1. **Country and Sector Background**

**Country Context**

The victory of Fernando Lugo, a former Catholic bishop, in the presidential elections of April 20, 2008 ended 61 years of Colorado Party dominance. The key priorities of Mr. Lugo’s Government and his political alliance, the Alianza Para el Cambio (APC), include a deep commitment to improve governance and government institutions and to reduce corruption, to improve the livelihoods and opportunities for the poor in a sustainable fashion, to strengthen the management of the country’s vast hydroelectric resources, and to consolidate the country’s democratic process. The Government and APC have also adopted a pragmatic economic policy stance based on maintaining sound macroeconomic management and a balanced view of the role of the State, while safeguarding the environment. However, the Government is also confronting challenges in pursuing these goals due to country specific institutional constraints, political context, and the effects of the international financial and economic crisis.

Paraguay’s public sector performance is poor and characterized by weak planning, policy implementation and service delivery. The public sector’s weak performance is clearly evidenced in its poor track record in social sector delivery, for instance in the prevention of epidemic diseases and infant mortality, as well as its difficulty in executing capital expenditures. There are many opportunities for improvement in areas ranging from (i) policy planning, (ii) resource allocation and budget execution; (iii) monitoring and evaluation; (iv) financial control; (v) institutional re-organization and development, and (vi) professionalization and de-politization of the civil service to name a few.

The legislative branch is endowed with a strong role within Paraguay’s division of powers, including attributions more usually held by the Executive including, inter alia, influence over the determination of individual civil servant salaries and the control over the approval process for externally financed projects. In addition, per the Financial Administration Law, the Legislature likewise has authority to increase total budgeted expenditures. The scope of legislative powers, compounded with party fragmentation in Congress, significantly undermine overall Government effectiveness, particularly as regards the Executive’s ability to embark on reform initiatives. This is enhanced by the current political context, as the APC did not obtain a majority of seats in either of
the two chambers of Congress, and passage of each new law is likely to entail broader coalition building efforts.

Government effectiveness in Paraguay is likewise affected by the prevalence of a clientelistic bureaucracy, and by the lack of inter-institutional coordination. On the one hand, the appointment and promotion of civil servants is significantly politicized; there are notorious salary distortions and arbitrariness that negatively affect incentives; while a significant proportion of civil servants demonstrate low professional skills. On the other hand, inter-institutional coordination mostly takes place at the Minister or General Director levels and rarely involves lower level positions. The absence of adequate formal mechanisms for inter-institutional communication and coordination frequently leads to institutional duplication and overlap.

Economic Developments and Outlook

Between 2003 and 2007, Paraguay experienced its biggest economic expansion since the 1970s, supported by a favorable external environment and sound macroeconomic policies. This period of rapid growth was fuelled by a recovery in domestic consumption and investment. Exports were boosted by high international commodity prices. The production of soy, which accounts for 40 percent of total exports, more than doubled between 2001 and 2008. Agriculture grew at an average annual rate of seven percent in real terms, more than any other sector. The service sector also performed strongly, driven by trade, transport and communication. At the same time, imports grew even faster boosted by domestic demand, resulting in negative net exports.

Table 1: Paraguay: Key macroeconomic indicators

<table>
<thead>
<tr>
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<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP growth (%)</td>
<td>4.1</td>
<td>2.9</td>
<td>4.3</td>
<td>6.8</td>
</tr>
<tr>
<td>GDP per capita (US$)</td>
<td>1,205</td>
<td>1,267</td>
<td>1,546</td>
<td>1,997</td>
</tr>
<tr>
<td>CPI inflation (eop, % change)</td>
<td>2.8</td>
<td>9.9</td>
<td>12.5</td>
<td>6.0</td>
</tr>
<tr>
<td>Central government primary balance (% of GDP)</td>
<td>2.7</td>
<td>2.0</td>
<td>1.5</td>
<td>1.8</td>
</tr>
<tr>
<td>Central government overall balance (% of GDP)</td>
<td>1.6</td>
<td>0.8</td>
<td>0.5</td>
<td>1.0</td>
</tr>
<tr>
<td>Current account (% of GDP)</td>
<td>2.1</td>
<td>0.2</td>
<td>1.3</td>
<td>0.8</td>
</tr>
<tr>
<td>Real effective exchange date (2000=100)</td>
<td>127.7</td>
<td>145.3</td>
<td>127.3</td>
<td>117.9</td>
</tr>
</tbody>
</table>

Source: Central Bank, Ministerio de Hacienda, IMF and Bank staff estimates.

Despite progress in recent years, poverty and inequality remain high relative to other Latin American countries. Incidence of moderate poverty peaked at 46 percent in 2002, and has since then fallen to 35.6 percent. Extreme poverty has fallen from 21.7 to 19.4 percent during the same period. This fall suggests that the recent economic growth has been to some extent pro-poor. Despite this positive trend, poverty levels are now only back at the levels observed in the late 1990s, suggesting that poverty remains a structural problem. At 0.55, Paraguay’s Gini coefficient of income distribution is the fourth highest in Latin America. The richest 10 percent of the population accounts for between 42 and 47 percent of total income. Similarly, inequality in land distribution is among the highest in the world. Reducing poverty and inequality in a sustained manner thus remains an important challenge, particularly with regards to access to productive assets, possibilities to accumulate human capital, and labor market opportunities.

The administration is committed to continue implementing prudent macroeconomic policies, and is focusing on fiscal sustainability, improved competitiveness and equitable growth – as laid out in the Government’s Strategic Economic and Social Plan for 2008-13 presented in September 2008. A key objective of the Plan is to create fiscal space, particularly on the revenue side, to dedicate more resources to priority spending programs, especially those aimed at reducing poverty.1 In order to achieve this, the Government is committed to maintaining inflation within single digits,

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1 This commitment was reinforced in the Economic Revitalization Plan announced in early 2009.
gradually increasing tax collections through better administration and the introduction of new
taxes, and improving the efficiency of public spending. The plan also envisions important reforms
to SOEs that would help address the contingent liabilities that these companies represent. This will
be even more important considering the unfavorable external environment Paraguay is now facing
as a result of the international economic crisis.

2. Operation Objectives
The overall development objective of the proposed Programmatic Development Policy Loan
(PDPL) is to contribute to the effectiveness and efficiency of the public sector, while maintaining a
stable macroeconomic policy framework. This will be achieved by: (i) strengthening tax
collections and improving the equity of the tax system; (ii) improving the effectiveness of internal
financial controls for the Central Administration through the establishment of a standardized
internal control framework, and a professional and independent internal audit function; (iii)
ensuring that the State exert effective oversight of state-owned enterprises (SOEs); (iv) improving
the efficiency and equity of social and capital expenditure with a view to better deliver public
services; and (v) contributing to the professionalization of the civil service through the adoption of
merit-based rules of recruitment and promotion of civil servants. Those objectives are inter-related
and address three main public sector outcomes: revenue stability, accountability, and public sector
efficiency.

The operation aims to contribute to the Government Plan’s overall objective of achieving
sustainable and more equitable growth through direct support to three of its pillars: (i)
macroeconomic policy; (ii) state-owned enterprises; and (iii) state modernization. Addressing these
three pillars will also have an impact on all seven strategic pillars of the Government Plan, in terms
of policy responsiveness and effective delivery of public service.

The PDPL is also expected to generate benefits in the short term by (i) safeguarding the proportion
of budgeted social expenditures during execution, as a contribution of the anti-crisis plan; and (ii)
paving the way for the reform process in the above-cited areas supported by the loan.

To these ends, the PDPL includes a series of three operations to be executed sequentially between
FY09 and FY11. Their respective tentative envelopes are US$100 million for the PDPL I and
US$50 for each of the two subsequent loans. The PDPL includes four components: tax system;
public sector financial control, covering central administration internal financial control and SOEs
oversight; expenditure management; and human resources management. It features clearly defined
upfront actions, and monitorable medium-term outcome indicators addressing key country
development challenges.

The following actions will be taken prior to Board presentation of PDPL I:
3. **Rationale for Bank Involvement**

This programmatic series of DPLs constitutes the centerpiece of the 2009-2013 CPS. The three cross-cutting themes addressed by the CPS program – governance, poverty reduction and sustainable growth – are supported by the series of PDPLs. First, with up to 40 percent of the CPS envelope, the PDPLs will serve as the main instrument through which the CSP will provide direct support to the governance theme. Second, the PDPLs will contribute to the poverty reduction and sustainable growth objectives of the CSP by supporting both macro-fiscal stability and fiscal space through increased tax revenue and higher social and capital expenditures – which is critical in the context of the current global economic crisis. Third, there are strong synergies between the PDPLs and several other Bank operations in Paraguay. Furthermore, the PDPLs are expected to play a key role in donor coordination, as evidenced in the recent cooperation for the preparation of the PDPL I package.

This first programmatic loan represents a significant proportion of the multi-donor emergency package supporting the 2009 anti-crisis plan. The US$300 million package is expected to be jointly funded by the World Bank, IDB, JICA and CAF. While the Bank and IDB are leading the work on distinct and complementary policy areas, CAF and JICA are expected to provide further support to these policy areas. In addition, the programmatic approach of the PDPLs provides the Government and relevant development stakeholders with a roadmap to undertake reforms in the areas identified in the matrix in a sequenced and coordinated manner.

4. **Financing**

<table>
<thead>
<tr>
<th>Source</th>
<th>($m.)</th>
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<tbody>
<tr>
<td>Borrower</td>
<td>0</td>
</tr>
<tr>
<td>International Bank for Reconstruction and Development</td>
<td>100</td>
</tr>
</tbody>
</table>
5. **Institutional and Implementation Arrangements**

The Bank and Government have agreed to regularly monitor progress under the PDPL program, including during periodic CPS implementation reviews. Discussions will be held with the Ministry of Finance, the main counterpart agency for the loan, which will be responsible for the overall monitoring and evaluation of the loan and for collecting data necessary to assess implementation progress from appropriate sources. Other agencies that will play an important role in this process are the Central Bank, the Public Administration Agency (SFP), the Council for SOEs, the Public Administration Secretariat (SFP), and the Internal Audit office of the Executive Power. The CPS review will focus on complying with the agreed triggers for continued policy-based lending, in particular, maintenance of a satisfactory macroeconomic framework and progress on the overall structural program.

**Fiduciary Arrangements.** Overall, Paraguay’s public financial management (PFM) remains weak and represents a high risk. The three main PFM challenges identified by IFA are related to improvements in: budget process efficiency, fiscal transparency, and control effectiveness. In particular, despite recent Government efforts, the limited degree of control system effectiveness continues to pose one of the country’s biggest PFM challenge. The common features underlying each of these challenges is their linkage to Paraguay’s political and institutional context and the difficulty in addressing their technical dimension without adopting broader governance changes. The Government is committed to address PFM and particularly control effectiveness issues. This commitment is most clearly evidenced in (i) the reforms recently initiated with the assistance of the USAID *Umbral* program, and (ii) through the prior actions and outcomes agreed within the framework of the PDPL, that expressly target strengthening of public financial control effectiveness, and improving overall efficiency in the allocation and execution of budget resources.

The IMF completed an update of the safeguards assessment of Central Banks in October 2006. In the case of Paraguay, the report states that while the Central Bank has made some progress in strengthening the safeguard framework since the 2003 safeguard assessment, vulnerabilities remain in certain areas such as financial and program data reporting to the Fund. However, according to the assessment, the current foreign exchange control environment within the central bank is satisfactory. According to the IMF 2007 Article IV Consultation, although significant progress has been made towards enhancing the health of the financial system, the much needed financial sector reform, in particular the strengthening of bank regulation and banking law, has not taken place.

**Disbursements and Audits.** Given the level of PFM risk and the weaknesses identified in the control environment surrounding Central Bank operations, and in accordance with Bank policies and procedures for DPLs, the Bank has identified the need for additional fiduciary arrangements to mitigate the potential reputational risk that loan proceeds be used for unintended purposes. As explained earlier, these additional fiduciary arrangements call for: (a) the establishment of a dedicated deposit account at the Central Bank whereby loan proceeds will be deposited by the Bank, (b) an audit of the dedicated deposit account to be undertaken within four months of the disbursement of loan proceeds, according to international audits standards and terms of reference acceptable to the Bank.

More specifically, disbursement arrangements for the proposed loan will follow Bank disbursement procedures for DPLs and will take into account additional fiduciary arrangements described in (a) in above paragraph: once the loan is approved by the Board and becomes effective, the proceeds of the loan will be deposited by the Bank in the dedicated deposit account in the
Central Bank of Paraguay at the request of the Borrower. The Borrower shall ensure that such funds be included in the country’s budget and subject to the country’s normal PFM processes.

The dedicated deposit account will be audited according to Bank policies and procedures and should follow the approach outlined in the relevant Bank guidelines. The audit should be carried out within four month of the single tranche disbursement and the scope should cover (a) the accuracy of the summary of transactions of the dedicated account, and (b) accuracy of exchange rate conversions. If the proceeds of the loan are used for ineligible purposes (the “negative list”) as defined in the Development Loan Agreement, the Bank will require the Borrower to promptly upon notice from the Bank refund an amount equal to the amount of said payment. Amounts refunded to the Bank upon such request shall be cancelled.

6. Benefits and Risks

Benefits

In the short term, the DPL will support two overriding benefits, namely: (i) safeguarding the proportion of budgeted social expenditures during execution, as a contribution of the anti-crisis plan; and (ii) paving the way of the reform process in the areas supported by the loan.

In the medium term, it is anticipated that reforms supported by the proposed loan series will improve the responsiveness and the credibility of Paraguay Public Sector through:

- Strengthening tax collections and improving the equity of the tax system;
- Improving the effectiveness of internal financial control for the Central Administration through the establishment of a standardized internal control framework, and a professional and independent internal audit function;
- Ensuring the State exert an effective oversight on state-owned enterprises (SOEs) through: the establishment of a consolidated institution acting as shareholder of SOEs on behalf of the State; the adoption of transparent and effective financial and business management rules for the SOEs; and the establishment of a single independent regulatory agency;
- Improving the efficiency and equity of social and capital expenditure with a view to better deliver public services;
- Contributing to the professionalization of the civil service through the adoption of merit-based rules of recruitment and promotion of civil servants.

Risks

The risks associated with the PDPL are considered high. However, there is no risk of non-compliance with the prior actions for the PDPL 1, as they have already been carried out by the Government.

Economic risks are high. A further deterioration in the external environment could have negative effects on Paraguay’s economy beyond those foreseen in the baseline projections. Vulnerabilities are particularly high with regards to the economic situation of Paraguay’s two large neighbors: even though there has been progress in diversifying export markets, Argentina and Brazil still account for 26 percent of all exports. If the decline in demand for Paraguay’s soy and meat exports is greater than anticipated, economic growth may slow down even further. An increase in non-performing loans as a result of a decline in agricultural production would put pressure on the financial system, which could ultimately result in important fiscal costs. In the presence of
relatively high fiscal rigidities and limited space for higher tax collections in the short run, lower growth could also result in a higher than expected fiscal deficit. There is also a significant exchange rate risk, as a large share of public sector debt is denominated in foreign currency and dollarization of the financial system remains high. However, as the debt sustainability analysis shows, the fiscal risks are manageable, and the financial sector is currently more robust than it has been in years. Overall, continued prudent macroeconomic management will be critical to reduce the impact of external shocks. It would also be important to continue strengthening of the financial system, including through better supervision and regulation especially of the cooperatives which represent a significant risk.

**Political risks are high.** Mr. Lugo’s Government may lose its political margin of maneuver to implement its program, and therefore progressively lose its political credibility and support. In particular, the administration’s political alliance is relatively fragmented and does not benefit from a majority of seats in Congress.

**Managerial and sustainability risks are high.** The compounded effect of the above-mentioned political risk, the limited capacities of public sector human resources, and the insufficient inter-institutional coordination represents a high risk for successfully implementing the Government’s reform program. In addition, triggers for the PDPL 2 related to the reform of SOEs will include legal changes and require an intensive path of activities. The current lack of majority in Congress coupled with limited capacities of the public administration represents the main managerial risks that could prevent implementation of those actions. Given that the objective of the proposed measures directly supports the government’s anti-crisis plan, the government’s ability and capacity to implement those measures is not expected to be negatively affected by the crisis. Mitigating measures are expected to include enhanced dialogue between the political and social stakeholders of the Government reform plan, and financial and technical support from International Financial Institutions and donors.

7. **Poverty and Social Impacts and Environment Aspects**

**Poverty and Social Impacts**

Actions supported under the programmatic series are expected to have an overall positive impact on poverty. The tax policy reforms supported under the PDPL 1 are not likely to have significant effects on the poor, and analytical work will be undertaken by the Government to assess the poverty and equity impact of tax policy actions supported under subsequent DPLs of the proposed program. The increase in social and investment spending foreseen for the program period is likely to have significant beneficial impacts on overall poverty and equity. Finally, measures related to financial control effectiveness, supervision of SOEs and civil service reform, are not likely to have significant direct poverty or equity effects.

**Environmental Aspects**

The specific policies supported by the proposed PDPL I are not expected to significantly impact the environment, forests or other natural resources. However, to the extent that measures supported by the PDPL I program are successful, over time, in improving effectiveness and efficiency of public sector, Paraguay’s national institutional capacity to identify and address environmental policy and regulatory issues will be strengthened. Paraguay’s environmental institutional and policy framework is defined under Law 1561 of 2000 and Law 3679 of 2008. The institutional framework consists of the Secretariat for Environment and the National Environment Council which are responsible for defining the environment policy and monitoring the environment system defined by Law 1561.
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