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UNITED STATES GOVERNMENT

memorandum

DATE: June 15, 1986

REPLY TO ATTN OF: John L. Lovaas, Acting Director, USAID/Panama

SUBJECT: Submission of FY87 ESF Concept Paper

TO: Mr. Terence Brown, Director - LAC/DR

Attached for AID/W review is USAID/Panama's FY87 ESF Concept Paper.

Regards, John

Encl. a/s

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FY 87 ESF CONCEPT PAPER

USAID/PANAMA

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Concept Paper for FY87 ESF Program

I. SUMMARY AND RECOMMENDATIONS

A. Summary

The concept paper proposes that AID provide a $28 million cash transfer for budget support to the Republic of Panama, to be disbursed in tranches during FY 87.

USAID/Panama proposes to support a state-owned enterprise divestiture effort by the GOP. The cash transfer for budget support will allow the GOP to meet expenditures which will be incurred as a result of the program. The purpose of the program is to rationalize the function of government by reducing public sector participation in commercial enterprises, to reduce public sector employment, to decrease medium and long term demand for credit thereby reducing public sector deficit and contributing to the financial stabilization program.

The divestiture program is predicated in part upon commitments already obtained from the GOP by the World Bank through the Structural Adjustment Loan (SAL II) and by the USAID ESF Agreement of August 1985. The program consists of two major thrusts. The first is to assist the GOP to establish and empower an office dedicated to planning and implementing a continued divestiture program, and to obtain from the GOP commitments for further divestiture; and the second is to assist the GOP in the tasks entailed by those commitments.

Divestiture efforts have been seriously hindered in many countries by labor settlement issues resulting from the closure, liquidation or privatization of state enterprises. Therefore, an integral part of the program is the establishment and funding of a severance program for employees of state enterprises and other government agencies. The severance program will facilitate execution of the divestiture program and the reduction in government employment.

B. Recommendations

The proposed program fully supports the GOP's divestiture program in furtherance of USAID/Panama's Financial Stabilization Program and the goals of the Central American initiative. Given the GOP's emerging commitment to divest a number of state enterprises, AID has an opportunity to contribute to the divestiture program and make a potentially significant impact on the country's long term economic development. Accordingly, the Mission recommends that the Concept Paper be approved so that we may promptly proceed to preparation of the PAAD and agreement negotiation.

II. BACKGROUND

The 1960s saw rapid economic expansion in Panama, with GDP growth averaging 8 percent per year. Much of the impetus came from Canal related activities, and the effects of the Remon - Eisenhower treaties which transferred some economic activities from the Canal Zone to Panama. The principal source of investment finance and entrepreneurial talent was the private sector. Private domestic savings averaged about 15% of GDP, while private investment increased at a real 12.5 percent annual rate between 1960 and 1970. Total employment grew at 3.5 percent per year, well in excess of the 3.0 percent annual increase in population. Nearly all of the expansion in employment opportunities was provided for by the private sector, and occurred in urban areas; in the agricultural sector, employment expanded at only 0.7 percent per year although agricultural production grew at an average rate of 5.6 percent during th 1960's.

While the performance of the agriculture sector during the 1960s was notable, the benefits were concentrated in relatively few hands. Acute poverty persisted, mostly in the countryside. Statistics in the most recent "World Development Report" indicate that Panama's income distribution in 1970 was one of the most skewed in the Latin American Region.

The development strategy initiated by the Torrijos Government in 1968 aimed at major social reforms while attempting to sustain growth. Greater national integration was achieved by increasing and improving the communications and transport linkages among the regions of the country; social improvements were made by supporting human resources development. The strategy was executed through expanded and improved social services, particularly in health and education, through an ambitious public investment program, and by constituting public utilities (electricity, telephones, water) into state enterprises.

Although the strategy of combining rapid growth and social reform was initially successful, the economy during the 1970s was affected adversely by external developments — in particular the oil price hikes and the worldwide recession of the mid 1970s. Domestic uncertainty stemmed from the extended Canal Treaty negotiations, and confidence was undermined by increased regulation of the economy. Consequently, private investment declined markedly both in absolute and relative terms.

To avoid the social and political impact of its economic policies which produced significant market distortions (i.e. price controls, labor code, rent controls, quotas, etc.) the government resorted to the creation of employment in the public sector. Thus, the overall productivity of the system was diminished not only by the direct effect of the economic policy (which caused, in first instance, the reduced employment growth rate) but also because of the indirect effect; that is, the one resulting from the self-imposed role of the government as employer of last resort.

The Government was the main source of new employment during the seventies. Of a total increase in employment of 83,800 persons, 61,600 found employment within the public sector, 73.5% of the employment generated during the seventies. Employment in the Government grew at a cumulative rate of 7.6% per year whereas employment in the private sector grew at a cummulative rate of 0.6% per year. The figures undoubtedly underestimate the contribution of the State's action in the creation of employment as they only measure direct employment and do not take into account the considerable employment generated by the increased level of public expenditure.

The growth in public sector employment was not limited to the traditional functions of government. Rather, in accordance with the new role assumed by the Government within the productive process, employment increased in areas in which the state had not participated before, that is, in the production of goods and services.

During the seventies, the Government decided to assume a more active role in the productive process, motivated partly by ideological considerations and partly due to the assumption that that was the best manner to overcome the recession which Panama was undergoing. The activist behavior of the public sector in the productive process is clearly reflected in the substantially increased public investment during the seventies and the composition of the investment. Total public sector investment was on the order of 4% of GDP during the sixties, 9.2% during the first five years of the seventies, and 12.7% during the second half of the decade. The Government increased its share of total investment from 20% in the sixties to 29% during the first half of the seventies, and to 52% during the second half.

With regard to the composition of public sector investment, there was a marked increase in investment in capital goods vis a vis construction, clearly indicating that the Government made direct investments in the productive process. During the sixties the acquisition of capital goods represented 12.5% of total public investment, during the seventies it represented 34.8%. Unfortunately, the Government not only devoted significant resources obtained in great part from foreign loans, to the production of goods and services, but also made substantial modifications to the rules of the game, creating privileges and monopolies which also decreased the profitability of private investment.

Private investment during the seventies was characterized by the acquisition of durable consumption goods and not by the installation of new plants and equipment. This change in the structure of private investment explains the decreased capital profitability in the private sector and the drop in the private sector employment growth rate.

III. PUBLIC SECTOR ENTERPRISES

The number of state-owned enterprises in Panama increased dramatically after the military takeover in 1968, through the creation of enterprises developed as part of the 1970's economic/political process and through acquisition of enterprises which defaulted on Government loans. The most recent GOP handbook of state organizations* lists 39 decentralized institutions (including state-owned enterprises). Only 13 of these existed prior to the Torrijos government (1968). Currently, Panama's total employed labor force is about 600,000. Approximately 140,000 persons, or 25% of the employed labor force, are in the government's payroll. Over 25,000 people are currently employed by state enterprises.

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* Manual de Organización del Gobierno de Panamá, MIPPE 1983

According to the 1986 Budget, there are at least twenty-eight parastatals whose operating budgets are subject to legislative review. (The GOP owns more parastatals than those outlined below, the Panamá Hilton, Cemento Bayano and the Corporación Bananera del Atlántico are rather prominent omissions from the list). Of the twenty-eight government owned enterprises, eight are financial institutions, most of which are engaged in development activities; twenty are corporate enterprises or operate as such.

As a group, the eight financial institutions are expected to mobilize over $420 million during the course of the current year. The bulk of these resources, approximately 85%, would be derived from loan recoveries, interest, fees, special taxes and/or incremental deposits. The balance, 15%, is to come from either (a) external credit largely from multilateral or bilateral sources ($56 million or 13.5% of the total) or (b) internal transfers from the Central Government ($7 million or 1.5%).

The four largest financial intermediaries are: Banco de Desarrollo Agropecuario (agriculture), Banco Hipotecario Nacional (mortgages), Banco Nacional de Panama (roughly equivalent to the Central Bank but with commercial operations), and Caja de Ahorros (savings institution). These four financial intermediaries are expected to mobilize $410 million or 98% of all government controlled financial intermediation activity, including all of the external credit to be drawn from multilateral and bilateral agencies and institutions.

The other twenty corporate parastatals are involved in a variety of activities, including:

(a) legalized gaming e.g., Loteria Nacional de Beneficencia, Casinos Nacionales, Hipódromo Presidente Remón (racetrack), and Bingos Nacionales.

(b) utility services e.g., Dirección Metropolitana de Aseo (solid waste removal), IDAAN (water), INTEL (communications), IRHE (power).

(c) transportation and support e.g., Air Panamá, Ferrocarril de Panamá, Ferrocarril de Chiriquí, Dirección de Aeronáutica Civil, and Autoridad Portuaria Nacional.

(d) tourism e.g. Contadora de Panamá.

(e) agroindustry, e.g. Corporación Azucarera La Victoria, Cítricos de Chiriquí, Empresa Nacional de Maquinaria Agrícola, Empresa Nacional de Semillas, and Instituto de Mercadeo Agropecuario.

The 1986 Budget anticipates that the group of twenty enterprises will generate in excess of $850 million in gross revenues from normal operations. The operating costs of this group are forescast to require $460 million or roughly 54% of total cash available. The balance net operating cash flow (available for debt service, non-recurring charges, capital investment, transfers to Central Government, etc.) is around $390 million, with five parastatals accounting for $340 million (86%) of the global amount as follows:

IRHE ($204 million), INTEL ($46 million), Loteria Nacional ($46 million), IDAAN ($32 million) Casinos Nacionales ($11 million).

The gaming and utility enteprises figure heavily in the total net operating cash flow generation of the twenty enterprises. Anticipated transfers from the group of twenty to the Central Government are on the order of $85 million, roughly 10% and 24%, respectively of total gross revenues and net operating cash flow as these magnitudes are outlined in the budget. Seven parastatals account for $79 million in transfers to the Central Government, or 91% of total transfers as follows: Lotería Nacional ($47 million) Casinos Nacionales ($10.7 million), IRHE ($8.4 million), Air Panama ($5.0 million), INTEL (3 million), Dirección de Aeronáutica ($2 million) and Hipódromo ($2 million).

The electric company derives its substantial cash flow by charging rates that are two times higher than those prevalent in other countries. Similarly, the prevailing tariff structure of the airport and (less so) seaport authorities are believed to be higher than elsewhere. The utility revenues are used to cross-subsidize the operating deficits of other parastatals. Affordable infrastructure services are a cornerstone of successful development policies and Panama would be better served by lower tariffs for infrastructure services. While unlikely in the short term, this could be accomplished by an overall privatization strategy which envisages outright divestiture of some utilities and authorities or, in the case of others, retention of ownership by the GOP, with rather extensive reliance placed on the contracting of their principal activities as a means of inducing operating efficiencies.

Annex A provides a brief description of the most important state owned enterprises.

IV. STATUS OF THE DIVESTITURE PROGRAM

While a structured and well organized divestiture program is not yet in place, a number of events in this area have occurred. In March of 1983 the GOP closed down the largest and least efficient of its four sugar mills, Felipillo. Subsequently, that same year the National Finance Corporation (COFINA) sold an unprofitable hotel (Marriott) to a Japanese investor group. This hotel has been converted into a profitable private enterprise and is considered the best in Panana. Under the Structural Adjustment Loan (SAL II), the World Bank has obtained preliminary GOP commitment to close or divest the Las Cabras sugar mill; to transfer to IDIAP the seed research activities of the state seed company (ENASEM) and to terminate ENASEM's seed marketing activities: to dispose assets of the State's agricultural machinery enterprise (ENDEMA); and to divest of an additional three government-owned enterprises.

A World Bank-financed consulting firm (Management Analysis Center, MAC) has analyzed the situation of nine agricultural sector state enterprises and provided strategic recommendations. The MAC studies recommend: (1) the closure of the Las Cabras sugar mill, the sale of equipment of the Felipillo mill, the reduction of personnel in the sugar corporation's office in Panama city and a reduction of the price paid for sugar cane, (2) the absorption of the Agricultural Development Bank (BDA) by the National Bank of Panama (BNP) and the elimination of the interest rate subsidy on agricultural credit, (3) the liquidation of ENDEMA, (4) the gradual transfer of the purchase, storage and sales functions of the Agricultural Marketing Institute (IMA) to the private sector and the transformation of IMA to function as a market information center, (5) the outright sale of Citricos de Chiriqui, (6) transfer to the private Secto · the Banana Corporation of the Atlantic (COBANA), (7) the transfer of the activities of ENASEM to the private sector, (8) the expansion of the portfolio of the Crop Insurance Agency (ISA), and (9) the closure of some asentamientos and continued government support of others.

USAID/Panama's August 1985 ESF agreement included two covenants directly related to the divestiture process; first the GOP is required to divest or turn over to the private sector the operation and management of three IMA silos facilities (one phase of the IMA transformation) and second, the GOP is to analyze and prepare a study resulting in recommendations on the sale, improvement or closure of state owned enterprises.

While the above noted efforts are underway, the Panamanian privatization program lacks a coordinated approach to plan and control the privatization activities that are occurring. Recognizing this need, the President of Panama assigned, in December 1985, these responsibilities to the Director of the Investment Council of Panama (ICP). USAID subsequently was instrumental in the formation of an ad hoc divestiture advisory committee, consisting of key representatives of the public and private sectors, and arranged for their attendance at the PRE sponsored Privatization Conference. This was followed by recruitment of an advisory team from the AID/W funded Center for Privatization which made specific recommendations for the organization and operation of a formalized divestiture unit. Some of these recommendations will lay the basis for the operation of an office devoted exclusively to divestiture, preferably under the Ministry of Hacienda where there is existing legal mandate to carry out such a program.

V. CONSTRAINTS TO PROGRAM IMPLEMENTATION

The potential constraints to an effective divestiture program include: the lack of systematic coordinated program, the lack of political will, employee resistance, the availability of potential buyers, and availability of credit and capital to facilitate acquisition and subsequent improvements. These constraints may limit a divestiture program to a greater or lesser degree depending on whether a state enterprise is privatized, closed or its assets liquidated.

Strong elements within the Panamanian ruling party (PRD) are likely to resist a significant divestiture program on ideological grounds. Also, powerful forces, some of which represent groups upon which the Government depends for support, will resist divestiture of some state-owned enterprises.

The most significant problem with a divestiture effort in Panama is likely to be labor settlement, a major factor undermining political will. The problem varies in magnitude depending upon whether the employees are governed by the Labor Code or the Administrative Code. For example, employees of Contadora, Aeroperlas, Air Panama and Cítricos de Chiriqui are covered by the

Labor Code while employees of the state sugar mills are covered by the Administrative Code. In the case of employees covered by the Administrative Code the problem is less complex financially. Each employee can be dismissed without regard to seniority, with payment of their accumulated vacation. Dismissing government employees under the Administrative Code however will be politically costly. (See Annex C). For employees covered by the Labor Code the situation is financially very costly. Employees can only be dismissed in order of seniority and the severance pay can be expensive. In most cases, no Panamanian private sector enterprise would be willing to acquire a parastatal unless all employees are dismissed and the severances paid by the government. As an example of its potential magnitude, the severance for an employee who started work in May 1968 and was dismissed in March 1986 would be entitled to forty-nine weeks of severance pay - essentially valued at his average monthly salary plus overtime for the last six months or the last thirty days (whichev(is greater) - plus a seniority premium (Prima de Antiguedad) amounting to seventeen additional weeks of salary calculated on the average total earnings of the previous five years. The severance pay could actually increase by as much as 50% if the employee contests the dismissal in court.

Another potential barrier to the divestiture process (although not to closure of enterprises and perhaps less so to the liquidation of assets of state enterprises) is the availability of investment capital and credit to finance privatization.

Equity capital could be raised through private placements to individual Panamanian investors. For example from June 1983 to June 1984 B/.21.3 millior of equity was raised in this manner. In some exceptional cases it may be possible to consider issuing stock in foreign stock exchanges. However, this alternative could require the parastatal to meet all of the requirements of th foreign regulatory agencies (i.e., the Securities and Exchange Commission in the U.S.). Bank credit may be another option. In theory, these could be the source of long-term bond and debt financing. Development banks could be good sources of financing under terms similar to venture capital firms. Financial institutions such as the FY 86 Private Sector Export Financing Project may be in a position to provide both equity and credit financing for some export-oriented enterprises. Another source of potential financing could be the International Finance Corporation (IFC), a member of the World Bank Group, which provides both equity capital and credit to private sector firms in developing countries. The Inter-American Investment Corporation is currently being established with a mandate similar to the IFC. Once established this will be a good source of equity and credit financing. In some cases, it may be feasible to convert existing commercial credit owed by the parastatal into equity capital of the new private enterprise. As an option of last resort, the Government of Panama may have to extend credit to the purchasers of the parastatals in order to facilitate the financing of the divestitures. This could be done through a form of long-term bonds or possibly a licensing/ royalty agreement that would tie payments to the level of sales of the enterprise. The provision of credit will be carefully analyzed during the intensive review.

A key assumption of the privatization and asset liquidation options in a divestiture program is the existence of potential buyers. The validity of this assumption will be analyzed during the intensive review. Finally, a significant administrative constraint is the lack of a substantive divestiture office to facilitate the central planning and direction needed to expedite and rationalize an effective divestiture program.

VI. PROPOSED PROGRAM

The objective of the proposed program is to assist the GOP plan to and implement a state enterprise divestiture program in order to (a) rationalize the function of government by reducing public sector particiation in commercial enterprises; (b) reduce public sector employment and (c) decrease public sector demand for credit thereby reducing public sector debt. The program will contribute to the GOP financial stabilization program, and to the shift in economic strategy where the private sector will increasingly recover its role as the engine for growth and employment creation in a more open, market-oriented economy.

The Mission proposes to provide a $28 million cash transfer for budget support during FY 87 to allow the GOP to meet expenditures which will be incurred as a result of a proposed severance fund for public sector employees. Annex B provides a macroeconomic context under which the proposed transfer is justified. The GOP will in turn agree to implement a divestiture program and a reduction in public sector work force as described below.

USAID/Panama proposes to support a state-owned enterprises divestiture effort by the GOP. The program is predicated upon commitments already obtained from the GOP by the World Bank through the Structural Adjustment Loan (SAL II) and by the USAID ESF agreement of August 1985. The SAL II calls for, *inter alia*, a 2% attrition reduction in government employment in 1986, GOP to divest one sugar mill, a seed production and distribution entity and an agricultural machinery and construction operation, as well as three of four other state-owned enterprises designated by the World Bank. The USAID agreement calls for professional review and evaluation of all state owned enterprises and recommendations for their disposal through privatization or other form of divestiture. It also calls for divestiture of three grain storage silos. The agreements thus establish short and medium term divestiture targets and requirements for a continuing divestiture program.

In pursuit of appropriate policy commitments, USAID has relied on continuing policy dialogue. USAID has also provided initial training and technical assistance to those who may effect both policy formation and policy implementation. We intend to continue selective technical assistance at the policy level so as to secure more precision in divestiture policy so that divestiture activities which are to be carried out result from clear and cogent governmental directives.

The GOP has begun to respond to the SAL II and ESF agreements by preparing for a rational and organized divestiture effort, and by carrying out evaluations of selected state-owned enterprises.

The proposed divestiture program consists of two major thrusts. The first is to establish and empower an office dedicated to planning and implementing a continued divestiture program, and to obtain from the GOP commitments for further divestiture; and the second is to assist the GOP in the tasks entailed by those commitments.

The Severance Bonus Plan

Panama's existing labor legislation, overstaffed Central government and state enterprises, large accumulated labor liabilities, together with resistance to divestiture by state employees and unions, make the solution to labor disposition the crucial first step to implementing a program to divest state enterprises.

Since no private investor would be willing to assume the large accumulated labor liabilities, the proposed program requires that the GOP establish and fund an effective severance mechanism for employees of state enterprises. A condition will be negotiated with the GOP which would alternatively allow reducing the number of government employees by an amount equal to the staff levels of divested enterprises. The formula would permit transfer of employees of divested enterprises to other agencies of Government, while yielding a net overall reduction in the workforce. The formula should also remove some of the basis for resistance to divestiture.

Essentially, the proposed severance program would entail payment of accumulated labor liabilities plus a resignation bonus of between 25 to 30%. (See Annex C for a full discussion of the severance plan). The program not only facilitates the sale of state enterprises but also produces savings for the Government in the long term.

The cost of a resignation bonus program for 9 of the 15 divestiture potential enterprises listed in Table 1, Section VI, is approximately $20 million. Annex C, Table 3, provides the comparative benefits under alternative bonus programs, and Table 4 provides the costs by enterprise of the preferred alternative. The Mission will explore the possibility of extending the program to include other public sector employees. Clearly additional potential exists but must be more carefully assessed during intensive review.

Experience with severance bonuses in Peru in 1983 - 1984, with labor legislation similar to Panama's, resulted in the closure of 30 fishmeal plants; the privatization of a tuna cannery, a supermarket chain and the fish marketing firm; and the resignation under a bonus program of several thousand government employees. Peru is not the only case where resignation bonus programs have been effective. They have been effectively carried out in Venezuela and Ecuador where there is relatively more flexible employment stability regulations. Importantly, in Panama the Bank of America recently sold off most of its branches and successfully reduced its staff from about 500 employees to 150 through a resignation bonus program.

The FY 1987 Divestiture Program

The dispersion of divestiture activities throughout the GOP has led to uneven development of the national divestiture effort. Neither the USAID nor the GOP fully appreciated the complexity of the tasks involved in the divestiture process. Moreover, the GOP's preoccupation with, and its difficulty in securing passage of three major pieces of legislation - Labor Code reform, a new industrial law and a new agricultural law - understandably led to concentration of effort on these matters, at the expense of other requirements. With the passage of those critical laws, which were of the highest priority, the GOP is in a position to tackle the next series of related issues viz. divestiture policy and personnel policy.

The following actions are intended to facilitate and accelerate the new GOP effort: Establish, with the GOP, a schedule and workplan for divestiture actions during 1987. The workplan will specify targets which can be reasonably met with an intensive effort by the GOP. It will be organized in two stages. The first, an organizational and strategic design phase, must be completed prior to signing an agreement. With USAID assistance, the GOP would:

a. Establish, empower and fund an office dedicated to divestiture.

b. Carry out a preliminary analysis of the net fiscal impact of all state enterprises.

c. Prepare a divestiture strategy and a work plan, and evaluate and make divestiture recommendations for not less than __ state enterprises. The strategy will include the criteria for divestiture of state-owned enterprises.

The second series of actions will consist of time phased activities designed to produce specific targeted results during FY 87. During that time, the GOP would carry out the following tasks:

a. Prepare and negotiate contracts with external consultants for a detailed analysis including a financial audit, an enterprise valuation and an action plan for divestiture.

b. Announce the enterprises which will be divested.

c. Divest three state-owned enterprises and reduce public sector employment by an amount equivalent to the number of employees in those enterprises and in enterprises divested under the SAL II.

The Mission will assist the GOP in the accomplishment of these tasks by providing consultancy services through the AID funded Center for Privatization and through the USAID Development Policy Studies project with MIPPE. The consultants will assist in the development of divestiture criteria, selection of targets, in preparation of terms of reference for evaluative studies, in preparation of divestiture strategies, and development of a schedule for the ensuing one-year period. Upon completion of the GOP divestiture strategy and work plan, USAID will review technical assistance requirements with the GOP, and, as appropriate, fund such assistance.

The mutually supportive linkage among divestiture, personnel reduction, and fiscal austerity measures will be maintained and strengthened through continued dialogue, conditional funding and technical assistance as required.

The following table presents a list of state enterprises. Some of these are not likely to be divested, others are considered potential targets for divestiture.

Table 1

1985 State Enterprises	Potential for Divestiture	Number of Employees
IRHE		5,193
IDAAN		2,132
INTEL		3,800
DIMA		1,672
Autoridad Portuaria		154
Aeronáutica Civil		1,382
Zona Libre		599
BHN		400
BDA		813
BNP		
Caja de Ahorros		965
Radio Nacional		
Casinos Nacionales		1,282
Bingos Nacionales		195
Lotería Nacional		1,395
Hipódromo		546
ISA		71
Ferrocarril de Panamá	X	438
Ferrocarril de Chiriquí	X	112
CALV	X	1,912
ENDEMA	X	426
ENASEM	X	43
IMA	X	839
Cítricos Chiriquí	X	673
COBANA	X	314
Corporación Bayano	X	
Corporación Bocas del Toro	X	
Cemento Bayano	X	397
Air Panama	X	504
Contadora	X	160
Aeroperlas	X	160
Panama Hilton	X	453
COFINA (Assets)	X	

Justification Grant

At the end of 1985 the GOP debt stood at $5.1 billion; the equivalent of over one year's GDP. The per capita public sector debt in Panama is among the highest in the world. About 3.6 billion of the debt is external. The interest on debt alone amounts to a one quarter of the government's budget ($400 million per year). About $600 million in external debt amortizations mature in 1986 and another $670 matures in 1987. The Government is unable to amortize its commercial debt in the foreseeable future and will have to roll it over in 1986 and 1987. Adding to this crushing debt burden would not serve our development interest. Grant financing will reduce the debt service burden and the rate of debt accumulation thereby supporting the financial stabilization program. Given the politically sensitive nature of the conditionality in the fact that the GOP severance fund will have to go through the legislative process, its success may be enhanced if the source of funding were attributable to a grant rather than another loan. Thus, we conclude that it would be highly preferable to grant finance this cash transfer as has been the case for ESF to date in Panama.

VII. NEGOTIATING OBJECTIVES

We anticipate that groups upon which the Government depends for support will oppose divestiture of some of the state-owned enterprises. Therefore, the GOP may not, in the short run, be able to respond fully to our recommendations. We do, however, expect that a serious divestiture effort will be made, that three additional divestitures will take place during 1987 and that precedents established by those divestitures will facilitate the divestiture of other state-owned enterprises, whose disposal may, at present, be inopportune.

The Mission proposes to tranche the disbursements and require that the GOP take specific actions prior to disbursements. The conditions will include the following:

1. That the GOP establish, empower and fund an office dedicated to divestiture.

2. That the GOP carry out a preliminary analysis of the net fiscal impact of all state enterprises.

3. That the GOP prepare a divestiture strategy, and a work plan, and evaluate and make divestiture recommendations for not less than __ state enterprises. The strategy will include the criteria for divestiture of state-owned enterprises.

4. That the GOP submit to the legislature the proposed severance plan for inclusion in the 1987 budget. The fund must be sufficiently capitalized to meet the cost of a severance incentive plan for a number of public sector employees equivalent to those in state-owned enterprises divested under the SAL II agreement and enterprises divested under this program.

5. That the GOP divest three state-owned enterprises acceptable to USAID/P and reduce public sector employment by an amount equivalent to the number of employees in those enterprises and in enterprises divested under the SAL II.

The Hydroelectric Resources Institute (IRHE) IRHE was created in 1961 for the purpose of planning, constructing and operating all electric power generation required by the country. IRHE has generated a substantial operating surplus in recent years. This surplus is important fiscally; between 1980 and 1983, it accounted for two thirds of the surplus of all state enterprises and nearly one third of consolidated public sector savings. Since 1975, the current cash cost of producing each kWh of electricity sold has risen from 4.7 US cents to 11.5 US cents in 1983. In constant 1970 prices this represents an increase of 55 percent or 5.6 percent per year. This partially reflects the rising cost of imported fuel oil which IRHE uses to fire its thermal generators, and for which it is currently paying higher than world prices to the local refinery. Nevertheless, other performance indicators have deteriorated markedly, particularly those reflecting labor productivity and system losses.

IRHE's high tariffs reflect high labor and debt servicing costs. The entity's total wage bill (including social charges and benefits) rose from B/.12 million in 1977 to B/.39 million in 1983, a real annual increase of 14 percent. Average labor costs per employee doubled over the same period from B/.300 to B/.600 per month, a real annual increase of over 5 percent. With regard to debt servicing, IRHE is the largest single public sector borrower outside the Central Government itself; its medium and long term debt, of US$433 million at the end of 1983, represented nearly half the total outstanding and disbursed obligations of the public sector apart from the Central Government. The entity's short-term debt is also significant. This stood at US$48 million at the end of 1983, 63 percent of the total for the entire non-financial public sector.

The National Water and Sewerage Institute (IDAAN) IDAAN was created in 1961, and is responsible for the operation of public water supply and sewerage facilities in communities of over 500 inhabitants throughout the country.

Financially, and in operational terms, the Institute's record since the mid 1970's has been mixed. Although the number of employees per 1,000 water connections has fallen from 19 to 15 over the same period, this remains very high compared to other Latin American water facilities of similar size. Even with the low degree of mechanization of most of the small systems located around the country, a ratio of no more than 9 employees per 1,000 connections would be justified. There may also be considerable scope for improving tariff collection through increasing the percentage of water supplies which are metered; the quantity of water unaccounted for has also risen significantly in recent years and was estimated at 36 percent in 1982. Improving these indicators will be necessary to increase internal cash generation and to contribute to the entity's investment plan for the remainder of this decade.

The National Telecommunications Institute (INTEL) INTEL was created in 1974, following the nationalization of the foreign enterprise then providing domestic telephone services, and was given exclusive rights to construct and exploit the country's telephone and telecommunications network. The Institute has also taken over the telegraph and telex services which had corresponded to the National Directorate of Telecommunications. INTEL therefore, exercises an effective monopoly over all telecommunication services in Panama.

Since its foundation, INTEL has generated a significant current surplus, second only to that of IRHE in importance among the public enterprises. This has enabled it to finance, over the 1974-83 period as a whole, all its capital expenditures and still have some resources to contribute to the overall fiscal balance. As a consequence, its medium and long term debt, nearly all related to suppliers' credits, is small: at US$41 million at the end of 1983 it amounted to just over one percent of the total for the nonfinancial public sector. Interest payments of about US$5 million in 1983 were only some 8 percent of INTEL's current revenues.

The institution's excellent financial performance conceals a deterioration trend which, if allowed to continue, could eventually lead to an overall financial deficit. While average revenues per telephone have increased from B/.148 per year in 1974 to B/.405 per year in 1983, current costs per telephone have risen much faster from B/.60 in 1974 to B/.288 in 1983. This is unusual for a telecommunication institution where substantial investments in modernized automated equipment should lead to reductions in current unit costs. The trend of unit operating costs gives serious cause for concern, and a thorough study could be made of INTEL's cost efficiency procedures to identify the scope for larger savings.

The Bayano Cement Company (Cemento Bayano) Construction of the Bayano cement project began in 1975, and production of cement on a significant scale in 1979. At the time of its foundation, the local market was adequately supplied by two private firms. One of the private firms closed down in 1976. In 1977 and 1978, the remaining private company, Cemento Panama, supplied the entire domestic market of some 270,000 metric tons per year.

The combined capacity of the two cement plants is now approximately double the size of the local market. The Government's stated original intention was therefore to export a substantial proportion of Cemento Bayano's output. Production costs ruled this out. The consumer, since 1981, has been paying three times the international price for cement.

The prospects for an efficient cement industry in Panama are bleak. The Panamanian consumer and economy will continue paying a heavy price for the cement industry investment decisions of the 1970's.

The Bayano Development Corporation (BDC) was created in 1975 to protect the watershed of the Bayano hidroelectric reservoir and to start a capital intensive state farm producing mostly rice, cattle and timber. BDC has required operating subsidies in each year; its capital cost per direct job created is over B/.100,000; and it has failed to achieve adequate yields of efficient production methods with the partial exception of the sawmills. Its financial record has also been impaired by the provision of free medical and education facilities, constructed and operated for the BDC employees but utilized by several hundred families from the surrounding area. Operating losses, before depreciation and interest, have averaged about B/.1 million in each year of the Corporation's existence. This is met by direct subsidy from the Central Government.

The Chiriqui Citrus Company, which consisted originally of a privately owned 5,000 ha. plantation and concentrate plant, was taken over by the Government in 1975 after being abandoned as a chronic loss maker. In late 1983, the GOP paid about US$6 million in compensation to the original owner, a sum never capitalized in the accounts of the enterprise itself. Plantation size was reduced to about 2,000 ha. in 1978. Yields are, however, low and costs are high. The average yield in 1983 was 1.25 boxes (90 lbs) per tree; a good yield would be 6 boxes. The plant's principal product is orange juice concentrate of which it produces about 140,000 gallons per year. It operates about 35 percent of capacity. This gross underutilization and high raw material costs, due to low yields, lead to high production costs. Direct production costs for orange juice concentrate in 1982 were B/.4.87 per gallon, plus a further B/.3.30 per gallon for marketing, administrative and other indirect costs. These high costs, which compared with about US$6 per gallon in Florida, can only be sustained in a protected domestic market. Thanks to temporarily high international prices, the plant was, nevertheless, able to export: some 80,000 gallons were sold to Costa Rica in 1983.

The La Victoria Sugar Corporation was started in the early 1970's with the objective of making sugar a leading export and expanding employment in poorer rural areas. While the original plans were for one mill, the high world sugar prices of 1974/75, which were projected to continue, lead to plans for four more. One was subsequently cancelled, due to falling world prices and high costs at La Victoria, the original mill. Capacity by 1983 was at 20,150 tons of cane per day, divided as follows: La Victoria (6,250), Felipillo (5,500), Alanje (7,200) and Azuero (1,200).

The Corporation continued to make heavy losses which by 1983 had exceeded an accumulated B/.200 million. In March, 1983, the Government closed down Felipillo, the least efficient mill, where total production costs for the 1982/83 harvest were 43 cents/lb compared to an average FOB export price of about 16 cents. Despite its having ceased operations, Felipillo, which has a book value of B/.38.4 million, is still a considerable part of the Corporation's debt burden; moreover, most of the employees have not been laid off.

The Corporation's mills, moreover, sustain heavy social costs for education, health and similar facilities. They are also overstaffed. La Victoria, Alanje and Azuero provide, between them, permanent jobs for 1,300 workers and seasonal employment for 8,500 more. The Corporation's bloated central office in Panama City costs about B/.2.2 million per year.

The Government intervenes in the provision of agricultural inputs and technical assistance through a variety of institutions, nearly all of which present problems of varying severity. The National Seed Corporation (ENASEM) contracts for the production of selected seeds from private growers which it resells to farmers at a small margin. Although it has only 15 percent of the market, ENASEM maintains that it plays a price setting role; prices of locally produced seeds have certainly increased much more slowly than those of imported hybrids were ENASEM has not intervened in the market. Financed by an IDB loan, ENASEM was to be considerably expanded; its goal was to market 56 percent of Panama's certified seed requirements by 1989. Given the existence of actual and potential private suppliers, the desirability of such market dominance by a state institution is unnecessary.

Farm machinery hire and repair services, crop insurance, and agricultural research services are provided respectively by the State Agricultural Machinery Enterprise (ENDEMA), the Crop Insurance Agency (ISA) and the Agricultural Reseaarch Institute (IDIAP). Until recently much of these

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institutions's efforts were directed towards assisting the asentamientos, leaving other farmers to private enterprise. ENDEMA operates inefficiently and state subsidies are heavy. Moreover, the entity is impeded from fulfilling its originally intended function of providing smaller producers with access to agricultural equipment by technical and financial shortcomings. ISA and IDIAP have substantially rationalized their operations and methods. These organizations are no longer serious fiscal burdens, nor are they institutionally part of MIDA as was once the case.

The Agricultural Marketing Institute (IMA) IMA was created in 1975 as a decentralized institution from the former marketing directorate of MIDA. The creation of IMA was therefore to streamline the state system rather than to correct inadequacies in private sector marketing. IMA was obliged to buy any surplus of specified crops at the ruling support price. These included rice, maize, soreghum, beans, onions, salt and coffee. IMA also administers a large modern abattoir, a chicken processing plant and the national marketing of hides and skins. It is the sole importer of maize, sorghum, beans, onions, potatoes and edible oils, either directly or by allocation to private traders, and it controls, together with the Office of Price Regulation, import quotas for a large number of food products. Since 1975, however, the State has increased its intervention, through IMA, into meat processing, the marketing of hides and skins, perishable produce and supervision of municipal wholesale markets.

IMA's financial position is severely compromised by the chronic rice surplus and losses from the purchase and storage of other domestic crops. Despite substantil profit margin from its import monopolies, IMA has sustained cash losses (before current transfers from Central Government) in every year since its foundation. The total accumulated loss up to the end of 1983 was B/.27 million. Since IMA's only significant sources of income to offset its losses from rice and other domestic crops are margins on the imported products it controls, it has a vital institutional stake in preventing the adoption of a freer trade regime.

In previous years, the Institute's losses have been met by transfers from Central Government. Since early 1983, however, these transfers have not been forthcoming in sufficient amounts and IMA has therefore resorted to short term borrowing from commercial banks. Outstanding short term debt doubled to over B/.18 million during the 12 months ending September 30, 1983. About three quarters of this was owed to commercial banks. IMA's financial situation is, in short, unsustainable and will require Central Government intervention to service the debt and meet the rice related losses. In the medium term IMA's problem can only be solved through fundamental reforms in the whole marketing system.

Contadora Panama, S.A. owns a complex of properties consisting of (1) real estate sales and development offices on Contadora Island; (2) public utilities services; (3) Aeroperlas S.A. and (4) Contadora Resort and Casino, S.A. The latter two properties are up for sale and have interested buyers.

The island was originally purchased and developed in 1968 by a group of Panamanian investors with the support and participation of the Melia group of Spain. They had two objectives, the development and operation of a luxury resort on the island and the development and sale of the adjoining land for luxury vacation homes. As the project progressed, it became obvious that the development was undercapitalized. The Panamanian Government, recognizing its potential value, purchased it from the original investors and continued to develop it.

By 1970, the Contadora Island airport was operational with a 730 meter hard surface runway. Currently, the island has 9 kilometers of paved runway, servicing 321 private homes as well as the Contadora Resort and Casino property. The island's public utilities are serviced on a 24 hour basis by four (4) diesel driven power generators with a total capacity of 2800 KW, two lakes containing a total of 28 million gallons of fresh water (during the rainy season) and direct national and international telephone service via Intel's microwave system.

Contadora Resort and Casino, itself, is a 150 room, 9 building hotel complex on 126,950 square meters of landscaped beach front property. The buildings and facilities required an original investment of $11,000,000 not counting the cost of the land.

Aeroperlas, S.A. owns four (4) Twin Otter aircraft with an air terminal based at Gelabert International Airport. Each of these cost approximately $2,500,000 when originally purchased. Although only two of these aircraft are operational currently, Aeroperlas, aside from Contadora Island, services Colon, David, Bocas del Toro, Changuinola and San Miguel. It faces competition from three other domestic airlines on some of these routes. Notwithstanding, Aeroperlas, S.A. is nominally profitable. Most of its cash flow, however, is siphoned off to meet some of the operating expenses of the Contadora Resort and Casino property.

Air Panama was purchased by COFINA from Iberia Airlines in the early 1970s for $30,000,000. At the time of its sale, Air Panama owed Citibank N.A. approximately $20,000,000, an obligation which was purchased from the bank by the Central Government.

Currently, Air Panama files two (2) fifteen year old, 727/100s on routes to Miami, Bogota, Guayaquil, Caracas, Lima and Mexico City. It also leases a third airplane one day a week to handle Colon Free Zone cargo to and from U.S. commercial markets. Air Panama issued a tender which will enable the firm to acquire, via lease, a new Airbus 300, a wide-bodied aircraft with additional cargo as well as seating capacity for 250 people.

As it is presently organized, Air Panama is not a profitable investment for the GOP, for various reasons, including the following:

- its two 727s are fuel inefficient and may require considerable down time for maintenance;

- the limited capacity of the aircraft (120-122 people per flight) makes the airline unattractive or unrealiable for booking by U.S. travel agencies and/or charter tour firms;

- considerable complementary travel services are provided by Air Panama to various agencies of the Government;

- Air Panama has at least 500 employees, probably almost twice the number needed for its normal operation;

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- its top management is politically appointed with no demonstrated operating experience nor requisite background in this highly specialized industry;

- continued inability for budgetary reasons to acquire aircraft to service attractive new routes, available through reciprocal landing rights, which include Puerto Rico, New York, Los Angeles, Buenos Aires, La Paz and numerous European cities.

Apparently, Air Panama lost money in both fiscal years 1984 and 1985. Nonetheless its current President thinks that the airline might be profitable during 1986 assuming that prices for fuel do not increase beyond their current levels.

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MACRO ECONOMIC CONTEXT

1987 ESF Needs:

Neither the fiscal nor the debt management crisis are over. In 1987 the GOP faces a projected government deficit of $100 million. Under the IMF performance criteria it cannot borrow from the National Bank, and there is no other accessible domestic source. Unless $100 million in net external financing is found, it will have to pare the budget back further. Because of entitlements, debt service, and other institutional constraints, the funding will have to come out of the investment budget. The investment budget was cut sharply in 1984, even more sharply in 1985, and although there are modest increases planed for 1986 and 1987, the account will still be well below the levels of the late 1970s and early 1980s. This account is significantly underfunded. Without adequate levels of public investment, the stock of public infrastructure deteriorates, the infrastructural foundations for growth is not created, and forward economic momentum becomes that much harder to achieve.

Apart from the fiscal deficit, there will be some $667.7 million in GOP debt maturing in 1987 ($58 million more than in 1986). With luck, strict observance of covenants, and considerable salemanship, the Government may get new official disbursements sufficient to offset the $200 million in debt coming due to governments and international organizations. It will also need to convince private lenders to roll-over some $459 million of debt maturing in 1987. At this latter, they may well succeed again as Panama's commercial creditors know the GOP cannot pay and would rather not have to write down the debt. Whether they would be prepared to yet again extend substantial new credit is a different question.

At this point, neither the deficit, nor sufficient new official credit, nor the needed roll-over of commercial debt, nor new commercial credits is in sight. Large amounts of additional assistance are required for which there is no source yet identified. There is no question that ESF resources are needed.

Moreover, we intend to condition our resources, _inter alia_, on progress in the divestiture area, more specifically, on the establishment of a severance fund for workers in SOEs. Over the long run divestiture of SOEs will improve the GOP fiscal position. However, in the short-run the process will create substantial new expenditures as compensation and inducements to employees of enterprises to be divested will accrue in advance of the sales proceeds of the enterprises.

We believe that a severance fund is a political prerequisite to progress in this area. Without our conditionality, such a fund is not likely to get established, and without our budget support, such a fund if established would further displace needed capital expenditures.

Macro Economic Context:

Summary: Panama has serious economic problems requiring financial discipline, major policy reform, and substantial external assistance. As it is, the government is struggling to pay its foreign debt; and there is little in the way of overall per capita growth. Such growth as there is occurs largely in the so called "autonomous sector" (the canal, transisthmian oil pipeline, and free zone) and generates disproportionately low employment opportunities. Unemployment is high and rising, and threatens to erode living standards for lower income groups. In the face of its fiscal problems and the inward migration to the Colon — Panama City metropolitan corridor, the government is not able to sustain the current level of social services. Crime, one measure of harder times is rising. The falling dollar is likely to increase the import bill and add a measure of instability to the currently high but stable price level. In the medium to long term, unless there is a reversal of Panama's economic prospects, all this will translate into serious social discontent and loss of political stability.

An interventionist public sector philosophy has held sway since the early 1970s, bloating the public sector, distorting the economy's price structure and resource allocation, and building a huge foreign debt. The exhaustion of government financial options, together with pressure from creditors, the IMF, the IBRD, and ourselves has brought a more realistic policy perspective to the government. Fiscal austerity commenced in 1983 and by the end of 1985, the public sector deficit, exclusive of debt repayment, was down to nearly manageable proportions. Thus far, the burden of austerity has fallen largely on public investment expenditures. It will be difficult to sustain these reductions let alone eliminate the remaining deficit. Moreover, if growth is not to suffer, it must be the current expenditures budget (especially payroll), not the development budget that takes the brunt of expenditure curbs.

Concurrently, Panama must deal with a staggering debt of some $5.1 billion. A 1986 re-scheduling package has been agreed upon and awaits final implementation. The country's commercial bank creditors will roll-over $378 million and provide another $60 million in fresh credit. This funding is strictly conditioned on a reactivation of the IMF Stand-by and strict adherence to its terms and conditions. Also required is agreement with the IBRD on a second Structural Ajustment Loan. This is $80 million SAL-II loan also seems close at hand and may disburse as much as $50 million in 1986.

Of even more fundamental concern, only a continued restructuring of economic policies can put Panama on a growth path leading to adequate employment opportunities. Prodded by the Bank, the Fund, ourselves, and most importantly by sheer necessity, the GOP has haltingly begun the process. Fiscal restraint and deep-rooted structural economic reforms are required under GOP agreements with the IMF, IBRD, and ourselves. There will be unavoidable economic dislocations as excessive price supports and price controls are eliminated, import protection phased down, a number of state enterprises closed, and the economy increasingly deregulated. A considerable measure of austerity will be required both for the economy and, especially, for the public sector.

Background:

Panama's 2 million people enjoy a per capita income of just over $2,000 — about average for middle income Latin American countries but high for Central America. High levels of health, education, and other social services are provided, and the country posesses a well-trained, literate work force. The income distribution is significantly skewed. The economy is heavily service-oriented and closely tied to the external sector. Roughly three quarters of GDP derives from services, of which 15 percentage points is directly accounted for by the canal and the transisthmian oil pipeline. Primary activities (agriculture and mining) account for only 11% of income but 29% of employment. The Canal is the dominant feature of the economy. The transisthmian oil pipeline adds to the importance of interoceanic transport. The Colon Free Zone serves as a the regional entrepot and Panama city as the regional Banking. center (129 private banks with over $32 billion in deposits). Services to the large USG establishment in the Canal area are of major proportions. (The USG non-US citizen payroll and retirement payments in Panama amount to $270 million; procurement of goods and services another, $101 million; payments required under the 1977 Canal treaty, $76 million; and personal spending by US Government citizen personnel is estimated at $77 million. In all some $525 million in 1985.)

The Panamanian Balboa, except for fractional coinage, is strictly a nominal currency tied on a 1:1 basis to the US dollar. It is the latter which is the medium of exchange and the legal tender. There are no controls on financial flows to and from the country. As a result, the Government has no control over monetary aggregates, interest rates, or exchange rates. This is a source of confidence to the financial sector and precludes printing press inflation so common in many parts of the world. At the same time, without exchange rate movement to buffer the effect, the full burden of affecting ajustment to international trends falls on domestic prices. In the process, distortions and dislocations caused by institutional rigidities in the prices of labor and many goods are effectively magnified.

Growth and Employment:

During the 1960s, Panama sustained an exceptionally impressive 8% average growth rate. This growth was highly unbalanced, benefiting largely the metropolitan corridor and increasing income disparity between the urban and rural, and between the domestic and internationally oriented sectors of the economy. The military government which took power in late 1968 attempted to correct this with a rising level of social services, social reforms, economic infrastructure, and state economic activism financed by deficit spending. The economy averaged a 7% growth rate through 1973 when high energy prices, the cummulative deficit, and the economic rigidities inherent in state economic activism caught up. Growth fell below two percent for the five year period ending in 1977. Following the Canal Treaty, there was a spurt of public sector driven growth (7% average rate) from 1978 to 1982 with a large increase in Government debt. With the end of easy credit from abroad and the imposition of austerity on the public sector, the growth rate in 1983 and 1984 fell to zero levels.

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According to preliminary official statistics, Panama's 1985 growth rate measured 3.3%, showing a modest recovery from the stagnation of the previous two years. However, this is deceptive in that much of the economy continues to stagnate. Virtually all recent growth is accounted for by the "autonomous" sector — the Canal, Free Zone and pipeline; none of which are particularly labor intensive. The statistics suggest a 2% growth in employment, insufficient for the need. Further, roughly half this employment growth was in the stagnant agricultural sector, suggesting that much of it is really underemployment. Preliminary unreleased statistics for 1985 show an 11.8% unemployment rate with some 84,500 unemployed and an estimated 70,000 underemployed. Many observers believe the actual unemployment rate is really in the 15 to 17% range, surging to 25 to 30% in areas such as Colon.

GDP SUMMARY TABLE

sector	% Composition By		annual % increase in value				
	value (1985)	employment (1983)	1981	1982	1983	1984	1985
GDP	100	100	4.2	5.5	0.4	-0.4	3.3
Agriculture	11	29	8.3	-1.5	3.3	0.2	2.9
Manufacturing	10	10	-3.3	2.2	-1.8	-0.6	1.0
Utilities	3	1	5.0	5.3	9.6	-0.3	5.3
Construction	5	6	3.2	20.6	-31.2	-11.3	-1.1
Commerce, hotels and restaurants	12	14	1.4	-0.8	-4.6	0.6	1.1
Transportation, warehousing and communications	25	6	5.7	12.6	8.8	-4.0	5.1
(Colon FZ)	(3)		(1.2	-16.2	-27.9	3.9	17.2)
(Canal Com.)	(9)		(7.3	8.7	-14.5	-0.2	1.4)
Finance, insur. and real estate	14	5	7.2	3.7	4.0	2.9	2.2
Social & community services	9.1		5.3	8.8	3.4	4.7	2.5
Gov't. Serv.	13.2	27	8.8	3.4	4.7	2.5	
Domestic Serv.	1.0		4.5	4.3	0.5	3.1	3.5
Import Duties	1.8		-1.4	6.9	10.5	1.5	9.6

This is the most fundamental economic problem facing Panama — the inability of the economy to generate adequate employment. Indeed, Panama's economy is moving along a growth path inconsistent with underlying demographic trends. During the 1970s increased schooling and early retirement were used (at considerable cost) as artifices to lower the labor force participation rate. Complementing these measures, public sector employment grew steadily and accounted for more than 70% of the economy's increase in employment during this period. These policy options for dealing with unemployment are no longer available. Currently, some 22,000 to 25,000 Panamanians enter the labor market each year while the economy is creating only some 12,000 to 15,000 new jobs, creating an employment deficit accumulating at some 12,000 jobs per year.

Panama desperately needs to broaden the base of economic growth. This will require major restructuring. Until now Panama's economic prosperity rested on the "autonomous" sector. The canal and the pipeline are largely uneffected by domestic economic policy. They are run autonomously and, in any event, geography has given Panama a very strong competitive position in transoceanic surface shipment. Similarly, the Free Zone and the international banks based in Panama operate more or less without hinderance from domestic economy policy. Income and growth in these areas are highly invariant against the rules that govern the domestic economy. But Panama requires greater growth than the autonomous sector alone can generate, and in this economic policy becomes crucial.

Income from the autonomus sector has masked increasing inefficiency throughout the domestic components of the economy. Panama's cost structure in terms of dollars or man-hours is prohibitively high. A restrictive labor code, agricultural price supports and marketing controls, consumer price controls, a patchwork system of import protection, use of parastatal enterprises, and general over-regulation have distorted the economy's cost and incentive structure. Studies commissioned by the USAID-supported Development Studies Project show a significant decline in the economy's overall level of productivity during the 1970s. If productivity had remained constant, GDP would have been at least 20% to 30% higher in 1980. It seems fair to conclude that the economy is producing many of the wrong things and producing them inefficiently. High costs are apparent even to the casual observer. Business that Panama should be ideally positioned for, e.g., ship repairs, goes elsewhere in the Caribbean where costs are as much lower.

Prodded by the Bank, the Fund, ourselves, and most importantly by sheer necessity, the GOP has haltingly begun the process of restructuring the economy. Fiscal restraint and deep-rooted structural economic reforms are required under GOP agreements with the IMF, IBRD, and ourselves. A considerable amount of deregulation is underway. The government is eliminating most price supports and price controls; it is eliminating quantitative import controls and rationalizing the tariff structure; it has loosened (slightly) the highly restrictive labor code; it will restructure the social security program, it has abandoned the goal of agricultural self-sufficiency in basic foodstuffs; and it has committed itself to a substantial divestiture effort. There will be unavoidable economic dislocations as excessive price supports and import protection are withdrawn, a number of state enterprises closed, and the economy increasingly deregulated. A considerable measure of austerity will be required both for the economy and, especially, for the public sector.

These measures will go a long way toward creating the basis for sustained growth. However, a great deal more is needed. The trend towards deregulation must be accelerated. More generally, there is a need to correct the long standing structural unbalance in the current account and begin to repay the foreign debt. To do this is going to require that the economy experience an increase in the price of internationally tradeable goods with respect to the price of non-tradeables; i.e., a fall in the "real" exchange rate of such items as wages in relation to import prices. Lastly, and most importantly, the size of the Government deficit must be kept to minimal levels.

Current Fiscal Situation:

Panama has a classic structural deficit, the budget has been in deficit every year for as far back as our data goes. However, at the same time the current account has always shown positive; i.e., a surplus before capital investment spending. Panama is a relatively high taxed economy — with tax burden at about 20% of GNP. Hence higher taxes are not a practical solution to the deficit problem. Rather a reduction is and rationalization of government spending is called for. Fiscal austerity commenced in 1983. By 1985, the annual government deficit was reduced to some $100 million, down by two-thirds from the previous year, and well within the IFM ceiling of $160 million. However the govenment was not able to avoid borrowing $55 million from the National Bank. As any net borrowing from this account was in violation of another IMF performance criteria, the funds plus interest will have to be repaid in 1986.

Public Sector Revenues and Expenditures
(in millions of dollars)

	1982	1983	1984	1985	1986*	1987*
Revenues	1265	1387	1395	1503	1593	1690
(taxes)	615	662	635	689	740	
(non-tax)	650	725	760	814	853	
Expenditures	1727	1652	-1699	-1622	-1685	-1794
(current)	1209	1245	1334	1374	1409	1479
(capital)	518	407	365	248	276	315
Net Excluded items	-2	+17	+8	+16	+15	+5
DEFICIT	-464	-243	-296	-103	-77	-100
(Deficit after ESF—memo item) (				-266	-123	-62)

FINANCING OF THE DEFICIT
(in millions of dollars)

	1984	1985	1986* projected	1987* projected
Financing	296	103	77	99.5
Net External Fin.	121	48	140	99.5
(ESF)	(30)	(20)	(15)	
Banco Nacional	175	55	-63	

* Note: 1986 and 1987 figures shown here represent the latest planning figures used by the Budget Office of the Ministry of Planning and Economic Policy for achieving compliance with IMF performance criteria and differ from figures shown in the government budget. Also, GOP figures have been ajusted to subtract ESF grants from the revenues figure and to add them to the external financing entries.

The Government deficit appears nearly under control and sufficient additional funds to cover the remaining gap are in sight. Revenues were up 7.5% in 1985 and may rise by another 5% or 6% in 1986. This increase reflects developments in the autonomous sector. The revival of international commerce generated higher non-tax revenues and the progressive extension of tax liability to Canal Zone entities generated higher tax revenues. However, by far the major factor in controling the deficit has been the reduction in public sector capital expenditures. These fell by 40% from the 1981-1984 average to $248 million in 1985. A modest increase in capital spending is projected for 1986 and 1987 but the overall levels will still be well below those of the late 1970s and early 1980s. The reduction in the deficit reflects not only government political will and donor pressure, but also sharply limited government access to fresh credit from the international banks. (Not having its own currency to print, the government is constrained in its financial options.)

A note of caution is in order. While at this writing adequate 1986 financing (after ESF) appears at hand, this is based on optimistic assumptions by the GOP on likely foreign assistance disbursements, its ability to restrain spending and otherwise maintain compliance with IMF, IBRD, and AID conditionality, and on the availability of external financing. There is little margin for error. A miscalculation could result in violation of its agreements with the IMF and others, and if confidence were lost, this could unravel the entire package and precipitate a financial crisis.

Debt Management:

Because Panama is a small, open, dollar based economy without its own currency, the cumulative government deficit and foreign debt are very closely related. Panama debt is the consequence of heavy deficit spending in the late 1970s and early 1980s. At the end of 1985 this debt stood at some $5 billion; the equivalent of one year's GDP. Some $3.6 billion of the debt is external; and of this $1.5 billion is owed to official entities. (The IMF, the IBRD, AID, the Venezuelan and Mexican Oil facilities account for almost all of

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this.) The remaining $2.1 billion is owed commercially, largely to banks. Roughly $1.4 billion is owed domestically by the GOP, more than half of this to the Social Security Fund and the National Bank. The interest on debt alone amounts to a quarter of the entire government budget or roughly $400 million per year. (External interest payments amount to $330 million).

A 1986 debt rescheduling package has been put together involving a reactivation of the IMF Standby with some $44 million in 1986 IMF SDR purchases; a commercial bank roll over of $378 million in maturing debt; and $60 million of fresh commercial bank credit. The commercial bank credit is strictly conditioned on new IMF fiscal performance targets and on reaching an agreement with the IBRD on a second Structural Ajustment Loan. Funding will be tranched, with disbursements conditioned on continued compliance with the IMF conditions. Agreement appears to have been reached on an $80 million SAL-II and the GOP anticipates that $50 million of this will disburse in '86. Thus, as of this writing (early June) all elements of the 1986 rescheduling package appear close at hand, with formal announcements pending. Under the terms of the 1986 standby, the current year deficit will have to be reduced to $62.4 million (after ESF) for the year as a whole, $63 million in 1985 borrowing and interest will have to be repaid to the National Bank, and strict ceilings will be placed on new borrowing. Failure of the government to meet any of the IMF quarterly performance targets will jeopardize the entire package.

Some $406 million in external debt matured in 1985, another $610 million matures in 1986, $667 million in 1987. In 1985, amortizations of debt to official organizations were more than covered by new disbursements from these same organizations; and the government successfully rolled over its $225 million in maturing commercial bank obligations. The GOP expects to sustain this pattern and is in the process of rolling over $378 million of 1986 commercial debt. (Since Panama cannot pay, the bankers may have little immediate choice, but the government needs to be careful. Problems here could reflect on Panama's investment climate. Moreover, the GOP still needs more commercial credit.)

External financing

	1985	1986	1987
		(in millions of dollars)	
Amortizations	-414	-610	-667
IMF, IBRD, IDB, & AID	76	99	
Commercial Banks	227	378	
Other	111	133	
Disbursements	+458	+735	
IMF, IBRD, IDB, & AID	162	245	
Commercial Bank roll-overs	225	+378	+459
Fresh bank credit		+60	
Other	71	53	
Balance	+44	+125	
Exclusions and inconsistencies	+4	+15*	
Net External Finance	+48	+140	

* appears to be a double counting of GOP ESF projection.

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The Balance of Payments:

The balance of payments is largely driven by external factors, and the GOP has surprising little control over it. Merchandise exports are but a small portion of the total and in any case are primary commodities whose prices and demand are externally determined. The terms of trade on merchandise items have not been par::iculary good for Panama with sugar, bananas, coffee, and shrimp accounting for the bulk of exports. The prices of manufactured items and oil which account for most imports has risen throughout recent years, though oil prices are now declining. Panama's basic contribution to the international economy is in the form of non-factor services, particularly inter-oceanic transport, the demand for which fluctuates with the global level of trade. Free Zone service demand is driven by trade and prosperity in the South and Central America. Similarly, the purchase of services by the US military establishment and its employees is largely unrelated to events in Panama.

BALANCE OF PAYMENTS
(millions of dollars)

	1982	1983	1984	1985	1986(proj.)
CURRENT ACCOUNT	-389	-173	-259	-176	-225
trade balance	-242	-263	-195	-201	-166
exports	322	307	279	313	340
imports	-1087	-968	-972	-1004	-1061
services balance	583	711	582	633	577
(int. on pub. debt	-350	-289	-317	-229	-331)
unreq. transfers	36	41	48	83	79

The merchandise trade account, as could be expected from the composition of earnings, is always strongly negative, compensated in large measure by a strong surplus in the services account. Overall the current account has been negative every year for at least the last 35 years, underwritten by external credit. Throughout the late 1970s and early 1980s high interest rates impacting on a rapidly accumulating external debt enlarged the overall deficit. Total debt became unmanageable in 1983 and led to the drying up of external credit in 1983, which, in turn, caused a sharp fall in the current account deficit that year.

Lacking a central bank and with limited local savings, Panama's current account deficit relates closely to the availability of foreign financing. Moreover, given the relative freedom from financial controls and reporting it is difficult to distinguish between domestic and foreign financing.

In 1984 and 1985 there was some improvement in the accounts owing to the drop in petroleum prices and interest rates. Panama's oil bill has fallen by $10 million per month and every percentage point drop in LIBOR reduces the average annual interest charge on Panama's external debt by some $40 million. Unfortunately, the downward slide of interest rates and petroleum prices may be over. With respect to the capital account, direct foreign investment has been dominated in the early 1980s by the building of the pipeline. With its completion, in 1983, net private foreign investment turned mildly.

(DOC. 9972n)

ANNEX C

THE SEVERANCE BONUS PROGRAM

I. INTRODUCTION

The purpose of this annex is to analyze and make certain recommendations as to the handling of the personnel problems of Panama's state-owned enterprises in the light of the government's present decision to privatize a number of those enterprises.

Existing labor legislation in Panama, overstaffed state-owned enterprises (SOE), in many cases carrying large accumulated labor liabilities, coupled with resistance to divestiture by employees and union officials make the solution of the personnel problem a crucial first priority when initiating a divestiture process be it sale or closure of the enterprise.

Not addressing this problem in a realistic and timely fashion will hold up or indefinitly paralyze any privatization process. Information gathered from private Panamanian investors and leading labor legislation experts all point clearly to the solution of the personnel problem as a first must.

It is felt that no private investor will purchase an SOE unless a solution is given to the personnel problem. The purchase of an SOE with its personnel not only implies bloated labor costs, but even worse, the assumption of accrued labor benefits which are normally not fully reflected in the balance sheet. Furthermore, limitations on firing, labor contracts which are normally more beneficial than similar ones in private companies, and the existence of what are called "established practices" and "acquired rights", are all elements that will require a solution of the personnel problem before an SOE is purchased.

On the other hand, the elimination or reduction of the employee problem will allow the government more flexibility and expediency to proceed with the privatization process, removing employee and union resistance and at the same time making the process more politically palatable by making bonus payments avaliable to employees who resign.

This report will analyze the labor legislation and its implications, and propose solutions for solving the personnel problem by creating a fund to offer a bonus for resignations.

An action program is proposed, and certain recommendations for the execution of the plan are included.

II. BACKGROUND

Labor legislation in Panama is established in two basic laws. The "Codigo de Trabajo" or "Labor Code" which encompasses employees in the private sector, (See articles 211 and 212 of the Labor Code in Annex 1) including those state owned enterprises constituted as "Sociedad Anónima" or private stock corporations under the mercantile laws of Panamá; and the administrative code or civil service statute that covers employment in the central government and those state owned enterprises established as parastatals institutions.

The difference between the two regimes is substantial in practically all aspects pertaining to employer/employee relations, in particular the capacity to fire employees and the benefits accrued to them for dismissal. Whereas no justification is needed to fire personnel, and no severance or additional benefits are granted to government employees, the "Labor Code" estabishes extremely restrictive limitations on the firing of employees and allows important benefits for those that are dismissed.

The "Labor Code" of Panamá issued in December of 1971 is an extensive document which includes 1,067 articles covering practically every aspect of labor relations in great detail. It is a very well written piece of legislation, with mutually reinforcing articles, and of a highly rigid nature leaving very little room for interpretation. The "Labor Code" is oriented to a strict protection of employees who have jobs, and incorporates the concept of "employment stability", very much in vogue during those years, and promoted by the International Labor Organization of the United Nations, also a coveted objective of major labor unions at the time. In the same period, similar legislation was enacted in other countries of the continent, notably Peru and Chile. Overall results have not been as expected, and there is now a greater concern for job creation rather than job protection. Chile has repealed the measure, Peru has modified it, and the I.L.O. has already reviewed its stance on the subject.

In accordance to the Labor Code, employees acquire stability after 2 years of continuous work, when there is a written contract or permanent employment relationship. Most work contracts incorporate a trial period of 3 months during which employees can be dismissed with no justification and no severance pay. At between 3 months and 2 years services they can also be dismissed but with payment of severance benefits. After 2 years, dismissal can only be done where justified causes exist and which are specifically spelled out in the "Labor Code" (See articles 211, 212 and 213 of the "Labor Code" in annex 1-).

Article 213 establishes the criteria for dismissal as: (a) of disciplinary nature, such as violent acts or pilfering among 14 other causes, (b) Of actions not imputable to the employer, such as prison, mental incapacity etc., and (c) for economic causes, such as bankruptcy or basic deterioration of business conditions. In all these cases employees have the right to contest the dismissal, and the labor authorities have the final decision after a complex procedure. If the ruling is favorable, employees can be reinstated with the payment of back salaries, or the employer can choose to fire him with a 50% penalty in addition to severance pay. In cases of bankruptcy workers are preferred creditors for the amount of their accrued benefits.

Any employee who is dismissed for any reason at all, justified or not is entitled under the "Labor Code" to a seniority premium after 10 years service, equivalent to one week's salary per year, calculated on the basis of salaries including bonuses and overtime, over the last six months or the last month, whichever is higher. (See article 224 of the "Labor Code" and article 6 of law No.46 of 17/3/86 in annex 1-).

If an employee is fired with no justification, he is entitled to an indemnity or severance premium according to the following scale (See articles 225 and 226 of the Labor Code in Annex 1-):

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Period	Yearly Severance Pay
0 to 1 year one week's pay for every 3 months employed	4 weeks
1 to 2 years one week's pay for every 2 months employed	6 weeks
2 to 10 years three weeks for each year employed	3 weeks
10 and over one week for each year employed*	1 week

*After 10 years the employee is elegible for seniority premium in addition.

In a typical case, an employee earning B/.125.00 per week, with 10 years services would be entitled to a total of 44 weeks pay, which includes 34 weeks of severance pay, plus a seniority premium of 10 weeks. His total indemnity cost would be as follows:

Severancy pay	B/ 4,250.00
Seniority premium	B/ 1,250.00
Unpaid 13th Salary	B/ 167.00
Unpaid vacation (1 year)	B/ 500.00
Total	B/ 6,167.00

If the employee contests the dismissal and wins the case, his dismissal could cost B/.2,125.00 more, increasing indemnity costs up to B/.8,292.00.

In some cases unions have obtained improvements on the "Labor Code", such as seniority premiums before the 10 year period, or additional bonuses, all of which have to be included in the severance pay calculations.

(For a more complete vision of severance benefits see Table 2).

A. The Administrative Code

The administrative code or civil service statute does not incorporate the concept of employment protection as does the "Labor Code", nor does it establish benefits for seniority. The dismissal of employees is very easy as no justificaion is required, and no benefits or severance payments are accrued. The only requirements for dismissal are 30 days advance notice and the payment of accumulated, unused vacations.

In practice however, rarely are employees fired from government jobs, and it is doubtful any government will face a major program of dismissal of employees.

All the SOEs established directly by the government and which are constituted as parastatal institutions have their employees governed by the administrative code. Only those SOEs, that were once private institutions and later taken over by the government are included in the Labor Code, although some such as IHRE and INTEL have special legislation. (For a complete list of the labor status of Panamá's SOEs see table 1-).

B. Effects of Labor Costs on Privatization of SOEs

The enormous costs associated with severance payments and seniority bonuses have forced most medium and large private Panamanian firms to establish separate reserves for such contingencies, in addition to limiting their hiring of personnel. Nevertheless, in the case of state-owned companies abiding by the "Labor Code", this has not been the case, and has not proved to be a deterrent for hiring. As a rule those companies have excess employees and bloated payrolls. Needless to say, these costs and labor rigidities do have a tremendous bearing on privatization of those SOEs.

The labor situation and costs involved will be a major stumbling block for the sale of an SOE, therefore it is one of the first aspects that must be addressed in this process.

For this purpose a detailed analysis must be made in each case, which will include collective agreements or labor contracts, individual evaluations of each employee to determine his accumulated labor benefits, in addition to determining the qualifications of each, and if they are redundant or not.

To illustrate what costs are involved let's assume an SOE that has 500 employees, with an average of 10 years of employment and with an average monthly salary of B/.500.00. Assuming no extra pecuniary benefits in the labor or union contract, the accumulated labor liabilities would be:

Seniority premium B/.125.00 x 10 x 500	B/.725,000.00
Unpaid vacations (50%) B/.500 x 250	B/.125,000.00
13th month (50%) B/.167 x 500	B/. 83,500.00
Total	B/.933,500.00
Per employee (approx. 3.7 months wages)	B/. 1,867.00

Assuming 250 employees are redundant and must be laid off, they would be entitled to an additional severance pay averaging 24 weeks salaries per employee as follows:

Severance pay B/.125.00 x 34 x 250	B/.1,062,500.00*
Per employee (8.5 months wages)	B/. 4,250.00

*Note This severance pay can be increased by 50% if the workers obtain favorable court rulings.

In short, the accumulated labor liability of the hypothetical SOE would be a total of B/.1,996,000.00 as a minimum.

If all the personnel (500) were to be liquidated the cost would be of B/.3,058,500.00 without including possible unfavorable court rulings or benefits included in labor contracts.

From this very general example we can derive that accumulated labor liabilities can add up to a very significant cost to any investor purchasing a Panamanian SOE whose workers are under the "Labor Code". This situation becomes more critical if there is an excess of employees all of which must be dismissed with the corresponding severance pay, and existing labor contract establishes additional benefits and working conditions, and practices not acceptable to a private, profit oriented institution.

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On the other hand we have the problem created by those workers in SOEs, governed by the administrative code. In this case the problem is easier to handle from the legal point of view. In the first place, as no corporate entity which may be purchased by the private sector exists, the divestiture constitutes a sale of assets. Insofar as the employees go, their transfer or incorporation into a new private corporation entity governed by the "Labor Code", will create a new contractual labor relationship in which the employees benefits only begin to accrue after the new contract date.

In the above case the prospective buyer will have no problem of accumulated labor liabilities to face. Nevertheless, the government will have to face the problem of disposing of those employees, or probably the great majority of them. The concept that will be put forth in this paper is the payment of some sort of severance bonus with the argument of the closure or sale of the enterprise by the government, which will entail a cost, but politically ease the solution of the personnel problem, and in the end facilitate the sale.

III. PROPOSAL FOR SOLVING THE LABOR PROBLEM IN THOSE STATE OWNED ENTERPRISES TO BE DIVESTED

The solution of the labor problem is of necessity a crucial first step before any SOE is divested. The rigidities imposed by the "Labor Code", the large accumulated labor liabilities and employee resistance to privatization all point to the definitive solving of the labor problem before the actual sale or closure of the enterprise is executed.

It is very likely that each individual SOE will have its own peculiarities and particular situation with regard to the labor problem. Furthermore, the political and environmental characteristics are probably different in each case, making the actual handling of the solution different.

Nevertheless the root of the problem is the same in each enterprise. Bloated labor forces, accumulated labor liabilities and difficulty to dispose of personnel.

Within this situation, the most effective and least costly solution is to dismiss all the personnel previous to a divestiture. This not only facilitates the sale, but produces savings for the government in a relatively short period.

The action must be carried out by the government as it is difficult to expect the buyer to assume the task and costs involved. Furthermore it is recommendable that the execution of a personnel reduction program be done within the existing legal framework as any modification may be counter-productive.

Several alternatives were analyzed. In the case of the "Labor Code" and the following possibilities for reducing personnel were evaluated.

A. By invoking paragraph (c) of article 213 of the "Labor Code" which establishes that employees may be dismissed for economic reasons (bankruptcy, economic crisis, etc.) The cost of this would be limited to seniority premiums to those employees with 10 years of services.

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B. By dismissing employees without a justified cause as established in the "Labor Code" which would involve the payment of seniority plus severance payments. In addition, if the decision is contested successfully, the employee may obtain up to a 50% bonus n his severance pay. (See article 219 of the "Labor Code" in annex 1). Legally this alternative can be applicable to only 10% of the labor force, but it is something that can be negotiated with the employees, as well as the 50% penalty.

C. By negotiating or obtaining from the employees, voluntary resignations, by the offering of financial incentives over and above what they would obtain for "unjustified dismissal".

Considering the political and labor environment, possible legal restrictions, and the ease of handling the execution, along with the need to handle this problem on a non-aggressive and low key basis, it is felt that alternative (c) presents the best possibility for handling the problem. In this case the severance costs may be slightly higher, but the effectiveness of the solution far outweighs the costs. (See table 2 for a comparison of costs).

The proposed solution has produced positive results elsewhere and in Panama as is shown in the following section.

In the case of administrative code employees, there is nearly absolute legal flexibility to dismiss an employee, as no justification is required, and the only benefit possible is the payment of unused vacations, which at best adds up to one month per year.

But on the other hand there are political restrictions (real or perceived), plus particular situations in each enterprise that do not allow for complete freedom of action as is legally permitted. It is difficult to envision the present government and for that matter any other government going through wholesale dismissals of SOE employees with no compensation but their unpaid vacations.

Furthermore, in a situation such as that in which Panama lives today with relatively few employment opportunities there is the question of protection, or the creation of some sort of temporary cushion for those that are forced out of their employment in SOEs, to which we must add an ingredient of equity in relation to those benefits available to "Labor Code" employees particularly those who are also on government payroll.

The legal framework for administrative code employees allows for a great deal of flexibility in dealing with dismissals or personnel reductions so a wide range of alternatives may be analyzed. But the basic suggestion put forth here is that a bonus should be paid to administrative code employees for resigning from their posts. The amount and conditions for the bonus will be discussed latter.

The proposed program for employees under the administrative code raises the question of precedent with regard to the rest of public sector employees who might see this as an opening to press for severance pay and seniority benefits for themselves. But it is believed that if the program is adequately handled, and strict conditionality applied, the problem of precedent can be

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overcome, for example it can be established that the bonus program is only applicable to SOEs slated to be sold or closed or whose sale is already arranged.

If political and environmental restrictions limit the dismissal of employees for SOEs, the only other alternative left for the government is to assume them into its own payroll, which will not solve the problem, as the cost continues to exist. Unless of course the new buyer absorbs part, or all of the personnel, which is highly unlikely.

In sum, the recommended approach with administrative code employees should be the offering of a bonus for resignation. Any left over personnel would then be offered to the new buyer.

A. The Result of Similar Experiences

Buy-outs or bonuses for resignation have generally been successful when applied in a form that is attractive to employees.

The first step is to make employees aware of the situation of their enterprise. Secondly, the presentation of the severance bonus in such a fashion that will make them aware of the possiblity of receiving a lump sum which will represent many months or years of wages, a benefit which would otherwise not accrue to them if they do not take advantage of the offer, which would also be limited in the time it will be available.

In Perú, where similar legislation to Panamá's "Labor Code" exists, large wholesale buy-outs or bonus programs for employees have taken place. In 1983, all 1800 workers of a state owned tuna cannery resigned with the payment of a resignation bonus, enabling the closing down and subsequent privatization of the enterprise to proceed. In 1984, PescaPerú the state owned fishmeal producing enterprise reduced 4,500 employees from its payroll of 6,000 and closed down 30 out of 37 plants in an effort to reduce excess capacity and privatize certain equipment. The same occurred with Epsep, the state fish marketing firm that reduced its payroll from 1,200 to 500 and leased out much of its infrastructure to the private sector. SuperEpsa, a super market chain, paid a bonus to i'ts 800 workers before divesting its assets. In another case, the Peruvian Government in 1978, offered a bonus of 8 months salary to employees who resigned from the Central government obtaining a reduction of 2% of its labor force.

The costs of these programs have normally been substantial and the funding has had to be assumed by the Central Government as the enterprises were in no shape to do so. In the case of PescaPerú the cost was about US$24,000,000, but it compared favorably with yearly losses of about US$35,000,000 or more.

Political and social implications are also involved in these actions, and even though the programs have been voluntary, opposition, sometimes violent, has been created by unions who in the end are the most affected. Nevertheless, even with Union intimidation, employee response has been always very positive.

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In the cases in Perú, experience has taught that a well prepared and well organized program is essential. Expeditiousness and the immediate availability of the funds is crucial to the success, as well as a determined and decisive action by the SOE management. At times, the appointment of special liquidators has been necessary to assure the program is well carried out. The contrary can mean delays and the creation of unnecessary problems. Not all has been successful in Perú, for example, a vegetable dehydrating plan liquidated in 1981 was only defintely closed in 1984, because the personnel reduction program was not carried out effectively.

Perú is not the only case where personnel buy-out programs have been effective. They have been carried out in Venezuela and Ecuador where there is relative (more flexible) employment stability. Furthermore it is constantly done by the privatre sector in Panama, on a more limited scale. Recently a major multinational bank sold off most of its branches and successfully reduced its staff from about 500 employees, to 150, through a bonus program for resignations.

One of the principal sources of concern for governments when executing such a buy-out program is the final destiny of the personnel that resigned. The Peruvian experience in PescaPerú, as a whole was satisfactory. Part of the employees were re-hired by the new private sector owners, but an important number became self-employed or set up small businesses. For example mechanics joined up to open repair shops, others opened up small stores, a few purchased cars to become taxi drivers, and some also acquired fishing boats to become fishermen. The acquisition of a small capital, through the retirement program played an important role in the creation of new activities for the personnel.

B. The Environment for the Program in Panama

From information gathered, and the current of opinion among top public sector officials and private sector representatives, there seems to be a general support of the reduction of the state's role in the economy, and the idea of a "Privatization Program". Furthermore, economic circumstances and international financial arrangements have committed the government in this direction.

Although the government has not announced a broad privatization plan, it has announced the sale or closure of individual SOEs, using the economic arguments for the purpose.

Even though there is the expected opposition from certain political sectors, particularly for ideological reasons, it seems that public opinion in general seems to approve the divestiture of money loosing enterprises.

The reaction of Ministers and high level government officials to the creation of a severance pay fund has been very positive as it provides a way out for a social and political problem, and there is the general feeling that the defusion of the labor problem will ease the way for the divestiture program.

The generally positive reaction perceived to date does not ensure this will persist, and once actual privatization takes place, what the reactions will be.

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The labor aspect will probably be the most delicate to handle, particularly if a reduction is to take place before the sale. Without a doubt, resistance should realistically be expected from some employees, but more so from the unions who will see their political base eroded and possibly local institutions in remote areas where the enterprise is the sole source of employment. The situation and reactions will probably be different in each case, but appropriate execution of the program can ensure positive results.

The report "Evaluation of the Privatization Program of the Government of Panama", April 1986, is probably correct in stating that " it is realistic to assume that the GOP will resist divesting the four gaming entities, the four utilities and the airport and seaport authorities". Not only do they contribute significantly to the Central Government's revenue base, but there are moral and religious outlooks at play with regard to the gaming entities, and any sale or divestiture of the utilities could cause political problems, accusations of being anti-nationalistic as these enterprises (Power and Telecommunications) were taken over from foreign concerns not too long ago (the nationalization date is still celebrated annually at IRHE and INTEL). Furthermore, these enterprises employ large numbers of people and they make up a significant political base for the most powerful labor unions in the country. Any perceived reduction of personnel will surely bring about a reaction from the unions.

The previously cited report refers to privatization of the utilities by contracting services to the private sector. While this approach is feasible, it will probably not imply personnel reductions, at best we can expect a freeze on present levels of employment.

The following is a partial list of enterprises where total or partial privatization may take place:

Enterprise	Labor Status	No. of Employees
Air Panama, S.A.	Labor Code	504
Contadora Panama, S.A. (Hotel)	Labor Code	160
Aero Perlas, S.A.	Labor Code	160
Cítricos de Chiriquí, S.A.	Labor Code	615
Corporación Azucarera La Victoria (CALV) (Azuero and Felipillo Mills)	Administrative Code	400
Empresa Nacional de Semillas (ENASEM)	Administrative Code	43
Empresa Nacional de Maquinarias (ENDEMA)	Administrative Code	426
Instituto de Mercadeo Agropecuario (IMA)	Administrative Code	839
Corporación Bananera del Atlántico (COBANA)	Administrative Code	374
TOTAL		3,423

C. Some Preliminary Conclusions

1. Existing labor legislation in Panama under the "Labor Code" and political limitations for dealing with administrative code employees all add up to creating a very rigid and costly framework for handling personnel reductions in state-owned enterprises.

2. The sale or divestiture of an SOE will be more effectively managed if the personnel problem is solved beforehand by obtaining their removal.

3. The system best suited to obtain employee resignations is the application of an incentive or bonus plan. This system has already been tested both in Panama and abroad.

4. The bonus program would be applied across the board to those SOEs slated for divestiture, and eventually on a limited scale in the rest.

5. The application of the bonus program would be applied on a case by case basis to the divested SOEs in the order the decisions are implemented.

6. There is favorable disposition of the government to the execution of the program as a necessary support to its general privatization objectives.

D. Personnel Rationalization Program of the GOP

1. Design of the Program

a. Objectives

The program would be aimed primarily at the reduction or elimination of personnel from those SOEs targeted for divestiture by the GOP.

The mechanism to be used would be the establishment of a fund within the Panamanian Government which would be used to pay bonuses to that personnel which will resign from the targeted SOEs.

b. Target agencies and Number of Personnel Involved

At this moment, it is difficult to pinpoint the exact number of personnel involved as it requires an indepth analysis of each SOE, and a definition by the GOP of a privatization program yet to be defined.

The total amount of personnel involved from the partial list of potential divestitures would be the following:

Enterprise	Number of Personnel to Resign	Work Code
Air Panama	504	Labor
Contadora Panama, S.A.	160	Labor
Aeroperlas, S.A.	82	Labor
Cítricos de Chiriquí, S.A.	673	Labor
CALV	400	Administrative
ENASEM	43	Administrative
ENDEMA	426	Administrative
IMA	300	Administrative
COBANA	374	Admimistrative
TOTAL	2,962	

c. Incentives To Be Offered

(1) Labor Code Employees

In the case of these employees, legally entitled to severance pay, and a seniority premium, the bonus to be offered for resigning personnel would be according to the following scale:

- Minimum amount for all employees	-	B/ 2,000.00
- From 0 to 2 years of service	-	8 weeks per year
- From 2 to 10 years of service	-	7 weeks per year
- From 10 to 20 years of service	-	6 weeks per year
- From 20 years of service on	-	5 weeks per year

On average, this proposal represents about a 25 to 30% bonus on top of the amount workers are legally entitled to, including the possible 50% penalty applicable in the case of adverse judgements as established in Article 219 of the "Labor Code". (For a comparison of costs from benefits under the "Labor Code" to this proposal, see Table 2.)

Alternative: A possible alternative to the above proposal would be the following:

1.50 months salary for each year of service from 1 to 5 years.
1.75 months salary for each year of service from 5 to 10 years.
2.00 months salary for each year of service from 10 years onward.

A minimum payment of 6 months and a maximum of 30 is applied to this formula. The costs of both alternatives are similar. (See Table 4.)

For the case of those employees who do not resign, part of them, up to 10% of the original labor force, could be dismissed with the payment of their accrued benefits, plus the 50% penalty on severance pay. Should there be any employees leftover, they would be assumed by the new buyer with a clause to be included in the sales contract that any of those employees that he dismisses within the next two-year period will have their indemnities paid by the government, from the severance pay funds. In this case, if the employee is to be substituted, preference could be given to former employees of the SOE.

(2) Administrative Code Employees

Although it is not convenient to apply the exact same bonus scale as to the "Labor Code" employees, the final amount should be similar, but possibly smaller.

The proposed scale would also be simpler.

A minimum payment of B/ 1,500 plus
1.5 months for each year of service, regardless of seniority.

A simple scale, or a single amount is suggested because this payment is to be considered as a bonus or incentive for retirement. It cannot and must not be treated as severance pay, both for legal and political reasons. The scale to be offered should not in any way be similar to severance pay benefits under the Labor Code. Furthermore, a simple scale or a single amount will limit discussion and argument on the subject, as a bonus must be considered a voluntary action on the part of the firm, and not a subject for discussion, that is, employees may or may not apply for the bonus.

To avoid the bonus becoming an acquired right, it must have clear legal justification, and it should only be available for a limited period of time, and on a voluntary basis for the employees. Further conditionality should be included into the bonus such as prohibition for the employee to enter government service for a five-year period.

Any personnel that does not resign can be either absorbed by the central government or alternatively by the new owner of the enterprise. Here again, a provision may be written into the sales contract whereby any employees that are dismissed within a two-year period will be paid by the severance pay fund.

This should not be costly, as the employee's labor contract with the new owner starts over again under the "Labor Code" and job stability is acquired only after the second year. Severance pay is 4 weeks in the first year and 6 weeks in the second, and no justification for dismissal is required. In this case, there would also be the requirement for preference in hiring former SOE employees as replacements.

d. Operational Structure and Institutional Framework

The proposal would be to create a simple non bureaucratic structure within a "Divestitutre Office" whose responsibility would be to execute the bonus program of employees when it is so decided, in each case, by the GOP.

In order to simplify legal procedures, and budgetary purposes, the funds required would be deposited in a special account in the Banco Nacional de Panama (BNP), and the disbursement would be decided by the Divestiture Office as each severance program is begun. Tentatively, the funds would be booked by the BNP as a loan to the SOE, to be repaid from the proceeds of the sale of the SOE or its assets.

In some cases, this would require a "crédito suplementario" or budget increase, when the amount of the bonus program does not fit under the approved budget of the SOE. This would require an application to the MIPPE and legislative approval. For those SOEs to be privatized in 1987 and onwards, the possible amounts of the bonus program may be included in the yearly budget.

e. Legal Aspects

The first analyses on the legal aspects, although very preliminary, have not shown the need for legislative changes, nevertheless a more in depth evaluation is recommended, particularly on the administrative code end.

The boards of directors of the SOEs can authorize the payment of the bonuses, and the funding would probably require a budget allocation or credits suplementario.

Adequately worded letters or resignation would be made available to the employees the moment the program is decided in each case.

IV. COSTS AND FUNDING

A. Cost

The total cost of the program is very difficult to estimate precisely at this point. For more exact figures a more detailed analysis of the benefits due to each employee is required. Nevertheless a very broad estimate has been made for the list of enterprises, assuming an average seniority based on the lifespan of the firm, and average wages. Following are the results obtained (for details see Table 4).

ENTERPRISE	ESTIMATED PROGRAM COST
Air Panama, S.A.	B/ 6,842,800
Contadora Hotel, S.A.	B/ 1,044,800
Aeroperlas, S.A.	B/ 902,434
Cítricos de Chiriquí, S.A.	B/ 1,998,800
CALV (Azuero, Felipillo, Central Office)	B/ 1,938,000
ENASEM	B/ 244,068
ENDEMA	B/ 1,468,848
IMA	B/ 4,121,168
COBANA	B/ 1,639,616
Total	B/ 20,200,534

There is no government decision on Air Panama, and only parts of IMA would be divested.

B. Funding

The liquidity of the SOEs will not permit them to use any of their own funds for this effort, therefore the use of AID funds would definitely be required if the project is to be carried out successfully. The timely provision of the funds required is crucial to the correct and successful execution of this program.