023	-19.3	29.5	4
Cocle	9420	7914	7840	-16.0	-0.9	7
Colon	2978	2684	2691	-9.9	0.3	9
Chiriqui	7760	5928	5947	-23.6	0.3	8
Darien	2640	2174	2228	-17.7	2.5	5
Herrera	1696	1242	1277	-26.8	2.8	10
Los Santos	1155	852	857	-26.2	0.6	13
Panama Oeste	4327	3737	3964	-13.6	6.1	11
Panama	4435	3617	3741	-18.4	3.4	12
Veraguas	8303	5996	6440	-27.8	7.4	6
Comarca Embera Wounaan	1350	1299	1302	-3.8	0.2	3
Comarca Guna Yala	3151	3097	4090	-1.7	32.1	2
Comarca Kuna Madungandi	591	584	740	-1.2	26.7	n.a.
Comarca Ngabe Bugle	16718	17157	23633	2.6	37.7	1
Comarca Kuna de Wargandi	193	193	199	0.0	3.1	n.a.
Total Beneficiary Households	**69,524**	**60,352**	**69,972**	**-13.2**	**15.9**	
Total Payments (million Balboas)	**6.63**	**5.75**	**6.43**	**-13.3**	**11.8**	

Source: MIDES[19] and MEF[20].
Note: The discrepancy between changes in beneficiaries and payments results from not all beneficiaries receiving payments: it appears that around five percent of eligible households fail to receive their payment each payment period.

7. A simulation exercise of the effect of the audit of *Red de Oportunidades* on beneficiary households suggests that the reallocation of resources decreased the extreme poverty rate by 0.9 percentage points. The 0.9 percentage reduction in extreme poverty was calculated by assigning the benefits that were freed-up to households closest to the poverty line.

[19] http://www.mides.gob.pa/wp-content/uploads/2014/09/NOV2015-RDO.pdf
[20] http://www.mef.gob.pa/es/informes/Documents/Actualizacion%20de%20las%20lineas%20de% 20pobreza %20-%202015.pdf

Thus, the simulation represents an upper bound on the impact of the audit on the reduction of extreme poverty. If, instead, the freed-up resources were targeted to the very poorest of the income distribution, the overall poverty rate would not change but the severity of poverty would decline by 0.4 percentage points, and the poverty gap would decline by 0.3-0.4 percentage points.

8. It is worth noting that based on the household survey data, additional reduction of leakages could have important effects on poverty reduction. The household survey data shows that the overall leakage of the program could be greater than the 9,200 households identified in the audit. In fact, while the 9,200 household represent 13 percent of the total beneficiary households, the survey data suggest that leakage is at the level of 25.6 percent of households. If this is the case, further reducing program leakages would allow more households living below the extreme poverty line to be covered in *Red de Oportunidades* in a fiscally neutral manner[21]. In short, the household-level data suggests that there are fewer non-receiving but eligible households than there are non-eligible receiving households. A simulation exercise shows that the elimination of program leakages would reduce the poverty rate by 1.8 percentage points, the severity of poverty by 0.8 percentage points, and the poverty gap by 1.1 percentage points. Of course, these magnitudes are meant for illustrative purposes, as the costs of reaching zero leakage are unknown and could potentially outweigh the benefits.

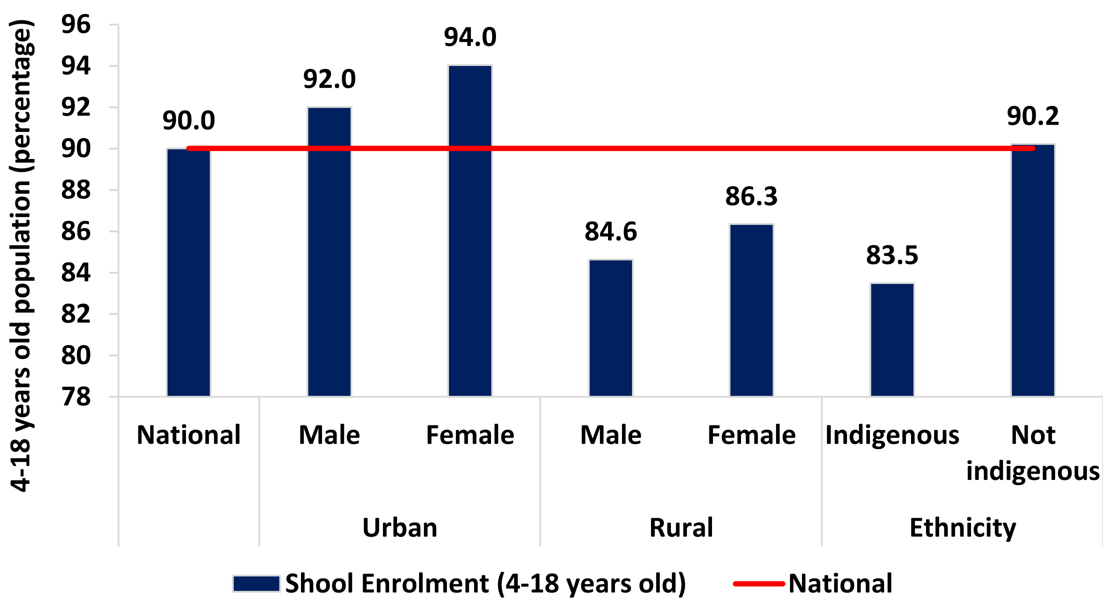
9. Improving the targeting mechanisms for *120 a los 65* and *Beca Universal* would further contribute to reduce poverty and inequality in Panama. As noted above, *120 a los 65* has contributed to decrease poverty among the elderly by 6.9 percentage points. However, its targeting is relatively weak and there is evidence of substantial leakage to the non-poor. For instance, the household data show that 55 percent of households receiving the *120 a los 65* benefit would not be poor if they ceased to receive the transfer and 75 percent would not be extremely poor. If the program were to disappear, only 21 percent of the households presently receiving benefits would be poor. Simulations of the welfare impacts of targeting the program to the extremely poor households, similar to those carried out above for *Red de Oportunidades*, show that extreme poverty could be reduced by 0.3 percent points. The effect would be larger on the elderly however, as re-targeting the program could decrease poverty among the elderly by 1.1 percentage points. In summary, targeting the program to the extremely poor households could both lower elderly poverty even further and free up government resources for other programs. In this regard, the DPF 3 triggers envisage reforms to improve the targeting formula for *120 a los 65* in addition to an evaluation of the *Beca Universal* program.

10. The creation of an Inclusion and Social Development Directorate within MIDES is expected to enhance the welfare impacts of *Red de Oportunidades* by addressing barriers to program take up. A qualitative study of the impact of *Red de Oportunidades* by Waters showed that a lack of differential services for the various ethnic groups in the country has undermined the

[21] The discrepancies between the leakage found in the household survey and the audit carried out by MIDES might be due to a variety of factors. They include differences in the precision of the proxy means test or non-reporting in the household survey. As further analysis of benefit incidence is expected to be carried out using the household survey, it may be useful to have an analysis of these disparities done to identify any data issues that may exist.

effects of the program in certain areas and among certain populations[22]. The National Plan for the Development of Indigenous Peoples in Panama (2012) also raises this issue of culturally appropriate services. For education, there continue to be problems in access and service quality, as well as a lack of multicultural, bilingual education in indigenous areas. School dropout rates among indigenous and rural populations are higher than among urban children: for children between four and 18 years of age, the enrolment rate of indigenous children is 80.4 percent compared to 91.9 percent of for non-indigenous children (Figure A.4). While much of this is due to distance and cost of schooling, the absence of bilingual and culturally appropriate education also plays a role. According to Waters (2009) health services were also under-utilized due to limited culturally appropriate health services and the absence of health workers with the specific skills needed to work in different cultural contexts. In terms of outcomes, the *Red de Oportunidades* has had less success in affecting malnutrition among indigenous communities than elsewhere in the country. Beneficiaries also raised specific concerns about implementation, cultural sensitivities not being addressed and inappropriate conditions being applied. The new Directorate is a positive step towards rectifying these problems. Given the cultural concerns raised by the Indigenous Peoples, it is imperative that the authorities of the Indigenous *comarcas* and territories be fully engaged with the Directorate and participate in the design and implementation the new efforts. A process evaluation around the Directorate could be a useful learning tool as the Directorate advances in its work program.

Figure A.4: Indigenous children are less likely to be enrolled in school
Enrollment Rates by Ethnicity and Location, Panama, 2015



Source: World Bank staff estimates, based on *Encuesta de Propósitos Múltiples*, March 2015

11. The overall impact on welfare of the new payment methods for *Red de Oportunidades* and other social assistance programs is expected to be neutral, although

[22] Waters (2009). Diseño de políticas y programas sociales. Estudio de Evaluación Cualitativa del Programa *Red de Oportunidades*.

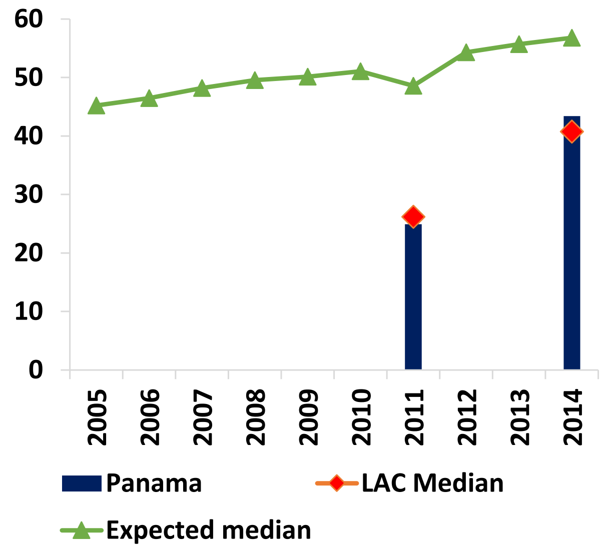
there is a possibility that the impact for some people living in remote rural areas could be negative. Payments through financial institution instead of via cash or electronic payment cards have many potential benefits. Physically, funds are safer in banks and recipients are not exposed to theft on payment days. Additionally, a move to payments through the banking system can reduce transaction costs by eliminating the need for beneficiaries to attend payment points at a specific time and allowing funds to be removed at the convenience of the recipient. However, studies done by CGAP (Government to Population Research Project, 2011) in other countries show that not all recipients benefit: transportation costs to banks may be high and bank fees can further erode the value of the benefit. The overall impact of the shift in payments methods on people living in remote areas will depend on both travel costs and the proximity of bank branches or ATMs. Further analysis of access to bank branches, transport costs and expected banking fees need to be understood, and monitored, to determine where the shift to banking may be inappropriate and to develop mitigation strategies as needed. The Government of Panama is aware of these challenges and plans to monitor the effects of the new payment methods on the most vulnerable.

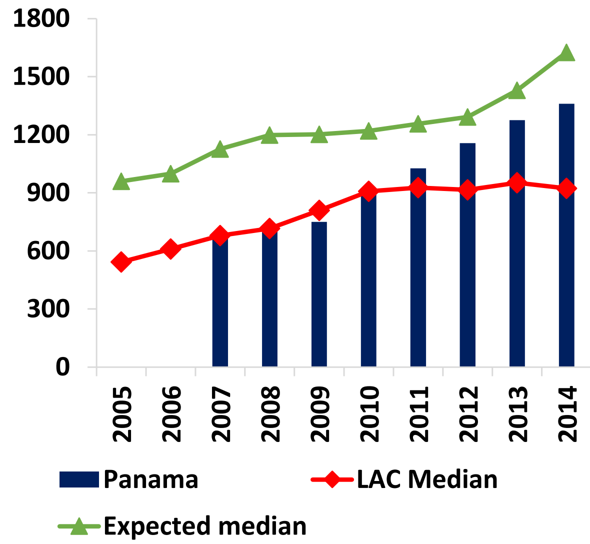
12. A second, oft-touted benefit of a shift to a bank-account based payment is access of formal financial services that this creates among program recipients who are usually among the least 'banked' segment of the population. As shown in Figures A.5 and A.6, improving financial access is an important goal in Panama: the country's level of financial access is lower than would be expected given its economic structure (Finstat, 2015). However, while the potential for increasing the use of savings and other formal financial instruments exists in theory, in practice there is little evidence that this occurs. Studies in Mexico, Colombia, Brazil and South Africa show that recipients tend to withdraw the full amount of their benefit at once, undermining the savings' benefit of the new payment mechanism, and also take no advantage of access to other financial services (CGAP, 2011) [23]. In part this is due to the concern that leaving money in the account sends a signal to authorities that one does not need the money. In part this is due to a distrust of banks in general. If Panama wants to generate a financial inclusion benefit from this payment shift in *Red de Oportunidades*, it will have to make an explicit effort at the implementation stage to overcome these barriers seen in other settings.

Figure A.5: Access to bank accounts is low in Panama given its GDP…
Adults with an Account at a Formal Financial Institution, percent

Figure A.6: …as are the number of accounts
Number of Accounts at Commercial Banks, per Thousand Adults

[23] Studies include: Mexico Country Report http://www.cgap.org/publications/cgap-g2p-research-project-mexico-country-report, Colombia Country Report http://www.cgap.org/publications/cgap-g2p-research-project-colombia-country-report, South Africa Country Report http://www.cgap.org/publications/cgap-g2p-research-project-southafrica-country-report, and Brazil Country Report http://www.cgap.org/publications/cgap-g2p-research-project-brazil-country-report.





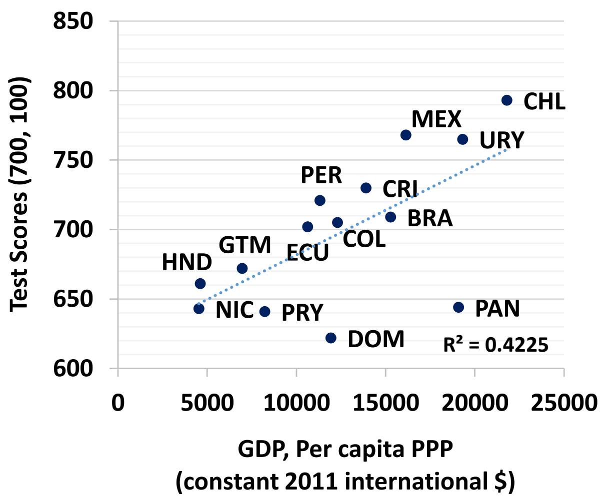
Source: Finstat Data Base, 2015.

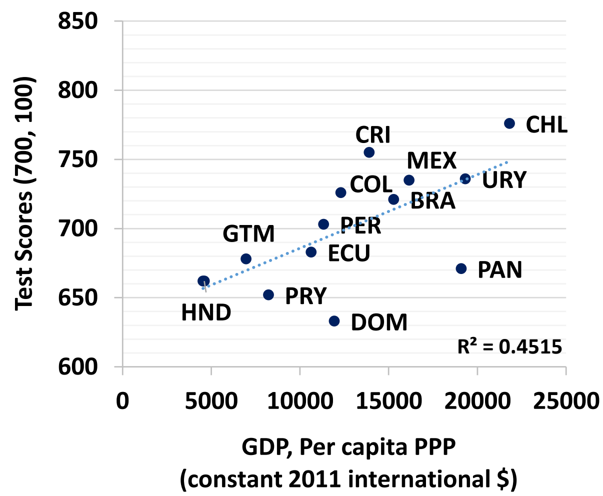
Education

13. **The proposed education reforms (publication of TERCE results, participation in PISA, the initiation of the *Panama Bilingüe* program, and the new curricula for technical schools) are likely to yield improvements in the quality of educational services over the medium- to long-term.** The international evidence suggests that the comparative data from international education testing can provide important incentives for improving the quality of educational services and outcomes, including among the poor and thus improving welfare. As evidenced by the TERCE results, Panama has been very successful in expanding access to schooling (the country has the highest social inclusion index across the region with the second highest level of enrollment among its indigenous population and the greatest number of households receiving public transfer conditional on school attendance), but the performance of Panamanian students is still below its peers: TERCE scores show a clear gap between the performance of Panama and what would be expected given its GDP (see Figure A.8). The need for improving school quality is clear. There is a strong and growing demand for highly educated workers: over the 2000-2010 decade, the number of jobs grew by almost 40 percent. Job growth was, however, linked to higher levels of education as one-third of all new jobs required a completed secondary education while one-half required tertiary education. To the extent that quality issues at lower levels affect transitions to higher levels, success in improving education can help to match demand and supply in the labor force. The publication of the new data on learning outcomes and Panama's participation in other international assessments will help the system to move from a focus on coverage to a focus on quality and provide useful inputs for the new programs around bi-lingual education and technical training. It will take time, however, for the results of the testing program to be translated into improved education quality.

Figure A.8: TERCE scores show Panama lagging behind

Mathematics, 6th grade *Language, 6th grade*





Source: Second report TERCE, Jul 2015[24].

[24] United Nations Educational, Scientific and Cultural Organization, 2015. Tercer Estudio Regional Comparativo y Explicativo", http://www.unesco.org/new/es/santiago/resources/single-publication/news/tercer_estudio_regional_comparativo_y_explicativo_terce_analisis_curricular/#.Vr3dWE9gmmR.

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

Prior Action 10: The Borrower has reduced electricity tariff subsidies through the replacement of the nation-wide Fund for Energy Compensation (FACE) with a geographically-targeted Fund for the Occidental Region (FTO), as evidenced by Cabinet Resolutions No. 59 and No.60, both dated June 23, 2015 and Cabinet Resolution No.2, dated January 5, 2015.

14. The elimination of the electricity subsidy FACE and its replacement with the geographically-targeted FTO is expected to have a very limited impact on poverty over the short-term. The FACE subsidy was eliminated for all households. However, the Rate Stabilization Fund will continue to provide tariff subsides to households consuming less than 350 kWh per month. The FACE reform affects over 80 percent of residential electricity consumption, which explains the large fiscal savings that the reform will generate (Table A.2). However, it will affect many fewer residential customers or households. Slightly more than 173,000 residential consumers or households will be see their rates rise due to the elimination of the subsidy, or only 18 percent of the total number of consumers (though these consumers will be those consuming more than 350 kWh per month). The electricity companies do not have a breakdown of households that will be affected by poverty status. However, residential clients have been characterized by their ownership of energy consuming appliances. The group with consumption levels above 400 kWh own a wide range of appliances, including multiple air conditioner units, deep freezes and swimming pool pumps. Households with consumption levels over 300 kWh are characterized as owning air conditioning units, clothes dryers, large screen televisions, video games and computers. Given that this list of items are not those owned by the extremely poor nor even the bulk of the poor in Panama; it is unlikely that the elimination of the FACE will have any appreciable impact on poverty.[25]

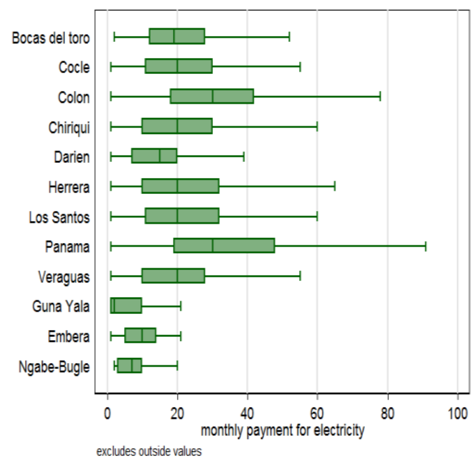
[25] It is worth mentioning that the FACE reform would have been even more progressive if the subsidy would have been eliminated nationwide. This is because FACE was replaced by a geographically-targeted subsidy fund (FTO) for the Chiriquí province, and thus FTO continues to subsidize consumers above the 350 kWh threshold in this province. Chiriquí is not one of the poorest provinces: in 2013 it ranked 8th of the 13 provinces and *comarcas* in terms of poverty. The burden of electricity expenditures in this province is around the average of the country (Figure A.9). On the more positive side, the customers of EDECHI represented only about 14 percent of electricity customers in the country (as of 2012) and, although Chiriquí as a province has one of the highest levels of electricity penetration, Chiriquí also had a smaller share of households in the top consumption brackets (Figure A.10). In summary, the continued subsidies in the Chiriqui will have little or no effect on poverty but perhaps will have a very small effect on inequality.

Table A.2: Most residential customers will be unaffected by the elimination of the FACE
Energy consumption, 2015

Consumption Level (kWh)	Number of Customers	% of Clients	% of Elect. Consump.	Mean Rate (B/kWh)	Appliances in household
< 300	690,716	73.0	15.6	0.12565	Refrigerator, washer, fans, small television, iron, hairdryer, microwave
301-400	81,603	8.6	4.8	0.14477	The above plus: Air conditioner, clothes dryer, large screen televisions, video games, computers
401 - 750	90,147	9.5	7.7	0.17768	
> 750	68,314	7.2	18.7	0.20747	The above plus: Freezer, wine cellar, various air conditioning units, electric stove and over, pool pump.
Other rates	14,932	1.6	53.4	0.23703	
Total	945,712	100.0	100.0		

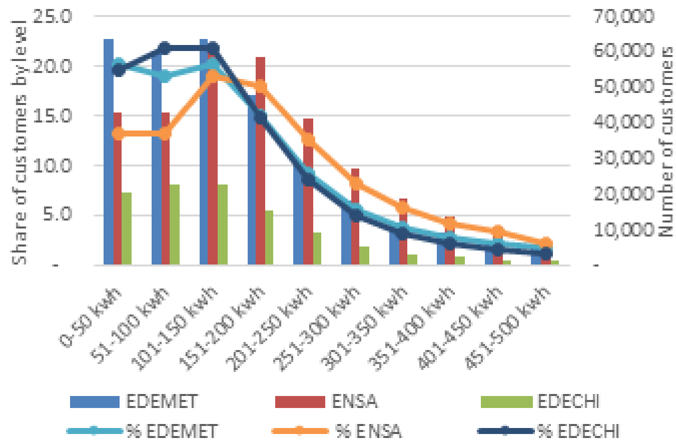
Source: "Focalización de Subsidio Eléctrico en los Grupos Vulnerables", June 2015.[26]
Note: Data from the second half of 2015.

Figure A.9: The burden of electricity spending in Chiriqui is not high
Expenditures on Electricity as Share of Household Income, by Province, 2015



Source: World Bank staff estimates, based on *Encuesta de Propósitos Múltiples*, March 2015.
Note: Amounts are actuals paid including existing subsidy in March 2015.

Figure A.10: More consumers are in the lower consumption levels in Chiriqui
Number of Customers by Provider and Share by Consumption Level



Source: Gallarda, 2012.[27]

15. In fiscal terms the energy subsidy reform is positive as it leads to immediate fiscal savings and at the same time limits the vulnerability of public finances to abrupt swings in international oil prices. A shift away from a universal program to this small program has created significant fiscal space. The Government ended subsidy program that costed over

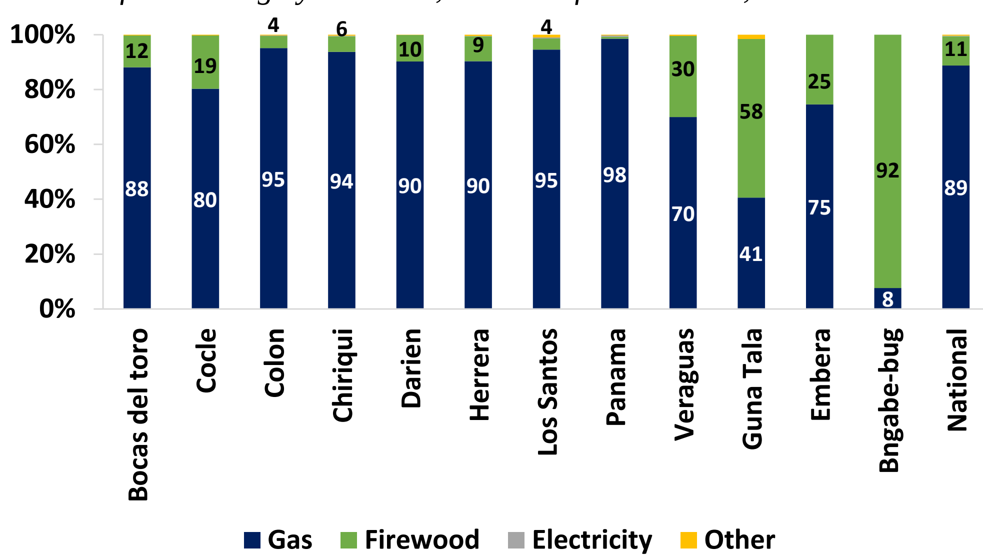
[26] Ministry of Economy and Finance and National Authority of Public Services, June 2015. "Focalización de Subsidio Eléctrico en los Grupos Vulnerables", Panama.
[27] Gallarda, 2012 "Descripción de la Problemática de los subsidios Eléctricos en la Economía Panameña", Report prepared for the World Bank.

US$240 million in 2014 alone, and replaced it with a program targeted to the province of Chiriquí for an amount closer to US$62 million. This creates the potential for an offsetting payment to be made to the poorest households through on of the existing social protection programs. It may also make it possible to begin to expand the electricity grid to those areas that are presently underserved which are areas where the poorest households live. Expanding the electricity grid would make electricity subsidies more progressive, given that the poor living in rural areas are the ones with less access to the grid and therefore do not benefit from electricity subsidy.

16. **One concern about eliminating or even decreasing a subsidy for electricity is that more people would move to using firewood than electricity; yet, in Panama's case this risk appears to be small.** If this happened it would have environmental implications due to increased pressure on forest resources which, in turn, could also affect water resources. As hydropower represents more than half of power generation in the country, affecting water resources has immediate economic and health implications. Cooking with wood is also associated with health risks for households and a policy that would shift people away from relatively clean electricity to wood could increase health costs. In Panama, it appears that the risk of the present electricity reform resulting in a shift towards wood for cooking is small. First, because the reform is not affecting the poorest households, those most likely to switch to wood. Second, the majority of households in Panama cook with gas and thus a shift in electricity prices will not raise the probability of households moving to wood for cooking.

Figure A.11: Increasing energy costs is unlikely to increase the use of biomass for cooking

Fuel Use for Cooking by Province, Percent of Households, 2015



Source: WB staff calculations based on *Encuesta de Propósitos Múltiples*, March 2015.

ANNEX 5: COMPARISON OF THE DPF 2 INDICATIVE TRIGGERS AND DPF 2 PRIOR ACTIONS [28]

DPF 2 Indicative Triggers	DPF 2 Prior Actions	Notes
Pillar 1: Strengthening the Frameworks for International Tax Transparency, Financial Integrity, and Fiscal Management		
	Prior Action 1: The Borrower, through the Ministry of Foreign Affairs, has taken initial actions aimed at conforming with the Common Reporting Standards for Automatic Exchange of Financial Account Information in Tax Matters (CRS) through its commitment to adhere to the CRS by 2018, as evidenced by Notification D.S.-MIRE-2016-25092, dated May 9, 2016.	New prior action.
	Prior Action 2: The Borrower has amended the Decentralization Law which, inter-alia: (i) establishes a mechanism to distribute property taxes to municipalities, (ii) establishes a municipal public investment program, and (iii) creates the National Secretariat for Decentralization to supervise and coordinate the decentralization process, as evidenced by Law 66, dated October 29, 2015, duly published in the Borrower's official gazette dated October 30, 2015.	New prior action.
	Prior Action 3: The Borrower, through MEF, has signed an agreement with the Comptroller General to define tasks and responsibilities for public debt servicing, including to allow for the use of the integrated SIGADE-ISTMO platform, as evidenced by *"Acuerdo Interinstitucional para la Implementacion de la Interfaz SIGADE-ISTMO"*, dated January 21, 2016.	New prior action.
Pillar 2: Strengthening Institutional Arrangements to Support Inclusion in Social Assistance and Education		
Trigger #1: The Government has institutionalized the National Council of Indigenous Peoples as the primary national consultative body which integrates the Indigenous Peoples for participation in Government processes.		The prior action was dropped to reflect the Government's updated timeline for the institutionalization of the National Council of Indigenous Peoples.
Trigger #2: The Government has amended *Red de Oportunidades* to respond to culturally differentiated needs of Indigenous People.	**Prior Action 6:** The Borrower, through MIDES, has completed an audit of beneficiaries of the conditional cash transfer program *"Red de Oportunidades"* to improve the coverage and targeting of beneficiaries while reducing fiscal leakage in the program, as evidenced by the official notification from MIDES to MEF, dated February 3, 2016.	The scope of the prior action was broadened to tackle challenges related to low coverage and inadequate targeting of social programs. *Red de Oportunidades* has been strengthened to respond to culturally differentiated needs of Indigenous People.
Trigger #5: The Government has (a) introduced a new	**Prior Action 7:** The Borrower, through MIDES, has signed an	The scope of the prior action was expanded

[28] DPF 2 indicative triggers 4, 8 and 9 (presented in the program document for DPF 1 and the corresponding Prior Actions 9, 5 and 4 presented in this program document remain unchanged (see Annex 1). The language of these prior actions was amended to reflect the legal nature of the policy measures.

DPF 2 Indicative Triggers	DPF 2 Prior Actions	Notes
payment modality by paying out benefits of *Red de Oportunidades* through the banking system; and (b) piloted a financial training for the beneficiaries of social protection programs.	agreement with a regulated financial institution to channel payments to beneficiaries of all conditional cash transfer programs through said financial institution, as evidenced by "*Convenio Clave Social 14-15*" between MIDES and the National Bank of Panama, dated June 15, 2015.	to include all CCTs and not only *Red de Oportunidades*. The Government has also piloted financial training for the beneficiaries of social protection programs.
Trigger #3: The Government has strengthened the monitoring and evaluation of the education system by (a) mandating the application of the monitoring and evaluation framework of the *Beca Universal* program; and (b) participating in the 2015 Program for International Student Assessment which aims to evaluate education systems worldwide.	**Prior Action 8:** The Borrower, through MEDUCA, has: (a) taken initial actions aimed at participating in the Program for International Student Assessment (PISA), through the issuance of an official notification to the OECD informing of its participation in the 2018 PISA, as evidenced by Letters from MEDUCA to the OECD (DM-280-2015, dated February 3, 2015; DM-2561-2015, dated November 26, 2015, and DM-082-2016, dated January 11, 2016); and (b) completed and published the microdata of the 2013 Third Regional Comparative and Explanatory Study (TERCE).	The scope of the prior action was broadened to include the publication of TERCE results in addition to the participation in PISA, and reflects the Government's changed timeline for developing a monitoring and evaluation system for *Beca Universal* (DPF 3 Trigger).
Pillar 3: Enhancing the Regulatory and Financial Sustainability Framework of Service Delivery in the Energy and Water Sectors		
Trigger #7: The Government has approved a national energy efficiency program designed to reduce energy consumption.	**Prior Action 10:** The Borrower has reduced electricity tariff subsidies through the replacement of the nation-wide Fund for Energy Compensation (FACE) with a geographically-targeted Fund for the Occidental Region (FTO), as evidenced by Cabinet Resolutions No. 59 and No.60, both dated June 23, 2015 and Cabinet Resolution No.2, dated January 5, 2015.	The prior action reflects a stronger policy measure to enhance the regulatory and financial sustainability of the energy sector. A long-term National Energy Strategy has been prepared. DPF 3 would support further measures in the area of energy efficiency.
Trigger #6: The Government has (a) implemented the basic sanitation plan to provide 100 percent access to drinking water and 0 latrines in pilot regions; and (b) has approved a strategy for institutional and tariff reforms of IDAAN.		The prior action was dropped to reflect the Government's updated timeline for the reform. The approval of a strategy for institutional strengthening of IDAAN is included as a trigger for DPF 3.