

previous Canal Zone territory. This enabled it to overcome a serious land constraint, and hence permitted rapid growth until the Latin American financial crisis took its inevitable toll in 1982.

53. Despite this impressive progress, much remains to be done if the country is to secure the full benefits from the reverted lands. They could, for example, be used for export-oriented industrial and service activities in accordance with the Government's new industrial strategy (paras 59-74). Such activities could concentrate on light industrial products, presently being shipped in their final form through the Canal, enhanced tourist facilities, and commercial operations particularly in the Colon area where the unemployment problem is at its most grave. In addition to the Colon Free Zone, other duty free areas and industrial estates could be established as well as modern wholesale markets for agricultural produce brought to the Metropolitan Area. Albrook Field on the outskirts of Panama City has been considered as a site for such activities for some time.

54. However, full exploitation of the assets is impeded by current legislation. The only public sector institution with the legal authority to rent or sell facilities in the old Canal Zone to the private sector is the Canal Authority, which was established after the signing of the Treaty. With the laudable aim of not creating another cumbersome bureaucracy, the Canal Authority was provided with no budgetary support, and cannot, therefore, operate. Legislation has been prepared, and presented to the Legislative Assembly, to permit the Ministry of Finance, as custodian of National Assets, to lease or sell the lands. This will not only facilitate their productive utilization, but will also be an important potential source of revenue for the public sector.

55. A good transport system is essential for the smooth functioning of the industrial-commercial complex which Panama expects to create on both sides of the Canal. Current land transport facilities are clearly inadequate for expanded modern cargo shipment. The two-lane trans-isthmian highway is already congested during peak hours, while the railway is rundown, and would require considerable modernization to handle more container traffic. From a fiscal viewpoint, the railway is already an important drain on resources. The current operating subsidy in 1982 was nearly US\$4.5 million, and substantial sums also had to be spent on emergency maintenance. The Government has requested Bank support for a study to assess the future land transport requirements of the trans-isthmian corridor, and to make recommendations on appropriate transport policy and investments, taking account of Panama's obligations under the Canal Treaty.

Reform of the Customs Administration

56. The Panamanian Customs Administration does not operate efficiently and, consequently, substantial sums are lost each year in the form of potential but uncollected revenues. The staff of the Administration are poorly trained and their methods of operation are inadequate to cope with the complex problems of modern commerce. This slows down, and at times even prevents, the introduction of desirable reforms to tariff policy. The Government is receiving technical assistance from an IMF expert who is preparing detailed recommendations concerning:

- (a) changes in the method of payment of customs duties to impede false declarations of value;
- (b) the introduction of the Brussels Nomenclature (for which a detailed study has already been prepared) following a period of intensive training for Customs staff;
- (c) a change from specific to ad valorem tariffs (this is already being implemented in the case of the tariffs replacing quantitative restrictions—see paragraphs 62-64);
- (d) a change from FOB to CIF as the basis for the assessment of tariffs.

Except for (c), the above reforms require fresh legislation and will probably be ready for implementation when the new Assembly takes office in October, 1984. The authorities are, however, currently studying the legal possibility of authorizing some partial reforms by Ministerial Decree.

Improved Public Sector Debt Management

57. Prior to early 1983, Central Government control and monitoring of the commercial borrowing of public sector enterprises and autonomous agencies was largely ineffective in practice. Moreover, up-dated statistical information was inadequate. As a consequence, several agencies were permitted to borrow short term funds to finance projects and activities with a return that would only materialize in the long term if at all. Not only has the Government improved control over public sector borrowing (para 34), but the statistical information on public sector debt is now among the best in the region. The terms, conditions and sources of each individual credit, together with amounts outstanding to each agency, are fully documented and easily accessible. In order to assist recent negotiations with commercial banks, coverage has been extended to short term credit lines to the National Bank of Panama and the Savings Bank as well as to the non-financial public sector.

58. One of the key objectives of both the short term stabilization and the structural adjustment programs is to slow down the rate of accumulation of external debt, while improving its maturity structure and thus the cost of servicing it. To this end, the rate of growth of public external indebtedness is programmed to fall sharply to 8½ percent in 1983 from 20 percent in 1982, and to an average of 6 percent per year, in nominal terms, for the rest of the 1980's. The investment program does not contemplate any net use of commercial bank credit, suppliers credits or foreign bond credits by the public sector in 1983 or 1984. In the medium term, the reduced scope of the public sector, the consequent smaller share of public investment in the GDP, combined with an improved public sector savings performance, is expected to significantly lower both the debt and the servicing burden (paragraphs 95-105).

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C. Industrial Policy, Trade Liberalization and Employment Overview

59. While Panama's previous policies have encouraged the development of a large, competitive service sector, they have not been conducive to labor-intensive, export oriented manufacturing activities. Manufacturing accounts for only about 10 percent of GDP and employs about the same percentage of the labor force. Production has been oriented almost entirely to the domestic market and consists mostly of food processing, light industries and petroleum refining. In the 1960's growth in manufacturing value added was slightly faster than that of GDP; since 1970, however, the sector has lagged behind with output growing at only 60 percent of the rate for the economy as a whole. Employment in the sector doubled from 24,000 in 1960 to 48,000 in 1970; since then, it has stagnated and was only just over 50,000 in 1982. Firms have become increasingly capital-intensive, and many manufacturing plants operate below full capacity, often with only one shift. In 1982, manufactured exports were 13 percent of total exports and only 2.6 percent of industrial output.

60. The trends described above are wholly consistent with the prevailing structure of incentives. The usual incentive mechanism for manufacturing investment is a contract with the Government under which the investor undertakes to carry out an investment project in return for exemptions from income tax and import duties, reduced rates of taxation and/or tax credit certificates. On expiring, these contracts have been renewed, almost automatically. In addition, benefits usually include protection against foreign competition normally through import quotas or

other quantitative restrictions. Incentives such as re-investment and accelerated depreciation allowances favor the intensive use of capital relative to labor. Effective protection of final goods produced for the local market is frequently excessive, has diverted entrepreneurial and financial resources away from exports; and indirectly raises Panama's already high wage bills. Individual contracts relate benefits to negotiating strength rather than desirability of the project, increase dispersion of effective protection, and discriminate against small firms. Quota protection is usually accompanied by price controls which limit profitability, favor consumption over savings and discourage investment.

61. The regulation of the labor market in Panama through a detailed Labor Code ^{5/} is a further factor militating against employment creation. It reinforces the country's relatively high wage levels through high severance pay, the curtailment of the freedom to adjust employment and high wage-based welfare taxes. Minimum wage regulations, while not regarded as pushing up wage costs, are unduly detailed. Ad hoc increases in wages decreed by the Government and a history of intervention in collective bargaining increase uncertainty and encourage entrepreneurs to build higher labor cost assumptions into their project planning.

62. As part of its structural adjustment program, the Government has therefore embarked upon a liberalization of its industrial and commercial policies. The ultimate aim of the new policy framework is to establish a low and uniform level of tariff protection for all private industrial activities, implying an end to quantitative restrictions and exonerations. The first steps in this process--the substitution of quantitative restrictions by tariffs--are already being taken. These have been accompanied by other specific measures to encourage employment and exports. The program and actions are described in the following paragraphs.

Conversion of Quantitative Restrictions into Tariffs

63. In late 1982, the Government began to implement an earlier Presidential Decree, calling for the elimination of import quotas as an instrument of protection. Initially, however, progress was slow. The Ministry of Commerce and Industry studied the mechanics of conversion to tariffs on a case-by-case basis so as to ensure the "adequate" amount of protection. This work was extremely time consuming, especially given the limited technical resources at the Ministry's disposal. By the end of February, 1983, studies had been completed on only eight products. Moreover, the Ministry was unable to effectively coordinate work on the quantitative restrictions administered by other government agencies.^{6/} At appraisal, however, the Government informed the Bank that the conversion of quantitative restrictions would be considerably accelerated. A working group, headed by

the Director of Economic and Social Planning at MIPPE, and made up of senior representatives of MIPPE, the Ministry of Finance, the Ministry of Commerce and Industry and of the other agencies directly administering quantitative restrictions has been formed to carry out the program. The universe of quantitative restrictions has been more precisely defined to include not only quotas of industrial products administered by the Ministry of Commerce and Industry, but all quantitative restrictions of whatever type,^{7/} administered by any government agency. This universe includes 304 tariff categories; of these 38 were eliminated by June 30, 1983. Of the remainder, a further 101 were lifted between June 30 and October 15, 1983. Thus, by the latter date, nearly 50 percent of the total universe of quantitative restrictions had been eliminated or substituted by tariffs. These actions have been put into effect by the issue of Ministerial Decrees after appropriate Cabinet authorization. They do not require new legislation.

64. The remaining quantitative restrictions, which are applied to products of a particularly sensitive nature, will be eliminated more gradually. Studies will be undertaken, some of them supported by the Bank, to assist in determining the initial level of tariff protection to replace the quota. These studies are expected to be completed by the end of May, 1984, at which time the Government will have prepared a timetable for the elimination of the remaining quantitative restrictions, and the proposed initial levels of tariff protection which will replace them. Approval of these would be conditions for the release of the second tranche of the proposed SAL (para. ____).

Maximum and Minimum Tariff Levels

65. The Government has announced that it will limit tariff protection afforded to new industrial activities to a maximum 125 percent effective protection in the first year, falling to 100 percent thereafter. In Panama, given the average proportion of value added in local manufacturing, these are equivalent to average nominal ad valorem tariffs of about 40 and 33 percent respectively. With regard to existing industries, most of the tariffs replacing quotas so far lifted are moderate, ranging from an equivalent of 25 to 75 percent ad valorem, with the average around 40 percent. While the government clearly anticipates cases where higher initial tariff protection may be required, this will never exceed 100 percent ad valorem in more than 25 industrial tariff categories (about 7.5 percent of the total universe).

66. The new minimum tariff level will be established by May 31, 1984, and will be incorporated into the new industrial incentives legislation to be drafted by that date (paragraph 68). The adoption of the minimum tariff will, by implication, end exonerations and will be applied to some industrial inputs, machinery and food product imports which now have very low or zero tariffs. This will help reduce effective protection for the production of final goods while increasing it for agricultural and intermediate inputs, activities traditionally penalized by the current structure of protection. The minimum tariff will be as nearly uniform as possible, while allowing for some flexibility in exceptional cases. Also by the end of May, 1984, the Government will have prepared a timetable for reduction of initial tariffs to

^{7/} Excluding items related to national security and public morality.

Maximum and Minimum Tariff Levels

65. The Government has announced that it will limit tariff protection afforded to new industrial activities to a maximum 125 percent effective protection in the first year, falling to 100 percent thereafter, and then progressively towards the minimum tariff level. In Panama, given the average proportion of value added in local manufacturing, these are equivalent to average nominal ad valorem tariffs of about 40 and 33 percent respectively. With regard to existing industries, most of the tariffs replacing quotas so far lifted are moderate, ranging from an equivalent of 25 to 75 percent ad valorem, with the average around 40 percent. While the government clearly anticipates cases where higher initial tariff protection may be required, this will never exceed 100 percent ad valorem in more than 25 industrial tariff categories (about 7.5 percent of the total universe).

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Industrial Incentives Legislation

67. The industrial incentives described in paragraph 59 are governed by a specific piece of legislation, Law No. 413 of December, 1970. Contracts under this Law are signed for up to 20 years. To date, no contract renewal proposal by a company has been refused. As of March, 1983, there were 483 firms which had contracts in force, and the average contract has another six years to run. About 80 percent of existing contracts will have expired by 1990.

68. In view of the undesirable features of the contract system, the Government will replace Law 413 by a general system of incentives to a wider potential group of beneficiaries, thereby eliminating the concept of individually negotiated contracts. The Government is to prepare a draft version of the new legislation by the end of May, 1984, and will ask the Bank to comment upon it. It is anticipated that the new Law will be considered by the Legislative Assembly before the end of 1984. The signing of new contracts and the renewal of existing ones under Law 413 will cease when the new legislation comes into effect. In the interim period, new contracts and renewals will be for a period of five years; the authorities feel that this is essential to enhance the new legislation's acceptability. Only 6 percent...

provides for a Price Regulation Office ^{8/} consisting of a Director and Price Adjustment Committee comprising seven members: one from the Economic Cabinet, two representing labor unions, and representatives for wholesalers, retailers, farmers and manufacturers. At present, the price controls are applied to about 75 items, 50 of which are food and food products. Fuel and items such as inexpensive clothes, shoes and pharmaceuticals are also included as are cement and some other construction materials. Prices for locally produced food are set at each stage of the production and distribution process, starting with the farmer. Other controls are enforced at the retail level. The Price Regulation Office does not appear to have a clear formula to determine prices. The private sector constantly complains of a long time lag between the petitioning and granting of a price increase. In some cases, this is more than a year. The increases, when granted, often take the form of one large hike, rather than incremented adjustments. This practice not only has a negative impact on sales, but also squeezes profit margins and discourages investment.

10. All the products with price controls also benefit from import quota protection administered by the Price Regulation Office. The elimination of most import quotas will render price controls on industrial products redundant since domestic prices will be regulated automatically by competition from imports. Local firms will be protected through tariffs. The Government has therefore decided to accompany the abolition of quantitative restrictions with the dismantling of price controls. This will provide an important stimulus to private investor confidence, and the consequent reduction in bureaucratic intervention will help to compensate firms for reduced quota and tariff protection. Following this, the role of the Price Regulation Office will be confined to a few very basic and politically sensitive items.

11. As well as the proposed easing of price controls on industrial products, the Government, in March 1983, freed rent controls on all new housing projects which carry a monthly unit rent of US\$250 or more. This is an important signal to the private sector and will help to ease supply constraints for middle class housing.

Export Incentives

12. In 1982, the Government established a National Investment Council to promote export industries and assist investors in dealing with the local bureaucracy. The Council is headed by a leading Panamanian businessman. In the relatively short time since beginning operations, it has already been successful in attracting a number of investors to Panama despite the difficult international economic climate. The Council is to receive a substantial amount of technical assistance from USAID to enable it to expand its promotion activities abroad.

^{8/} This Office, although theoretically under the authority of the Ministry of Commerce and Industry, enjoys a considerable measure of political autonomy.

73. Direct export stimulation is difficult in Panama, as the exchange rate mechanism cannot be used and there is a fiscal constraint to export subsidies. At present, the tariff protection afforded to domestic production activities is counterbalanced by an export incentive in the form of redeemable tax certificates (CATs), currently 20 percent of the value added of non-traditional ^{9/} exported goods. The CATs are negotiable and their holders may use them to meet a variety of tax obligations. Despite complicated and lengthy application procedures, CATs are considered an important incentive by the private sector and have undoubtedly contributed to the recent growth in manufactured exports. ^{10/} The authorities are studying a simplification of the process for obtaining CATs and relating their value to the wage bill of the factory workforce. This will provide incentives not only for exports but for employment also. Moreover, an appropriate mechanism will be devised for compensating exporters for their loss of import duty exonerations. The new incentives system is expected to be ready for inclusion in the new draft industrial legislation by the end of May, 1984 (para 68). Considerable care will be taken to prevent discrimination against smaller firms with lower paid workers and adverse fiscal repercussions. The Government would aim to finance additional expenditures on the export/employment subsidy by the extra revenues generated by replacing quotas by tariffs and eliminating import duty exonerations.

Employment

74. In its efforts to stimulate employment, the Government attaches much greater importance to improvements in the investment climate than attempting to reduce costs by direct intervention in the labor market. Panama will likely remain a relatively high wage center, even with a labor subsidy. This has to be counterbalanced by stressing its compensating comparative advantages, and by reforms in labor legislation (para 61). Despite its political sensitivity, the Government has already introduced some modifications in the Labor Code's interpretation, while small firms have been exonerated from severance payments. The Government has established a Legal Commission, headed by the Attorney General, to examine further possible changes in interpretation. With a view to more fundamental reforms, it intends to commission a study, financed by USAID, to ascertain the extent to which private investment and job creation have been discouraged by the Code, and to suggest appropriate modifications. The results of the study will be available to the Government before the end of 1984.

^{9/} Principal traditional exports are bananas, sugar, shrimp, coffee and fishmeal.

^{10/} Since 1974, when the CATs were introduced, non-traditional exports have increased at a rate of 21.5 percent per year (albeit from a low base) compared to 4.8 percent for total exports, and the proportion of non-traditional exports benefitting from CATs has risen from 36 percent to 67 percent.

D. Agricultural Policy

Overview

75. For a considerable period of time the agricultural sector has been the least dynamic of the Panamanian economy. Its average annual growth from 1970-72 to 1980-82 was only 1.7 percent, compared with 5.7 percent for non-agricultural GDP. This reflects the duality of sectoral policy in the 1970's, which attempted to transfer income to specific rural groups as well as stimulate higher output. This low growth occurred despite the investment of substantial public resources, both in terms of finance and personnel. The total number of public employees in the sector is nearly 7,600; 5 percent of the total agricultural labor force. The 1982 budget for the Ministry of Agriculture and Livestock Development (MIDA), and the autonomous and semi-autonomous agencies operating in the sector, is about US\$175 million, over 40 percent of agriculture's value added.

76. During 1969-73 the Government undertook an ambitious land reform; over 16 percent of Panama's land changed hands in 5 years. More than 140 agrarian reform settlements (asentamientos) were formed on this land, and considerable government attention was paid to them. The lending of the state-owned agricultural bank was increased rapidly, and much of its lending went to them. Asentamientos were linked strongly to the political system, while new institutions were formed to assist in marketing their output. Even the traditional services of MIDA were channelled towards their needs during the 1970s. Because the asentamientos produce almost entirely for the domestic market, most MIDA policies emphasize import substitution. To encourage exports, the Government made major investments in three new sugar mills, took over a financially weak citrus establishment, and opened new state enterprises in bananas and other export crops. Unfortunately, these actions resulted in many unrecoverable loans, an inflexible price support system, and poorly managed state enterprises. An indirect, unquantifiable cost was the adverse effect they had on the previously buoyant private agricultural sector.

77. There is no agronomic reason why considerably higher rates of agricultural growth--perhaps as much as double historical rates--cannot be reached. Such a goal would imply production based more on Panama's comparative advantages and less on protection against foreign competition. Panama's long term advantage seems to lie principally in: (a) forestry in the central mountain areas, based on reforestation with fast growing lumber and pulp species; (b) dual purpose semi-intensive cattle raising in the central and western coastal plains and foothills; (c) small scale, labor intensive production of tropical export crops (e.g. coffee, cacao), and of temperate zone vegetable and fruit crops in the upper altitudes; and (d) equally small

scale, labor-intensive growing of selected vegetable and fruit crops with irrigation near the rivers of the central provinces. Movement toward this, or a similar output pattern, would reduce the importance of crops with marked seasonality of employment, such as sugar cane, which have high labor costs during peak periods.

78. The Government is aware that the execution of this development strategy implies the need for a fundamental change in agricultural policy which would orient the sector towards higher productivity and output. This new policy aims to increase productive employment in agriculture, reduce the costs of basic foodstuffs by increasing efficiency and productivity, and expand exports. The specific measures to achieve this include: (a) reducing price controls and subsidies to inefficient producers; (b) separating policies aimed at improving the social welfare of the rural poor from production policies; (c) revising the role of public institutions in agriculture to achieve these objectives; (d) reducing and eventually eliminating subsidies for state-owned agricultural corporations and enterprises; and (e) increasing productivity through more effective and selective research and technology transfer.

79. A number of important reforms have already been carried out, covering public sector institutions in agriculture, the legislative framework, and pricing and trade policy. However, further progress in the execution of this complex program is considerably impeded by lack of knowledge. Accordingly the Government is accompanying specific measures with a series of studies to determine how best to ameliorate many of the sector's remaining problems.

The Public Sector Institutions

80. State intervention in Panama's agriculture extends from the MIDA itself, to credit and marketing and to direct production by parastatal enterprises. While much of MIDA's efforts are directed towards the asentamientos, it has neglected the bulk of small and medium-sized farmers and thus many of the rural poor. Moreover, it has not developed the capacity to analyze policy or to guide and coordinate the rest of the state sector in agriculture. Consequently each entity tends to take decisions in a policy vacuum. The Agricultural Marketing Institute (IMA) is primarily involved in implementing the Government's pricing policies (para 85). The Agricultural Development Bank (BDA) is practically the sole lender to small and medium-sized farmers, reflecting the lack of interest of other banks. Most of its lending goes to rice producers, and only a small proportion is directed towards crops where Panama has a greater comparative advantage. Because of excessive lending costs (estimated to be 6 percent), it operates at a loss despite charging a strongly positive rate of interest ^{11/}. The Institute for Agricultural Research, IDIAP, focusses on traditional crops such as corn and rice and has paid inadequate attention to the special agronomic problems of Panama. Another service institution, the Agricultural Machinery Enterprise, INDEMA, hires out agricultural equipment at heavily subsidized rates with priority given to asentamientos. The most important directly productive state enterprise is the La Victoria Sugar Corporation (CALV), which consists of four mills, three of them built during the 1970's. Total milling capacity is some 18,000 tons per day. CALV has required large

^{11/} 9 percent as of June 30, 1983.

subsidies every year since 1975; 1982 operating losses by the Corporation were about US\$40 million, 8.6 percent of the total public sector deficit. Other state producers are the Chiriqui Citrus Company, the Bayano Development Corporation, and two banana producers, COBAPA and COBANA; all have required operating subsidies.

81. The Government's comprehensive review of state enterprises in the agricultural sector has resulted in a number of important actions, reducing subsidies by about 10 percent of the 1983 public sector deficit:

- On March 12, 1983, the Government announced the closure of the Felipillo sugar mill, the largest and most inefficient of the CALV complex. Felipillos' losses in 1982 amounted to US\$15.5 million (39 percent of the Corporation's total). At the other mills, the harvesting season was cut short. The average cost per pound of sugar produced by CALV as a whole in 1982 was just over 30 cents; at Felipillo it was 48.5 cents. This compares with an average FOB price, received by Panama, of 22.5 cents per lb. The closure of Felipillo is the first step in a rationalization program for the Corporation as a whole. This program will be further developed, as a result of the studies of agricultural institutions financed under the proposed Technical Assistance Loan.

- In 1982, the state-owned banana corporations COBAPA and COEANA ^{12/} were closed down generating savings of about US\$1.5 per year in subsidies. They had incurred heavy losses since 1980 following a change of management, labor problems and marketing difficulties. COBAPA's plantation in Chiriqui Province occupied about 1,300 hectares which previously belonged to the United Brands Corporation. The bulk of Panama's banana crop is currently produced by United Brands on their existing Pacific Coast plantation of some 10,000 hectares, and by independent producers.

- At the beginning of 1983, the Government announced that state subsidies for the Bayano Development Corporation (BDC) and the Chiriqui Citrus Company would cease, involving a saving of just over US\$1 million per year. The BDC was created in 1975 to protect the watershed of the Bayano hydroelectric reserve, and to develop the lands around the reservoir. Most of its output consists of timber, rice, sugar cane and beef cattle. Despite substantial capital expenditures, yields have remained generally low. BDC's financial situation, already weak from poor operating results, has suffered from heavy outlays on technical assistance to tenant farmers and social services to surrounding rural communities. The Chiriqui Citrus Company incorporating orchards and a processing plant, was taken over by the Government after it was abandoned as unprofitable by a US corporation. Initially, after takeover, it suffered heavy operating losses; however, these have been reduced in recent years. Alternatives for disposing of BDC and the Chiriqui Company will be studied under the proposed Technical Assistance Loan.

^{12/} Although they were two corporations, COBAPA managed both operations since 1979.

- A number of actions have been taken to reduce losses at the Agricultural Development Bank (BDA). A new management team, appointed in August 1982, is making a serious effort to reduce the number of bad debts in the bank's portfolio. Recent credit restrictions will lower the bank's lendable funds to about US\$33 million in 1983, compared to US\$44 million in 1982. No further access to commercial bank credit will be permitted. This tightness of funds will force the bank to be more selective in terms of credit risks. The interest rate subsidy has been reduced from 7 to 3 percentage points since 1981, and is now wholly financed from a surcharge on all other commercial loans by the banking system. Losses will be further reduced in 1983 by increasing to 95 percent the proportion of new loans covered by adequate crop insurance.

82. Further institutional reforms would be determined with the assistance of a comprehensive study of agricultural institutions, financed by the proposed Technical Assistance Loan. The study would aim to reveal the main institutional factors impeding the implementation of the Government's new agricultural strategy, and the extent to which policy discourages higher output. Using its recommendations, the Government will adopt measures to ameliorate many of the sector's remaining problems. Specific issues to be addressed will include:

- Design of a management system to provide more effective coordination of the state institutions in the agricultural sector;
- Creation of a more viable and financially sound Agricultural Development Bank;
- Reducing state intervention in marketing and eliminating some state marketing monopolies.
- Reducing wholesale and retail price controls of agricultural and agroindustrial products;
- Institutional strengthening of the reformed settlements and conversion of some of them into cooperatives or individual land holdings in accordance with the law;
- Strengthening the capability of the Agricultural Research Institute;
- Strengthening formulation and execution of policy in the forestry subsector.

Agricultural Legislation

83. The Government has undertaken to drastically revise the Agricultural Incentives Law. Just as policy in the industrial sector is dominated by the provisions of Law 413 (para 68), so the Agricultural Incentives Law encapsulates the philosophy of past agricultural policy into one legislative instrument. According to the Law, imports of foodstuffs are quantitatively restricted and annual percentage targets are established for

their replacement by home produced goods. Price controls on the family food basket are maintained. The Law permits and encourages state intervention in factor and input prices, capital markets and agricultural production. The existence of this Law is clearly contrary to the new development strategy for the economy and the sector, and the actions described in paragraphs 81 and 86 are against its spirit if not its letter. Accordingly, it is to be substantially modified. The same timetable is to be followed as in the case of the Industrial Incentives Law--a draft version of the new legislation is to be prepared by the end of May, 1984, on which the Bank will be asked to comment. It is the intention to present the proposed new Law to the Legislative Assembly before the end of 1984.

Agricultural Trade and Pricing Policy

84. The principal objective of the Government's new trade and pricing policy for agriculture is to reduce resource misallocations, and hence stimulate higher output, by reorienting price signals and incentives towards areas where Panama has a greater comparative advantage. This implies a reduction of the state's role in agricultural marketing, elimination of most monopolies and greater reliance on market forces in determining the allocation of resources among alternative crops. It does not imply a complete disappearance of the state's role in the sector; it is understood that a certain amount of regulatory intervention will be necessary to smooth out sharp fluctuations in supply and the price movements that result from them. In certain specific cases, the authorities also wish to retain the legal capability of quantitatively controlling imports and exports to prevent shortages, and large surpluses resulting from dumping.

85. Previous price policy in the agricultural sector has been oriented towards providing incentives for certain basic products (rice, corn, beans and sugar), in most cases with the aim of achieving national self sufficiency. In order to subsidise domestic consumption, price controls are imposed and restrictions placed on exports of other products (notably, beef and coffee until recently, fishmeal and cacao). This has led to the overconcentration of resources in areas where Panama's comparative advantage is weak while providing disincentives for the production of export goods. Support prices are high, especially for rice, and this has encouraged substantial overproduction plus illegal importing from neighboring countries. In order to finance its rice operation, IMA has a monopoly as importer of maize, onions, beans, sorghum and edible oils, which it directly retails, or sells to private traders. Since mid-1982, however, these profits have not sufficed and IMA's financial situation has considerably worsened due to the large volume of rice accumulated.

86. The Government has already taken a number of important actions to modify its trade and pricing policy in accordance with its overall strategy for the sector:

- In March 1983, the support price for rice was reduced by US\$22 per ton (8 percent). This will discourage surplus production and lead to annual fiscal savings of over US\$4 million. In order to reduce the impact on farmers' incomes of further support price reductions, the Government is introducing a system of production and distribution of

certified seeds with special emphasis on rice, corn and sorghum. This system, which is supported by the IDB, will be ready for implementation in early 1985. It will enable substantial increase in productivity in these crops and thereby permit an accelerated reduction in support prices toward border levels.

- In March 1983, beef exports were liberated. Export quotas had resulted in output stagnation during the 1970s. Prior project work, including a recent Bank study, had underlined the importance of ending the export quota system. Future actions will concentrate on rehabilitating slaughter houses and processing plants to export standard.
- Domestic price controls on the higher quality cuts of meat were lifted in September, 1983.
- The price of potatoes, another major staple, was freed in March, 1983.
- Export quota restrictions on coffee were lifted in September, 1983.
- Milk was previously classified as either Grade A or industrial quality. As a result, low income groups were restricted to extremely poor quality fresh milk. Also, many farmers, technically incapable of producing Grade A milk, had no incentive to improve quality and increase production. In March, 1983, milk was reclassified into three grades, including an intermediate Grade B; the corresponding price adjustments are to be made before the end of 1983.
- In September 1983, import quotas were lifted for five agricultural products and a considerable number of processed items. A timetable for further liberalization measures will be prepared by the end of May 1984, and its approval will be a condition of the proposed second tranche of the SAL (para 63).

87. To assist its efforts in further policy modifications, the Government will cover price and trade policies in its agricultural institution study (para 82). The study will examine the impact of price and trade policies on sector growth, and make detailed recommendations of specific measures. These will be ready for implementation before the end of 1984.

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- In March 1983, beef exports were liberated. Export quotas had resulted in output stagnation during the 1970s. Prior project work, including a recent Bank study, had underlined the importance of ending the export quota system. Future actions will concentrate on rehabilitating slaughter houses and processing plants to export standard.
- Domestic price controls on the higher quality cuts of meat were lifted in September, 1983.
- The price of potatoes, another major staple, was freed in March, 1983.
- Export quota restrictions on coffee were lifted in September, 1983.
- Milk was previously classified as either Grade A or industrial quality. As a result, low income groups were restricted to extremely poor quality fresh milk. Also, many farmers, technically incapable of producing Grade A milk, had no incentive to improve quality and increase production. In March, 1983, milk was reclassified into three grades, including an intermediate Grade B; the corresponding price adjustments are to be made before the end of 1983.
- In September 1983, import quotas were lifted for five agricultural products and a considerable number of processed items. A timetable for further liberalization measures will be prepared by the end of May 1984, and its approval will be a condition of the proposed second tranche of the SAL (para 63).

87. To assist its efforts in further policy modifications, the Government will cover price and trade policies in its agricultural institution study (para 82). The study will examine the impact of price and trade policies on sector growth, and make detailed recommendations of specific measures. These will be ready for implementation before the end of 1984.

PART III - THE PROPOSED LOAN

*Parameters Applicable to
AND 75.0 MM LOANS*

1. Background

88. The proposed loan would support the Government's strategy of structural adjustment and economic recovery. The principal objective of this strategy is to create the environment conducive to directing economic activity towards areas of Panama's comparative advantage. The loan was

prepared during the intensive dialogue with the Government since December 1982, on its structural adjustment program and in close consultation with the IMF. It was appraised in June 1983 and negotiations were held in October 1983. The Panamanian delegation was led by..... Annex III contains a supplementary loan data sheet.

89. The growth of the public sector and the development of Panama's infrastructure in the 1970s, combined with social reform and the effect of international inflation increased the budget deficit, which the Government financed through heavy dollar borrowing. Higher interest rates in the 1980s added to the burden on the budget. Additionally, Government pricing and trade policies and direct intervention in production led to misallocation of resources (paras 15-18). The world recession, the financial crisis in Latin America and local political uncertainties in the last two years have had their toll on the Panamanian economy and Government revenues. Since the second half of 1982 the Government has had to resort to strict fiscal discipline and to retrench its expenditures. With the support of the Bank it has initiated a strategy aiming at accelerating economic development and the creation of job opportunities through remedying existing policy inconsistencies, encouraging private investments, promoting and diversifying exports and improving public sector efficiency (paras 19-23).

B. Relationship with the Government's Short Term Stabilization Program and the Standby Arrangement with the IMF

90. Following two years of favorable trends in public sector finances in 1980 and 1981, a number of internal and external factors contributed to a sharp deterioration in 1982, while the economy entered into a deepening economic recession (paras 19-21). The Government, recognizing the difficulties the country would face for some time, started to take a series of actions in late 1982 and early 1983. These may be divided into two broad groups: structural reforms to enable the economy to meet the challenges of the more difficult international environment of the 1980's; and short term stabilization measures to provide the necessary context of financial stability for the new development strategy. While the latter is supported by the Fund through the Standby-cum-CFF facility (paras 27-28), the Government has requested structural adjustment support from the Bank for the former. This broad division should not, however, obscure the fact that in several important senses the stabilization and structural adjustment measures form an integral part of the same program of economic reform. Both share the goals of a more limited and more efficient public sector, better budgetary and institutional control, a more open and less regulated economy in the productive sectors, and consequently improved resource allocation.

91. During the preparation of the Standby and the proposed SAL, there has been close collaboration between Bank and Fund staff to ensure consistency between short term stabilization measures and medium term structural changes. This collaboration has aimed to achieve complementarity and the best use of each institution's resources. Because Panama uses the US dollar as legal tender and has no independent monetary policy, Fund staff

usually emphasize the reduction of the public finance disequilibrium in their agreements; Bank staff generally concentrate on specific actions, not only in the public finance areas, but in the economic sectors as well. The Bank's identification mission for the SAL overlapped with the Fund mission which negotiated the Standby. Information has been freely interchanged and there have been discussions between Bank and Fund staff on various draft documents including aide memoires, the Government's Letter of Intent and Letter of Economic Policy. The Bank's review of the public sector investment program was included in the Fund's Standby documents. There has been agreement both on matters of general approach and on specific measures. Bank and Fund staff have also worked together in supporting the Government's presentation to commercial banks for a new credit to enable amortization obligations to be met in 1983 and 1984. We will continue to liaise closely with the Fund staff, especially during the monitoring of the 1984 investment budget and action program.

The Structural Adjustment Program and the Proposed Loan

92. The proposed loan would support measures taken by the Government in 1983 and to be taken in 1984 and 1985 as part of its structural adjustment program. Action taken so far reflect understandings reached with the Government during its continuing dialogue with the Bank on economic policy. Most of the measures to be taken in 1984 and beyond require further studies to assist in identifying policy options, strategies and technical assistance for public sector institutions in the economic field. It is therefore proposed that the proposed loan be supported by a technical assistance project to help carry out these studies and activities. In addition, USAID and UNDP are providing technical assistance for the strengthening of the planning capabilities of MIPPE and MIDA, for the strengthening of other public sector institutions and the revision of labor laws. The Pan American Health Organization is carrying out a study financed by IDB, of the Health Systems in Panama, while IDB is also financing an Industrial Sector Study.

93. The specific actions supported by the proposed SAL (set out in the Government's letter dated August..., 1983) were reviewed in detail during appraisal and are summarized in Annex V. Actions already taken by the Government in 1983, include (paras. 32 -....):

- (a) improvement of the planning process and control of investment expenditures for the 1983-85 programs;
- (b) improved control of public sector borrowing through the establishment of a new post of Director of Public Credit in MIPPE;
- (c) substitution of tariffs for import quotas and advalorem tariffs for specific tariffs;
- (d) abolition of support price for rice;
- (e) institution of an intermediate grade B milk for direct consumption;
- (f) abolition of quotas on beef exports;
- (g) initiation of IMF technical assistance to the Customs Administration;
- (h) improvement of the management of the public-owned development finance corporation and agreeing to the restructuring of its ownership, by which the Government will take a minority share;

- (i) discontinuing direct mortgage financing of housing by CSS;
- (j) setting a firm timetable for rationalization of the publicly-owned cement company;
- (k) sale of a major money-losing hotel the ownership of which had passed to the Government in settlement of a Government guaranteed loan;
- (l) closure of an inefficient sugar mill and of a banana corporation;

94. In addition, the following measures are expected to be taken in 1984 and 1985, after completion of the necessary studies and, in some cases, necessary legislative action:

- (a) abolition of restrictions on the export of coffee, fishmeal and cacao;
- (b) further reduction in agricultural support prices and freeing of other agricultural prices;
- (c) reduction in state intervention in agriculture;
- (d) reform and strengthening of agricultural institutions, including BDA and research institutions;
- (e) extension of program of land titling;
- (f) program for conversion of some reformed settlements into cooperatives or individual ownership;
- (g) creation of effective agricultural policy coordination;
- (h) reduction of state role in direct agricultural production;
- (i) issuing new Agricultural Incentives Law;
- (j) issuing new Industrial Incentives Law;
- (k) linking industrial incentives to employment;
- (l) further removal of import quotas;
- (m) dismantling of price controls on industrial products;
- (n) reduction of tariff protection;
- (o) rationalization of the Labor Code;
- (p) reform of the Customs Administration;
- (q) disposal of unprofitable public enterprises;
- (r) reduction of domestic cement price;

(s) restructuring of the capital of COFINA and reforming its management; and

(t) completion of studies for the strengthening of the Health System, and of the Social Security Agency.

Bank review of the studies and the draft Bills for the Agricultural and Industrial Incentives Laws would be conditions for the release of the US\$20 million second tranche of the proposed loan (paraof Schedule 1 to the draft Loan Agreement).

Impact of the Structural Adjustment Program

Economic Prospects with the Program

95. After passing through a period of stagnation in 1983, and of projected slow growth in 1984, the Government's adjustment program will likely return the economy to a new growth path by the mid-1980's. The projections outlined in table 2 assume a gradual recovery in the economies of the OECD countries, with real growth of 2 percent in 1983 and 3.7 percent thereafter ^{12/}. It is also assumed that the majority of Latin American economies resume growth of 5 percent per annum after 1985. These are critical assumptions, particularly with regard to non-traditional and service exports. On this basis, Panama's GDP could grow by 3.5 percent in 1984, and by just over 5 percent per year between 1985 and 1990.

96. The principal engine of growth would be private sector initiative in the industrial and service sectors geared towards export markets. Industrial growth could reach 8 percent by the latter part of the decade, and exports of non-traditional goods, since they start from a very low base, could grow at about 13 percent per year. The greater part of these exports would be manufactured goods. This rapid growth reflects the inclusion of the goods sectors among the beneficiaries of Panama's geographical and institutional advantages. Services could also expand, though at a somewhat lower growth rate than that experienced during the 1970's. The Colon Free Zone will have to become less dependent on the Latin American market although significant recovery there, and in the financial services subsector, will depend upon a resumption of growth in the Region. Value added from the Canal and related activities is expected to be relatively stagnant, although this will be compensated for by diversification into new services activities stemming from the more efficient use and development of the old Canal Zone assets.

97. Agricultural output should begin to expand again as a result of the important institutional and policy reforms to be carried out as part of the structural adjustment program. Growth is forecast at 3.5 percent per year from 1985 onwards, compared to 1.7 percent during the 1970's. Much of the stimulus for growth is expected to come from the livestock subsector, where Panama has its greatest comparative advantage, and which will benefit from the lifting of export restrictions and the introduction of a new intermediate milk grade for direct consumption. Construction and utilities are projected to grow in line with total value added, while government services are to grow more slowly than GDP.

98. The projections imply a decline in investment as a percentage of GDP. This results partly from a sharp reduction in the relative importance of public sector investment, which declines to about 7 percent of GDP by 1990 compared to an average of over 13 percent between 1976 and 1982. The decline also reflects an increase in the efficiency of capital. This stems both from the switch to private from public sector investment, and from a change in the structure of private sector incentives. These will no longer encourage the use of highly capital intensive techniques in inefficient activities.

99. Traditionally, economic expansion in Panama has been fueled to a significant extent by foreign financial resources. This has been facilitated by the openness of the economy and the integration of its financial system with international capital markets. Now, however, the era of easy access to foreign finance is at an end. Commercial banks are clearly anxious to limit their total exposure in the country. The availability of credit to the private sector, therefore, now depends on limiting the public sector's demands as well as on confidence in the economy's future. The structural adjustment program is vital to ensure a continued flow of necessary resources. Public sector savings would increase as a result of institutional reforms and higher tax revenues from economic growth. Public investment would be at a lower relative level and financed to a larger extent by concessionary sources. These improvements would reduce the public sector deficit to just over 3 percent of GDP by 1990, compared to 11 percent in 1982. Moreover, total public sector debt would fall substantially in relation to GDP, and commercial debt even more. Debt servicing would absorb a considerably lower proportion of public sector revenues.^{13/} All these developments would mean a much greater availability of foreign commercial bank credit for the private sector. Its share of total net external capital inflows is expected to increase from 52.5 percent in 1982 to 63 percent by 1990.

100. The openness of Panama's economy, and its importance as an entrepot center, signify a high marginal and average propensity to import. Despite the considerable acceleration in exports, therefore, it is anticipated that the gap between exports and imports of goods and nonfactor services will decline only slightly over the period, from 5.4 percent of GDP in 1982 to 5 percent in 1990. However, due mainly to the decreasing public sector debt burden and reduced interest rate cost to the economy, the overall current account deficit is expected to decline from 12.6 percent of GDP in 1982 to 8.6 percent in 1990.

101. Another important long-term benefit from the structural adjustment program would be higher employment generation. While a quantification of this effect is not feasible with the information available, the difference in total output (21.2 percent by 1990) could be taken as a minimum estimate. The reduction of anti-labor biases which the program contemplates (para 74) will undoubtedly enhance the employment generation effects of the increase in output; accordingly, the relative increase in employment could be considerably higher than that in GDP.

^{13/} Assuming real international interest rates of about 3 percent in the medium term.

102. Finally, attention must be drawn to the assumptions which underly these projections and the inevitable uncertainty which accompanies them. This chiefly concerns the prospects for economic recovery in the Western Hemisphere and in the rest of the world economy. Should this take longer than expected, or should its impact on Panama be weakened by other factors (e.g., higher protectionism, continued reluctance of commercial bankers to lend), then the necessity of the structural adjustment program for Panama's economic survival would become even more clearly pronounced. Furthermore, the positive effects from the program will continue to be felt well beyond 1990. It will be in that later period that the structural transformation of the Panamanian economy will bear full fruit. The analysis presented above can therefore only be a partial estimate of the program's potential impact on Panama's future development.

Economic Prospects Without the Program

103. In the Structural Adjustment Program, important steps have been and are being taken with regard to liberalization of the economy, the encouragement of private investment, reorientation of incentives towards exports and employment, and improved resource allocation through the strengthening of the market system and greater public sector efficiency. In the program's absence, private sector confidence, and hence investment, would likely remain at a very low ebb. The extent to which the public sector could compensate for this would be limited by the availability of credit. Under these circumstances, the inflow of external capital would be drastically reduced and total investment would fall by over half in 1983 and 1984. From 1985 onwards some recovery could occur; however, in the absence of the proper environment, investment in real terms would still be 25 percent less by 1990 than in 1982. Furthermore, the investment that would take place might well be far less efficient. The share of the public sector would increase to over 50 percent, while the private sector would be limited to services, and industries geared to the local market. The incremental capital/output ratio could very well remain at high historical levels.

104. The consequences of these trends are clearly shown in table 2. Growth of GDP would be around 2 percent per year for the period as a whole, implying a decline in per capita incomes. Due to lower savings and a higher relative level of public investment, the public sector deficit would be more than double that forecast under the program. The public sector external debt would increase in relation to GDP, and the decline in the debt servicing burden would be insignificant, reflecting only marginal changes in assumed interest rates. In the absence of incentives and confidence, the productive sector of the economy would continue to stagnate and exports would increase by even less than GDP.

105. Even this gloomy scenario is probably optimistic in that it assumes that a public sector deficit of some 6 or 7 percent of GDP could be sustained despite very low growth rates. In reality the authorities would find it acutely difficult to finance such a deficit, and would be forced to reduce current and capital outlays accordingly. The resulting economic contraction would not only feed back on public sector revenues in a downward spiral, but would also lead to a deepening social crisis. The point would soon be reached where the country would no longer be considered creditworthy and would be unable to meet its external obligations.

E. Benefits and Risk

106. The main benefits of the SAL would be the expected reorientation of the Panamanian economic activity and incentives towards areas of Panama's comparative advantages in agriculture, industry and services, and the redirection and strengthening of public agencies towards supporting these activities. Major agencies that would benefit would be MIPPE, MIDA, the Customs Office, the Social Security Agency, institutions working in the agricultural sector, COFINA and the Integrated Health System. The environment would also be provided for the private sector to invest in areas of Panama's comparative advantage. This should pave the way for sustained economic development, and would increase job opportunities, resource inflows and Government revenues, as well as reducing wasteful expenditures and subsidies.

107. The main risk associated with the SAL is possible delays in implementation of the recommendations to be agreed after completion of the technical assistance studies. Such risk is in fact minimal since a consensus exists in the Government and in major opposition parties on the need for the new direction of the economy. In addition progress of the studies and their policy recommendations will be closely monitored and we plan to maintain an intensive dialogue thereon under both the SAL and the proposed Technical Assistance project. The Technical Assistance project is designed to ensure close involvement of staff of beneficiary agencies in carrying out the ensuing recommendations and reforms.

F. Loan Amount

108. The proposed loan of US\$60.2 million (including the capitalized front-end fee) would meet about six percent of Panama's total gross external capital requirements for 1983/84, and would finance just over two percent of the merchandise imports for the two years.

G. Disbursement and Procurement

109. The proposed loan of US\$60.2 million equivalent would be disbursed in two tranches. The first in an amount of US\$40.2 million equivalent would be made available upon effectiveness of the Loan Agreement to finance the CIF cost of eligible imports and the front-end fee. All imports into Panama from eligible countries, except for military equipment and luxury consumer goods would be eligible for financing. The second tranche of US\$20 million equivalent would be made available upon satisfactory review of the progress of the technical assistance studies and the draft Bills of the Agricultural and Industrial Incentives Laws (paras 68 and 33).

110. Disbursements would be made against Customs Declarations evidencing importation of the goods to be financed and their countries of origin. Public and private sector imports would be eligible for financing. All purchases under contracts of US\$5 million equivalent or more each would be procured through international competitive bidding. Public sector imports under contracts below US\$5 million equivalent would be in accordance with standard Government practices, which ensure adequate competition. Private sector imports under contracts below US\$5 million equivalent would follow normal commercial practices.