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ECONOMIC ASSISTANCE STRATEGY

PANAMA

1991 TO 1996



MAY 1991

USAID/PANAMA

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EXECUTIVE SUMMARY

"The morning hours of December 20, 1989 marked the end of 21 years of military dictatorship in Panama."

The morning hours of December 20, 1989 marked the end of 21 years of military dictatorship in Panama. The legacy of this period, one quarter of Panama's short history as a nation, was profoundly disturbing. The narco-dictator was out, but the Panamanian people and their

newly installed, democratically elected government were left with the task of rebuilding a nation characterized by:

- Corrupt, dysfunctional, overstaffed and bankrupt public institutions;
- Severe economic policy distortions, the product of years of populist leadership, special privileges, political favors, and the influence of drug interests;
- Isolation from official and private international capital markets, a paralyzed banking system, a \$1 billion GOP overdraft in the National Bank and \$5.5 billion in external debt;
- Severely deteriorated public infrastructure;
- An alarming rate of deforestation exacerbated by a corrupt military leadership

The United States paid for the restoration of Panamanian democracy in blood: 23 American lives were lost. In taking this measure, the over-arching long term U.S. objectives were obvious: restore democratic rule and political stability to Panama. In

Panama these objectives take on a singular importance for the U.S. given the unique historical relationship between our two countries deriving from the Canal and the role of the U.S. in Panama's independence. Preservation of the integrity and operations of the Canal was clearly another consideration in deciding to remove Panama's narco-dictator.

The Panama Canal Treaties call for the complete turn over of Panama Canal operations at noon, December 31, 1999. A stable, democratic and prosperous Panama is essential to the successful implementation of these treaties and to the continued operation of the Canal under Panamanian ownership. The Panama

"The Panama Canal Treaties call for the complete turnover of Panama Canal operations on December 31, 1999."

development strategy flows from this premise and calls for a narrow focus on the following three strategic objectives:

- Consolidation of democratic processes and institutions, including all elements of the judicial system;
- Economic diversification and export-led economic growth; and
- Successful implementation of the Canal Treaties.

The A.I.D. program resources required to achieve the CDSS objectives should be relatively small, roughly \$15 to \$20 million per year in Development Assistance funds and \$10 million per year in ESF for police training and equipment and improvement of the corrections system. Panama's comparatively high per capita income, its dollar-based economy and its position as an international banking center put the country in an enviable position vis a vis other countries in the region. After the initial injection of capital provided by the FY 1990 Dire Emergency Supplemental, Panama should be able to obtain its capital financing needs from other U.S.G. sources such as EX-IM and OPIC, private international capital sources and the International Financial Institutions (including EAI funded programs). This argues strongly against the allocation of large ESF capital transfers for Panama from declining A.I.D. resources.

The A.I.D. development strategy for Panama thus calls for a program of institutional and human resource development, primarily composed of technical assistance and training to support genuine Panamanian reform initiatives. The program will be managed by a small USDH staff (10 persons starting in 1994) made possible by program discipline and focus, i.e., by not seeking to be all things

to all people. The Panama Mission might be viewed as an experiment in doing less with less in keeping with declining A.I.D. resources, changing geopolitical realities and the promise of accelerated private sector led growth offered by the trend toward economic liberalization in Latin America economies.

I. DEVELOPMENT AND DEMOCRACY IN PANAMA - A COUNTRY IN TRANSITION

A. THE LEGACY OF THE DICTATORS

"Panama is not a country, it is a business."

"Panama is not a country, it is a business." This oft quoted phrase well describes Panama during the 21 years it suffered under the extremes of corruption and repression of military rule. All civil institutions,

including the justice system, were subservient to the military and, at best, were only permitted to function in a marginal sense or when it was convenient or the military. Elections under the military were consistently marred by blatant fraud. The public treasury was looted and corruption was rampant. Under Noriega's mafia-like leadership, Panama was not just a "business," it was a criminal business. Respect for human rights and freedom of the press were eroded during the Torrijos years and finally under Noriega all pretense of democracy was discarded. By 1989, civil and political rights were essentially nonexistent.

The "economic development strategy" of the military leaders responded to populist themes with little consideration for economic consequences. To reduce unemployment, the government enacted populist laws providing for costly increases in education and retirement benefits with no regard for their impact on the national budget. The labor force participation rate for those between 10 years and 24 years of age fell by 10 percent, and by a like amount for those 55 and older. Public sector patronage soared with public employment almost quadrupling from 42,000 in 1971 to a peak of 157,000 in 1989. Public sector borrowing soared.

Heavy public expenditures on social services did produce commendable gains in health and education at first. The level of social services, however, deteriorated in recent years because funds were no longer available to maintain them. One serious consequence of the dictators' "strategy" has been indebtedness: the government's debt increased twenty-fold between 1978 and 1989.

Thus, on December 21, 1989, the coalition leaders, Guillermo Endara, Ricardo Arias Calderon and Guillermo Ford, took office only to find an empty treasury, a bloated public payroll, an economy in shambles, 30-40 percent unemployment, \$5.5 billion of external debt (one of the highest per capita debt burdens in the world), corrupt

and bankrupt public institutions, no security force to help maintain order, and an entire generation of Panamanians who had never experienced democracy; a daunting picture, but one that needs to be understood to appreciate what has been accomplished in the coalition government's first year and what yet needs to be done.

B. 1990: A YEAR OF POLITICAL TRANSITION

The leaders of Panama's elected civilian government are successful professionals but first time entrants into the business of government. President Endara is a lawyer by training; First Vice-President Ricardo Arias Calderon, a professor; and Second Vice-President, Guillermo (Billy) Ford has a background in banking and insurance. On December 21, 1989 the Government of Panama consisted of these three men. They faced the formidable task of political reconciliation and guiding Panama on the path from military dictatorship to institutionalized democratic government.

"On December 21, 1989 The Government of Panama consisted of these three men."

The coalition was forged on the basis of a common enemy: Noriega, the narco-dictator. With Noriega gone, the coalition

leaders, not surprisingly, are now struggling to find the statesmanship, cohesion and political will needed to accomplish their historical task and implement fundamental political and economic reforms.

The legislature is made up of 67 legislators, most of whom are serving for the first time in such a capacity. The assembly has quickly established itself as a serious branch of government, fully intent on playing its rightful constitutional role. It is not the rubber stamp assembly of the past and is given to lively debate and controversy in good democratic fashion.

The judiciary is the weakest branch of government, particularly after two decades of corruption and mismanagement. It inherited a backlog of 16,000 cases and now struggles to cope with these cases plus over 30,000 new cases filed since December 1989. Added to this burden are a lack of trained judges, prosecutors and public defenders; outmoded procedures; and severe budgetary constraints. Of the three branches of government, it has received the harshest public criticism for lack of movement.

The old Panama Defense Force (PDF) was dismantled as a result of the U.S. military action. The once omnipotent PDF lost its stranglehold on the government. The Endara government purged some

500 of the PDF's most senior officers including all colonels, lieutenant colonels, and 80 percent of the majors, a process which continues as of this writing. The total number of security personnel was reduced from 17,000 to 12,000. What remained of the old PDF was broken up into separate entities under civilian control: the Panamanian National Police Force (PNP); an Air Service; a Maritime Service; and the Judicial Technical Police. Most of the remaining troops were turned into police officers in the new PNP, supervised by a civilian chief under the Ministry of Government and Justice. The process of converting these old PDF troops into civilian police, more than anything else, requires a fundamental change in attitude and self image, a process that will take some years to complete.

C. PANAMA AT AN ECONOMIC CROSSROADS

Because of the Panama Canal, transport was the leading sector of the economy well into the early 1970s. Two additional centers of growth then emerged. Banking services grew rapidly once favorable banking legislation was passed in 1970. According to the World Bank, the sector grew by 11 percent per year during the decade, so that by the early 1980s there were 130 banks active in Panama employing over 7,000 people. Similar growth was seen for economic activity associated with the Colon Free Zone. Warehousing, trans-shipment and related free zone activities grew by 14 percent per annum during the same period.

Panama's success in providing services to the international market is evident in its achievement - despite a narrow resource base - of a per capita income (about \$2,000 in 1990) well above those of its Central American neighbors. About 80 percent of GDP is generated from the service sectors, the highest ratio in the world according to the World Bank. Production and export of services will continue to play an important role over the medium term, despite the sector's lackluster performance in the recent past. The off-shore banking center underwent a secular decline during much of the 1980s, reflecting both political instability and economic problems within Panama and the general scaling back of international bank operations in Latin America.

"About 80% of GDP is generated from service sectors, the highest ratio in the world according to the World Bank."

Agriculture and manufacturing are less important than elsewhere in Central America, and only contribute about 10 percent each to GDP. The small size of these two sectors results largely

from Panama's restrictive policy environment. Businessmen in these sectors confront price controls and government intrusion in all aspects of marketing and production.

The general inefficiency of the Panamanian economy is a complex problem that dates back to the 1970s or earlier. The incremental capital-output ratio (the number of units of investment required to increase output by one unit) rose from 4.5 observed in 1965-73 to 6.0 in 1973-80 and to 9.2 during 1980-85. A USAID-financed study of the sources of growth in Panama concluded that the decline in efficiency during the 1970s amounted to the equivalent of over 35 percent of GDP.

External factors such as reduced Panamanian service exports arising from stagnation of the world economy account for part of the loss in efficiency. Of greater interest, however, are inefficiencies resulting from misguided public policy, i.e.:

- Public resources are not well allocated, particularly in the public enterprise sector;
- There is excessive public sector involvement in private production decisions and price-setting;
- Trade and commercial policies are highly protective and biased against export, and
- Both the labor code and tax structure artificially inflate the cost of employing labor.

Panama must decide between two fundamental growth strategies: muddle along under the existing economic policy regime which is highly protectionist and inward looking; or, join the growing number of Latin countries that are opening their economies to compete in the global market place. The former is politically less costly in the short term and will likely produce a growth rate slightly higher than the population growth rate. However, it is not likely to generate the employment needed to absorb the currently unemployed and new job seekers. The latter option will require a great deal of political resolve since it will gore a number of sacred economic cows that benefit from the current structure. But it also will allow Panama to take full advantage of its enviable resource base and optimize economic growth over the medium to long term.

II. PROBLEM ANALYSIS AND DESCRIPTION

A. THE PROBLEMS OF DEMOCRATIC TRANSITION

The restoration of an elected government in Panama is only the first step on the path towards a stable and truly democratic society. At this point Panama's democracy is immature. Panama is still largely governed by individuals, albeit individuals strongly dedicated to democratic principles. Political parties respond to the leader of the hour rather than some set of party principles. All the institutions that make up the foundation of a durable and lasting democracy have been devastated. In a real sense the present government of Panama faces many of the same challenges as the founding sponsors of U.S. democracy, including fundamental constitutional issues and the need to develop a government that functions on the basis of institutions and laws rather than personalities.

"...restoration of an elected government in Panama is only the first step on the path towards a stable and truly democratic society."

Private institutions essential to a democratic society face similar challenges. After so many years of repression, freedom of the press has returned with a vengeance in Panama. The Panamanian media needs to raise its level of professionalism in order to serve effectively as society's watchdog over democratic principles. Panamanian labor institutions, so long manipulated by Panama's opportunistic leaders, must establish genuine independence from politics and be responsive to the real long term interests of labor.

In order to ensure an enduring democracy for present and future generations of Panamanians, Panama's new leaders will have to simultaneously pursue the following fundamental changes:

- Install a fair and effective system of justice, starting almost from ground zero.
- Complete the metamorphosis of the PDF from a brutal and corrupt military institution into a responsible, civilian controlled police force.

- Develop the technical and professional capacity of the Legislative Assembly to effectively play its balancing role in the democratic process.
- Develop and install an effective system of institutionalized controls for managing public resources, eliminate deeply ingrained corrupt practices and restore integrity and fiscal responsibility to public institutions.
- Develop a system for insuring free, fair and open elections at all levels.
- Develop a sense of civic responsibility among an electorate that has not experienced democracy nor a fair election in an entire generation.

"Panamanian leaders have much work and many challenges ahead, and many promises to keep, before enduring democracy becomes a Panamanian reality."

Such change will require unity of vision, statesmanship and will. Panamanian leaders clearly have much work and many challenges ahead, and many promises to keep, before enduring democracy becomes a Panamanian reality.

B. ECONOMIC LIBERALIZATION AND MODERNIZATION OF PANAMA'S FORGOTTEN ECONOMIC SECTORS

The years of military rule left an economy in shambles, with declining investment, highly protective trade barriers following import substitution policies, inefficient and narrowly based productive sectors, a bloated and inefficient public sector, a \$5.5 billion external debt and high rates of unemployment. The open unemployment recorded in Panama today is close to 20 percent. The traditional growth sectors - banking, the Colon free zone, the Canal and military bases, and the public sector - offer little hope of being able to absorb the currently unemployed or the new entrants into the work force. The scaling back of public sector employment will only exacerbate this problem. For this reason, the Government of Panama is now seeking to reform economic policy to open up the economy, reduce protection, and promote greater opportunity for agriculture and manufacturing exports.

In areas where Panama's past leadership did decide to move aggressively into international markets, for example banking and financial services, the country has had resounding success in

reforming laws and regulations, and otherwise creating the conditions for rapid growth. Unfortunately, this philosophy was not applied to all sectors of the economy. In agriculture and manufacturing, Panama has operated as a traditional import-substituter. It is a paradox that, in a country with one of the most important international trade assets, the Panama Canal, the industrial and farming sectors are oriented toward a protected, small domestic market.

During 1990, the private sector contributed greatly to the rebuilding effort, buoyed by the restoration of democratic rule and the expectation that the new government would make needed reforms to stimulate economic growth. As a result real GDP grew by 3.4 percent (GOP estimate) to 5.8 percent (private estimate) in 1990.

To restore investor confidence in Panama and assure continued investment and growth, the new government must prove that it is serious about making fundamental economic changes needed to establish a competitive, market based economy, promote economic diversification and expand exports. The GOP must also ensure investors of adequate physical security and public order, one of the advantages offered by a professional, civilian-controlled police force. Under conditions of a coherent economic policy structure, political stability and adequate physical security, Panama should be highly competitive in the world economy in light of the following advantages:

- Panama is close to both U.S. and Latin American markets, and has a strong comparative advantage in transportation;
- The dollar economy provides perfect monetary transparency and reduces the risk for foreign investors;
- The country has a skilled, bilingual work force. Wages are relatively high but they reflect the skill mix and education of the population. The characteristics of the labor force suggest that high technology services have potential as a source of growth;
- Panama has already received valuable land and infrastructure under the Canal treaties including the ports and the railroad. Although they have been poorly managed and maintained, they still represent potentially valuable economic resources; and,
- The transfer of the U.S. military base properties will bring important new infrastructure and lands that offer significant opportunity for economic exploitation.

C. TRANSFER OF THE CANAL, AND DEFORESTATION

Panama also faces the task of preparing to assume full responsibility for operation of the Canal in less than nine years, including receipt of base facilities and other assets to be turned over in accord with the Panama Canal treaties. Closely related to the Canal transfer issue is the need to halt deterioration of the Canal watershed. The new government must focus on the watershed area and its natural resource base. While Panama has a set of policies, laws, and regulations designed to protect the environment, they are not enforced. In 1947 Panama's forest coverage was 70 percent; in 1989, 38 percent. If unchecked, the present rate of deforestation will reduce forest coverage to 10 percent by the year 2000. About 1,000,000 hectares or 14 percent of Panama's total land area is nominally under the control of national parks. While the country has a Tropical Forest Action Plan developed with the FAO, the GOP lacks the resources to carry out the plan. The National Institute for Renewable Natural Resources (INRENARE) has only 10 operating vehicles and 49 park rangers to patrol one million hectares.

"In 1947, Panama's forest coverage was 70%; in 1989, 38%. If unchecked, the present rate of deforestation will reduce Panama's forest coverage to 10% by the year 2000."

Destruction of forests in the Panama Canal watershed is increasing the rate of siltation of Madden and Gatun lakes. These lakes provide water for the Canal, Panama City and Colon, and are sources of hydro-electric power. The alarming rate of deforestation in what is left of Panama's tropical forests presents a serious threat to bio-diversity as well as future economic growth.

The issue of adequate public security and order also relates to the long term viability of the Canal. The Canal's competitive advantage depends heavily on shipper's confidence that the Canal will continue to operate within a stable and secure environment. Anything less will prompt shippers to consider other options to inter-ocean traffic.

III. U.S. DEVELOPMENT ASSISTANCE STRATEGY FOR PANAMA

A. STRATEGIC OBJECTIVES

The three strategic objectives for the Panama economic assistance program identified by the Mission are:

- Consolidation of democratic processes and institutions, including all elements of the judicial system;
- Economic diversification and export-led economic growth; and
- Successful implementation of the Canal Treaties.

These strategic objectives are interdependent. Political stability requires public institutions and an informed electorate that function effectively in carrying out their respective mandates in a democratic society. This ranges from the most basic responsibilities of enacting fair and equitable laws and enforcement of those laws, to the management of public resources (financial, human and natural). A professional, civilian-controlled police force is a *sine qua non* for public security and social stability. A secure and stable environment is, in turn, essential for the confidence of investors and Canal users and the employment opportunities and incomes that they offer. Adequate employment and incomes, in their turn, are fundamental to social and economic stability.

The relationship between the United States and Panama began with Panama's independence, when the United States was the first country to recognize it as a sovereign nation. The initial focus of our relations with Panama was the Canal. Now, even though the special relationship between our two countries is no longer solely tied to the waterway, it continues to be the single most important element in our bilateral relationship with Panama. Both countries have strong interests in a successful transition of the Canal from U.S. to Panamanian ownership in 1999. Panama must produce a plan to incorporate the Canal and its operations into its economy. This task dwarfs the planning that must be done to ensure a successful transition of Canal management from the U.S. to Panama.

The strategy thus focuses on developing democratic institutions and diversifying and protecting the Panamanian productive base. This focus is fully in keeping with Enterprise for the Americas Initiative (EAI) objectives of trade, investment and debt reduction as well as the development and democracy objectives of the Partnership for Democracy and Development (PDD)

initiative. This is particularly true in the areas of public and private sector institution building and support for Panama's economic integration with its Central American neighbors. It is important to note that Panama is by no means yet convinced that it should be a full partner in Central American integration.

To the extent that the PDD is successful in coordinating and rationalizing development assistance to the Region as well as the individual efforts of the Central Americans themselves it will serve to complement and enhance the effectiveness of the U.S. bilateral programs. The themes addressed in the Panama strategy also closely parallel those set forth in the Central American Assistance Strategy.

The only active programs that existed when the Mission was reopened in Panama in February 1990 were CAPS and scholarship programs with two local PVOs (which were ably managed by a small FSN staff during the absence of USDH staff). We are thus blessed with the opportunity to design the Panama program for the 90's from the ground up. We will limit our activities to only those that directly support the strategic objectives identified above. This means that traditional projects in areas such as rural health, basic education, and family planning will not be part of the USAID/Panama program.

B. CONSOLIDATION OF DEMOCRATIC PROCESSES AND INSTITUTIONS

- Sub-objective: Strengthen competent, civilian government institutions, including inter alia the Attorney General's Office, the court system and the National Police, so that they merit the confidence of political leaders, citizens, and investors.

- Sub-objective: Encourage pluralism and public support for democratic values and processes by governmental and nongovernmental bodies including the press, labor unions, political parties, civic organizations and business associations.

1. Implementation Strategy

Policy dialogue in support of democratic initiatives and Panama's transition to a stable and democratic society must be carried out in close concert with other relevant U.S.G. agencies and the country team. A.I.D., with its experience in supporting democratization initiatives throughout Central and South America, has some comparative advantage over other U. S. agencies and donors in this area. To this end, we will seek to take advantage of relevant regional programs. Wherever appropriate, USAID/Panama,

with LAC support, will also consider cost-sharing and complementary support of major democratic institution-building activities with other donors, including the European Community (EC) and the Japanese, who have recently expressed greater interest in supporting democratization.

Support for democratization must be internalized. Even within the context of continued budget austerity throughout the 1990's, the lion's share of financial support for a program of democratic strengthening must come directly from the Government of Panama. A.I.D. assistance can help develop master plans for building democratic institutions and offer the know-how and the appropriate mix of skills; however, the commitment to democratic change and political resolve must come from the GOP and the Panamanian people. Given the high level of support received by the democracy strengthening program to date, we have every reason to believe that the level of commitment necessary will be forthcoming during the CDSS period.

USAID/Panama will pursue a focussed institutional development strategy. Primary targets for interventions in the public sector are: the judicial system including the police and corrections; the legislature; the electoral tribunal; and selected executive branch organizations specifically related to financial management, tax administration, and economic policy. We will also work with private civic organizations and labor unions to foster greater understanding of democratic institutions and processes.

The constraints that need to be overcome, across the board, relate to poor management; excessive, inexperienced and poorly trained staff; and, inefficient and ineffective coordination among agencies and between the various branches of government.

The justice system was virtually destroyed by years of neglect, mismanagement and corruption. The problems and constraints facing the system are many and well-known. The efforts of A.I.D. to strengthen the Judiciary and the Public Ministry, and of ICITAP to improve the Panamanian National Police and Judicial Technical Police, form the core of our strategy to support the consolidation of democracy in Panama. A fair and efficient system of justice is necessary to a country's economic development, to generate confidence that human rights will be respected, crime punished, contracts honored, and respect for law will prevail over special interests. Citizens and investors alike must have confidence that public security and order will be maintained by professional and competent law enforcement agencies. Current A.I.D. and ICITAP programs continue until FY 94-95. USAID/Panama may eventually direct resources to areas related to civil and commercial law. Also, a mechanism and legislative authority to

provide assistance to the corrections system is necessary. Corrections infrastructure is in a state of decay, overcrowding is the norm and violence in the system is endemic. A trained civilian guard service is needed along with modernized management practices. To support these efforts, we will encourage the GOP to fulfill its responsibility by ensuring adequate budgetary support to the judicial modernization efforts initially financed with U.S. resources.

Democratic pluralism carried out through the active participation in society by a number of nongovernmental bodies strengthens and supports governmental institutions. In Panama, except for the business associations, there are very few nongovernmental democratic groups capable of participating in public dialogue and policy debate. Those organizations which do exist are new and have few resources and little knowledge in organizational skills. Also, while there may be a large number of labor unions and political parties; the internal dynamics and functioning of these are often non-democratic. Furthermore, a whole generation of Panamanians came of age in a period of dictatorship and is unfamiliar with the ways and values of a democratic society. Labor unions, the media, and even political parties need to evolve into responsible actors in public policy debate. Civic organizations, including free and democratic labor unions will need to be strengthened to more effectively represent their constituencies and to foster a broader understanding of the democratic processes and practices, especially among youth.

In the executive branch, restoring the integrity of public sector financial management is an urgent concern, given the legacy of the Noriega regime. USAID/Panama is now assisting the Controller General to upgrade the quality of financial management and to initiate an independent, standardized post-expenditure audit program for the GOP. Due to the magnitude of the problem, bringing the GOP financial management and budgeting system into the twenty-first century will require follow-on assistance and a GOP commitment to institutional reforms needed to ensure transparency and integrity in the management of public resources.

Tax administration in Panama is an area of very little public confidence at the present time. Constraints include insufficient and improperly trained staff, antiquated equipment, and inappropriate use of scarce resources. Policy reform coupled with improved administrative procedures is now being pursued by USAID/Panama and other donors. Additional attention in the medium term is expected to yield substantial benefits in permitting government functions to be financed with less recourse to borrowing.

In the area of economic and public policy reform, donor assistance in the past has generated studies of needed reform with little tangible action taken to implement the recommendations. Largely, this has reflected a lack of political will. It also reflects a lack of coordination and internal discussion on policy matters within the GOP itself. USAID/Panama will provide institutional support to the Ministry of Planning and Economic Policy to assist in analyzing problems and providing a coherent policy response. One major objective in this area will be to establish the policy framework needed to permit other donor follow-on efforts.

Following improvements in basic accounting and financial management, USAID/Panama's support for public administration will seek to support modernization and improvement in the execution of the budget, personnel policies and procurement procedures. Now, there is no civil service career law. The need for a career civil service is currently being discussed and new legislation is expected in a year or two. USAID/Panama will provide technical assistance and training needed to develop and implement an effective civil service system.

The legislature as an institution was stripped of authority during the military regimes. It lacks support infrastructure, staff, and public respect, all of which hamper its ability to serve as a true representative body in a larger democratic society. It also suffers from many organizational weaknesses such as misunderstood lines of authority and responsibility; lack of internal communication and management information systems; and, lack of adequate support services for legislators. USAID/Panama will help address these weaknesses. Our activities should be complemented with resources and programs available through USIS and other donors such as the Europeans. Also, we will encourage exchanges with Central American legislatures and regional organizations such as ATALCA.

During the CDSS period, there will be one national election and a constitutional referendum. Panama's Electoral Tribunal (TE), therefore, must work to re-establish the respect of the populace and the institutional integrity which is accorded to electoral bodies in a fully functioning democracy. The civil registry and citizen identification system is a mess, voter lists need to be purged, equipment is out of date, management systems at the national, regional and local level barely function, and legislative reform of the electoral code is necessary. Also, the political parties and media must learn to respect the electoral process. With USAID/Panama funding, the initial program of technical assistance and training for the TE will culminate in a major institutional needs assessment of the organization. A master plan

for institutional development of the TE will be developed. The TE will be encouraged to seek other donor support to supplement resources available from USAID/Panama.

2. Monitoring and Evaluation

a. Credible institutions carrying out executive, legislative, judicial and electoral functions free from undue political influence, corruption or intimidation that undermines their independence and integrity - Indicators of program achievement:

(1) By 1996, the National Police functions as a professional, civilian-controlled police force, with a positive human rights record.

(2) In 1994, elected officials complete their terms of office followed by a peaceful transition of government based on free and fair elections carried out by technically competent and nonpartisan electoral officials.

(3) By 1996, legislative and executive branches have a clear understanding of their respective roles and act effectively.

(4) Throughout the CDSS period, the judicial branch operates independently of executive branch control.

(5) By 1996, effective interaction and coordination exists government-wide regarding budget preparation and execution.

b. Operation of adequate systems to foster and maintain professionalism, honesty and continuity in public service - Indicators of program achievement:

(1) Throughout the CDSS period, corruption within public institutions is prosecuted in accordance with the law and administrative regulations.

(2) By 1996, a career civil service and merit promotion system is in place and operational throughout the public sector.

c. Nongovernmental bodies such as the media, labor unions, and civic organizations participate and show tolerance of opposing views in public dialogue on national policy - Indicators of program achievement:

(1) By 1996, the media conduct responsible and informative reporting and analysis of the issues and news in accordance with internationally recognized guidelines.

(2) By 1996, Panamanian labor unions, organized and conducting their internal affairs in accordance with democratic principles, responsibly and effectively represent their membership.

(3) By 1996, widespread familiarity with, and support for, democratic values and practices among the public, including school age children.

C. ECONOMIC DIVERSIFICATION AND EXPORT LED GROWTH

- Sub-objective: Expand employment and exports through diversification of the economy.

- Sub-objective: Improve management of Panama's natural resource base.

1. Implementation Strategy

A.I.D. will work with Panama to eliminate distortions in trade, labor and fiscal policy and to create an environment where products and services can be efficiently produced and are competitive in international markets. This environment encompasses not only regulatory and policy concerns, but also the base of human and natural resources. Rapid degradation of the environment and inappropriate energy policies cannot coexist with the country's plans to expand and diversify production of goods and services, if production is to be sustained over the long term. Achieving the objective of a diversified economy will protect Panama from the abrupt fluctuations excess reliance on a few sectors can bring, and will expand employment opportunities.

USAID/Panama will channel its efforts through both public and private sector institutions to assist Panama to diversify its economy, expand exports and employment, and protect the environment. Program and project assistance will emphasize several areas of opportunity where A.I.D. assistance can be leveraged to achieve change. These areas are:

- Policy dialogue with the public and private sectors for reform of trade policy and other policies which impede competitiveness in world markets;

- Promotion of trade and investment through the private sector;

- Privatization through divestiture and expanded private sector participation in provision of public services;
- Development of the micro and small business sector; and
- Improved management of energy and natural resources.

In the area of policy dialogue, USAID will support GOP and private sector efforts to create an environment where Panamanian products and services can compete in world markets. Competitiveness will depend on liberalization of trade policy, elimination of special privileges and establishment of tax and pricing policies that do not disproportionately inflate the costs of key inputs, particularly energy and labor. Energy cost reduction will require hard decisions about the operations of several public enterprises. In the area of labor, Panama has recognized the need to rethink its restrictive labor code which has substantially inflated the cost of labor in Panama, making it one of the costliest in the Caribbean Basin. These elements of policy change are contained in the current Government's strategy for reform; USAID technical assistance will be critical to the elaboration of the specific reforms and to their implementation.

USAID will also offer assistance to the private sector in the area of trade and investment promotion. Reorienting production from a highly protected domestic market to the "survival of the fittest" in world markets will take time and require painful short term adjustments. The private sector will tend to postpone investment until the new "rules of the game" are firmly established. To attract investment during this transition period, USAID/Panama will promote the development of privately-owned Export Processing Zones (EPZs). Their strong international track record in job creation makes EPZ investment attractive for Panama given its high rate of open unemployment.

USAID/Panama will also work closely with private sector institutions to identify nontraditional high-value export products, by comparing opportunities in international markets with Panama's areas of comparative advantage. Assistance in production technology and export marketing will encourage local producers to take advantage of these opportunities. Emphasis will be placed on the production of intensive agricultural export crops that make the most use of limited resources (soil, water and available infrastructure) as well as environmentally sound industrial production.

In the later years of the CDSS period, the Mission will continue to provide support to the Panamanian private sector to promote trade and investment. Industry and agriculture are

expected to continue as the dominant focus. Nonetheless, given Panama's traditional comparative advantage, export services may also be the target of technical assistance. Possible service exports where USAID/Panama may direct resources are modernization of financial services and tourism.

USAID is actively promoting greater private sector participation in areas traditionally dominated by the public sector. This includes participation in state-owned enterprises and selected central government activities such as the financing and construction of low-cost housing. Privatization is one of the key themes of the current Government's economic program. Not only does the GOP plan to divest itself of a long list of public enterprises, it also is interested in having the private sector take a more active role in areas that will remain under public sector ownership. For example, in power generation, while the GOP will continue to operate the public electric company, it has taken action to encourage private investment in generation, through rehabilitation of old power plants or construction of new ones.

USAID/Panama will assist the GOP in increasing private sector participation in areas that are now being managed or operated solely by the public sector. Private participation can range from management contracts to outright divestiture. We will offer assistance to help in formulating privatization initiatives and to carry out such initiatives in a transparent manner. The primary objective of such assistance will be to improve the efficiency and reduce the costs of services that were previously the sole domain of the public sector.

Development of the micro and small business sectors also holds great promise as a means to create employment and diversify economic production. Micro and small businesses provide an estimated 80 percent of the employment opportunities in Panama. Despite their importance to the economy, these businesses have the greatest difficulty in obtaining credit and technical assistance. For this reason, their potential to contribute even more toward Panama's economic growth is largely unrealized.

USAID/Panama will work with private and public sector institutions to reduce the institutional and regulatory constraints to more rapid expansion of production by micro and small businesses. The focus will be to increase the access of micro and small entrepreneur borrowers to commercial financial markets either through an intermediary institution or guarantee mechanisms. In addition, the Mission will explore mechanisms to provide technical assistance to smaller firms on a permanent basis.

None of the Mission's activities to diversify production and generate employment will have sustained results without improved management of Panama's natural resource base. Deforestation has already affected most watersheds throughout the country, especially the critical Canal watershed. Further reduction of forest cover will accelerate silting of this strategic waterway and will also affect Panama's hydroelectric generation capacity and worsen its dependence on imported energy. Moreover, intensive agriculture that will produce high-value exports is dependent on rational management of Panama's limited soil and water resources. For these reasons, USAID will work with public and private sectors to develop strategies for protecting environmental resources, and through training and technical assistance, assist in their implementation.

2. Monitoring and Evaluation

a. Expand employment and exports through increased competitiveness of Panamanian products on world markets - Indicators of program achievement:

(1) Sustained real GDP growth averaging at least six percent per year through the year 1996.

(2) Reduce open unemployment from 18 percent in 1991 to 12 percent in 1996.

(3) Increase export earnings by 8 percent or more annually through the year 1996.

(4) Institute a transparent privatization program which will reduce the number of state-owned enterprises by 35 percent by 1996.

b. Improve management of Panama's natural resources - Indicator of program achievement:

(1) Reduce the rate of deforestation so that by the year 1996, at least 35 percent of the country's original natural forest remains, as compared to 38 percent in 1990.

D. SUCCESSFUL IMPLEMENTATION OF THE CANAL TREATIES

- Sub-objective: Strengthen Government of Panama capability to implement the Panama Canal Treaties and assume Canal operations.

- Sub-objective: Assist the Government of Panama to develop plans for the use of reverted Canal properties and military base facilities.

1. Implementation Strategy

Concern for the future viability and neutrality of the transoceanic Canal is justified. There was little, if any, preparation for the effective use of reverted canal lands and other assets or transition of Canal operations carried out under the Torrijos-Noriega regimes. Panama now has less than nine years to make a number of key decisions and organize itself to take over base and Canal facilities, and the Canal itself, an asset that accounts directly for ten percent of national income.

The present Government recognizes the challenge ahead. To date, however, the pressing short-run imperatives of reestablishing law and order and consolidating democratic rule have pushed problems related to the effective use of reverting (and already reverted) base and Canal assets and the Canal transition to the back burner. The longer key decisions are delayed - decisions on the effective integration of reverted base and canal assets into the Panamanian economy and assumption of responsibility for Canal operations - the greater the risk that they will be ill-considered and poorly implemented. Evidence now that coherent planning is taking place to maintain the competitiveness of the Canal will be important to shipping interests in their own plans to continue to use the Canal route or begin to plan for alternatives. Without such evidence, shipping companies may well opt for the alternatives and greatly reduce the Canal's value to the Panamanian economy. Panama's past management of the ports and railroad turned over in the late seventies does not instill confidence for the future.

There may be political sensitivities that would limit A.I.D.'s direct involvement in recommending to the Government of Panama how the Canal should be managed or how the reverted Canal and base assets should be used. Nonetheless, it is in the U.S. interest to be in a position to offer assistance, if the GOP requests it, in these areas. The Mission will therefore make funding available from several programs to provide training and technical assistance. In addition, we will make funds available to carry out analyses and develop plans relating to use of reverted assets, personnel policies, rates, ownership and management structures, and other technical issues that the GOP will have to decide on in a timely fashion if there is to be a smooth transition of Canal ownership. In addition, the Mission will support efforts by Panamanian groups to mount conferences and seminars aimed at promoting public understanding and sensitivity to Canal issues. Where appropriate the Mission will pursue co-financing of studies with other donor agencies or private sector institutions.

Planning for use of the reverted lands, infrastructure and property of the Canal Zone and military bases has barely begun,

despite the fact that almost two thirds of the Canal lands were turned over to Panama when the Carter-Torrijos treaties were signed and almost all of the base facilities will be turned over by 2000. At the same time, there is an urgent need for planning and development of a policy for use of the Canal and base lands and structures, including a strategy to protect the Canal watershed. Panama's recent reverted areas law makes a start in establishing that lands and infrastructure may be leased to the private sector, but there is much work and many decisions ahead. USAID/Panama will assist the Government of Panama to plan for use of the reverted areas, through provision of technical assistance and training to public sector officials responsible for this task.

Part of the Canal transition involves training Panamanians to assume positions within the Canal that traditionally have been held by foreign nationals. Now, about 87 percent of the Canal work force is Panamanian. The remaining positions tend to be found in the high-technology and top management spheres of Canal operations, implying that training will need to be longer term, and in some cases, both off-the-job and on-the-job preparation will be required. In addition, since the Panamanian Government will assume an oversight function for the Canal after 1999, there are identifiable training needs for civil servants as well.

Part of the needed training can best be defined only when the Canal management mode has been decided upon. In this category fall training for top management and civil servants. USAID will devote resources from its CAPS and project-related training activities as appropriate opportunities arise. For example, it may be worthwhile to establish public and private sector internships relating to future Canal management and oversight. In the more technical areas, training needs can be identified right away. For example, USAID is currently financing training in maritime navigation to create a larger pool of Panamanians capable of serving as Canal pilots.

On the movable property side, an equally daunting task lies ahead to distribute property no longer needed by the Canal Commission or the military bases. USAID/Panama has initiated an Excess Property Program at post to assist in transferring released property to Panamanian government institutions and private voluntary organizations.

2. Monitoring and Evaluation

a. By the end of the CDSS period, the Government of Panama has taken the decisions and developed the necessary plans to assume full control and management of the Canal - Indicators of program achievement:

(1) By 1994, a national decision has been taken regarding the management mode for the Canal, and plans for implementation of this mode are underway.

(2) By 1995, the GOP has made all critical decisions regarding the structure and organization of Canal operations.

(3) By 1996, at least 90 percent of the Canal work force is Panamanian.

b. The Canal and base lands, structures and movable property are allocated according to a rational plan which maximizes their contribution to national development - Indicators of program achievement:

(1) By 1993, a plan for use of already reverted lands is completed and adopted by the Government of Panama.

(2) By 1994, a plan for use of lands to be reverted by 1999 is completed and adopted by the Government of Panama.