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I. COUNTRY AND SECTOR BACKGROUND

With a multi-ethnic population of about 13 million and a per-capita GDP of about $2,200, Guatemala is the largest economy in Central America. While a source of cultural strength and rich historical heritage, Guatemala's ethnic diversity has also unfortunately been accompanied by a pattern of conflict and exclusion since colonial times. In the latter half of the 20th century, long-standing socio-political and economic tensions sparked a debilitating 36-year civil war, which ended in 1996 with the signing of a set of Peace Accords between government and guerrilla leaders, following protracted negotiations.

The Peace Accords marked an important turning point in Guatemala's development. In addition to ending the armed conflict, they aimed to reverse the country's historically exclusionary pattern of social and economic development, setting national targets in four main areas: (i) resettlement, reincorporation and reconciliation, (ii) human development, (iii) productive and sustainable development, and, (iv) modernization of the state and improved governance. In the nine years since the signing of the Accords, progress towards achievement of the specific targets contained therein has been uneven, with major gains in some areas (e.g., reductions in the military, decentralization, coverage –albeit not quality-- of social and basic services) but slower-than-hoped-for progress in others (accelerating economic growth, raising tax revenues to 12% of GDP, land registration/redistribution and reducing crime/violence).

Largely as a result of the country's historical legacy, poverty and inequality are high and social indicators (health, nutrition, education) are low relative to the country's average income. About 56 percent of all Guatemalans lived in poverty in 2000 and about 16 percent in extreme poverty, despite a decline in the late1990s when growth rates reached 4 percent or about 1.4 percent per capita on average. The Government is currently undertaking a new living standards measurement survey which will provide updated poverty and welfare statistics by late this year. An economic slowdown in the first years of the millennium (2001-2003) is likely to have dampened the rate of poverty reduction, although rising remittance flows from family members working abroad probably offset this for many households.

II. PROGRESS UNDER THE GOVERNMENT'S DEVELOPMENT PROGRAM

Besides maintaining macroeconomic stability, Guatemala's key challenges in restoring broad-based growth are: (i) taking advantage of expanding trade opportunities and ensuring that SMEs can share in those opportunities, (ii) strengthening the climate for both domestic and foreign investment and business, (iii) modernizing property rights, (iv) addressing infrastructure bottlenecks to growth, (v) continuing to strengthen and deepen the financial sector, (vi) enhancing the capacity for efficient and effective poverty-oriented public spending –especially for education and health, and (vii) strengthening public sector management and transparency. The principal issues and government plans with respect to each of these areas are discussed further below in some depth as they form the background to the specific actions supported by this DPL series. Controlling the high levels of crime and violence is another key element of the effort to promote growth (as well as security) in Guatemala. Issues in this

area are not described here as they lie beyond the scope of this DPL operation. It should be noted, however, that Government is currently working with a number of bilateral donors (including Japan, Spain and USA) to implement an integrated strategy to address this problem, within a regional context.

A. Trade and Regional Integration

The Berger Administration regards international trade expansion as a principal driver of growth in Guatemala in the short- to medium-term and has expended considerable political and institutional capital on expanding trade and investment opportunities. The Guatemalan Congress ratified the US-Central America-Dominican Republic Free Trade Agreement—DR-CAFTA—in March 2005 (a prior action for DPL I). Over the past year, the focus has been on passing the CAFTA Implementation Law, an omnibus law involving amendments to existing legislation in a number of areas related to CAFTA provisions. Following a tough set of negotiations initially with USTR and subsequently with domestic interest groups and congressional blocs, the CAFTA implementation law was finally approved in early June 2006 and CAFTA became effective on July 1, 2006. Free trade agreements are now also in place with Mexico and Taiwan, and discussions with Brazil, Canada, Chile, Colombia and the European Union are ongoing. To ensure that opportunities opened up by the new agreements are widely disseminated and to help Guatemalan businesses understand requirements to access international markets, the Government has established an FTA Management and Trade Compliance Office. It has also taken steps to facilitate and promote foreign investment and support quality improvements in Guatemalan products, as discussed further below.

Guatemala is also spearheading regional integration efforts within Central America, with steps already being taken towards a Central America customs union, through the harmonizing and simplification of customs procedures with neighboring countries, most notably El Salvador and Honduras. Specific achievements to date in this area include: (i) harmonization of about 95% of customs duties among all Central American countries—with work ongoing for the remainder; (ii) use of identical customs forms (FAUCAS) for by Guatemala, Honduras and El Salvador; (iii) reduction of customs clearance times to 2 hours (against 1-2 days previously) for air and road cargo between Guatemala, El Salvador and Honduras through adoption of an electronic filing system and a reduction in physical inspections for goods originating in these cooperating countries; (iv) implementation of a pilot scheme to eliminate customs inspections at the national borders for goods cleared through specified Central American border entry points[1]; and (v) provision for customs inspections by other Central American countries at elected regional ports and borders.

The strategy for trade expansion assigns a central role to ensuring that the benefits of new trade opportunities are accessible to SMEs, both directly through access to export markets and indirectly by developing strategic linkages with foreign and local exporting companies. This effort is being supported through the Rural Economic Program operation which assists rural cooperatives to form production/TA and marketing linkages with larger formal sector businesses. In addition, the Presidential Commission for Competitiveness (PRONACOM) has supported the establishment networks of SME entrepreneurs (the "grupos gestores") throughout the country. It is also supporting improved availability of market intelligence, including data on export contacts, via a joint program with the National Institute of Statistics (INE). Special efforts are being made to reach out to indigenous entrepreneurs through the Association of Mayan Entrepreneurs and support to CECMA to create an Indigenous Competitiveness Research Center. Finally, a network of "infocenters", with internet connectivity, is being established to disseminate information throughout the country, in part with assistance from the Bank's Rural Economic Program operation approved earlier this year. The infocenters are expected to act as important focal points for support to SMEs.

To assist low income farmers and laborers (especially those involved with maize production) to shift away from traditional livelihoods, the government has also launched an initiative to promote alternative employment in non-traditional agriculture, sustainable forestry and off-farm activities in sectors such as tourism and agribusiness. In partnership with the private banking sector and groups such as the non-traditional exporters association, Agexpront, the initiative combines technical assistance and marketing help for micro, small and medium rural

[1] Tecun Uman, Puerto Quetzal, Puerto Santo Tomas and Puerto Barrios in Guatemala, Puerto Cortes in Honduras, Puerto Cutuco and Puerto de Ajacutla in El Salvador, and Penas Blancas in Nicaragua.

producers with improved access to finance via the commercial banking system, through the provision of a Government guarantee. The initiative is being supported by USAID and other donors. Consideration is also being given to consolidation of disparate social assistance programs to create a single Conditional Cash Transfer scheme targeted to the poorest rural municipalities.

B. Investment Promotion and Business Climate

32. While Guatemala still has a long way to go in improving the overall business climate, there have been some notable achievements in reducing the costs of doing business over the past 1-2 years—an important factor in assisting SMEs in particular. One important achievement has been the implementation of a lower time limit for customs processing, from 4 to 2 days. If the required time expires and the cargo is not cleared, the trader can go to the warehouse and claim it. There has also been a reduction in discretionality and "red lights" in customs, through adoption of a new risk based system for inspections, which relies on objective risk profiles such as type of import, place of origin, product type etc). On the basis of this system, the number of physical inspections of cargo has been falling steadily to levels more consistent with international practice—from physical inspection of about 81% of imports in January 2005 to about 45% in June 2006. A second major initiative has been the recent establishment of a "one-stop shop" for business start-ups allowing prospective firms to apply for company, tax and social security registration in one step and check the status of their applications on line, with help services provided through a chat line. Once this registration agency is fully operational it is expected to grant same-day temporary registration and final registration within around 22 days. A third important development since DPL I has been the passage of a new law (effective November 2005) which restricts the abuse of nullity actions (a motion that requests dismissal of a case on procedural grounds). Previously, debtors seeking to avoid contract enforcement could file a nullity action for as little as a spelling error in a contract, thereby buying considerable time (up to 5-6 months) while the case came up for adjudication. Under the new law, judges have been given more discretion to reject nullity motions and new, shorter time limits have been set for the presentation of nullities.

Another area in which progress is apparent is the promotion of foreign direct investment (FDI). A newly-established agency, Invest in Guatemala (IIG), leads this effort with assistance from MIGA. The agency has recently finalized its promotion strategy which highlights investments in light manufacturing, tourism, call centers/business process outsourcing and agribusiness. The strategy outlines targets for new investments, job creation, indirect employment, and the expected impact of these FDI flows on exports. Currently, IIG is seeking to effectively measure the amount of local value added. This will set a benchmark to implement programs that increase linkages between the local private sector and international investors operating in Guatemala to provide goods and services that further increase local value added. IIG can already point to a number of successes in attracting foreign investments—e.g., since it became fully operational about a year ago (a prior action for DPL I), IIG has been instrumental in attracting about US$120 million in FDI to Guatemala, involving the creation of 6,000 new jobs. Over the next several months, Government intends to increase the operating autonomy of IIG, through a partnership with reputable private sector foundation(s) operating in Guatemala.

To ensure institutional coordination in the competitiveness area, the Government has created an Office of the Presidential Commissioner for the Promotion of National Competitiveness (Pronacom) and maintains a system of monthly meetings between Pronacom, the Ministry of Economy, and representatives of the private sector, universities and civil society, to review and monitor work plans and progress achieved. Pronacom is part of a Central American network of government competitiveness agencies, allowing the region to coordinate closely as it faces the challenges presented by the DR-CAFTA agreement. In carrying out its mandate, Pronacom has developed a strategy of alliances with key local partners such as Agexpront and the tourism sector as well as close connections with regional and international institutions such as INCAE, the USDA, the World Bank Group and the UN system. Thus far, Pronacom is holding itself to a high standard of performance, with concrete indicators in priority areas for the private sector and DR-CAFTA.

The adoption of new technologies and promoting innovation are key elements of the Guatemalan Government's effort to increase the productivity of Guatemalan businesses. In addition to the appointment of a Presidential Commissioner for Science and Technology, the Government has established a program linking universities and

research centers with the private sector in order to stimulate the research and development process. Another priority since 2004 has been the reform of the national training system, led by INTECAP, as a means of raising the skills level of the labor force. In this regard, some pilot programs have been implemented in the past year under which INTECAP acts as a regulator and certifier of training programs organized and implemented by the private sector, rather than providing the training directly as it has traditionally done. Depending on the success of these pilots, the end-goal is to transform INTECAP's role from training provider to regulator in the medium-term. A third initiative has been to reorient the focus of the Council of Science and Technology towards improved technological diffusion among small- and medium-sized enterprises and to expand the role of the private sector in its advisory board. In addition, a system of incentives has been established to promote the acquisition of new technology via capital goods purchases, technology licensing arrangements and other appropriate mechanisms.

C. Property Rights

Fundamental to Guatemala's growth agenda—as well as to the achievement of increased social solidarity and a better business climate—is the establishment of secure rights to land. Over the past several years, considerable progress has been made on cadastral surveying and regularization of land—largely in urban, but also in rural, areas where most poor households live. Until 2004, however, this progress was threatened by limited titling and the transitory nature of the institutional framework. An example is the Department of Peten, where the cadastral work was substantially completed by early 2005 but only about a quarter of land parcels surveyed had been titled and registered, reflecting both the institutional weaknesses of the titling entities (municipalities for urban, and FONTIERRAS for rural, land) and the transitory nature of the cadastral process. With the aim of rectifying these problems, Government, in 2005, passed a modern law of cadastre and land registry which, inter alia, establishes an autonomous, unified registry and cadastral office (registro de informacion catastral—RIC) outside of the court system, and increases the transparency and accountability of the RIC through establishment of an independent Board with members representing different societal interests. Since passage of the law, the new Registry has been established, it's board installed, and a new, independently-selected, director appointed. Moreover, over the past year or so, the time to register property fell by almost two weeks due to an increase in the number of registrars from 3 to 14 and full implementation of an electronic registration system. The RIC is now establishing physical maps of all properties which will help resolve cases of overlapping property titles. The Bank's ongoing Land Administration project is supporting these efforts.

D. Infrastructure

On the supply side of the economy, the Government's growth strategy places strong emphasis on public-private partnerships for both financing and implementation of investments in infrastructure (roads, ports and airports, telecommunication and ICTs and renewable energy). As a first priority, the Government has promoted a series of large infrastructure projects in the transport sector to be implemented via public private partnerships. These include: link roads in the northern and Pacific corridors, a link road connecting the Atlantic and Pacific ports, a partial metropolitan beltway for Guatemala City and the construction of a freeway from Guatemala City to El Rancho. To establish a clear legal basis for this effort, the Government presented a framework law for public-private partnerships to the Congress in 2005 as well as specific laws facilitating private participation in the construction of (i) the 362 km northern link-road connecting some of the poorest areas of the country (Franja Transversal del Norte) and (ii) the 100km partial metropolitan beltway (Anillo Metropolitano). Congress enacted the two specific laws in late 2005 and an international bidding process has been initiated for their construction, with bids expected in August 2006. Work has also begun on the Guatemala-El Rancho freeway with assistance from the Government of Taiwan, albeit outside of the PPP model. Thus far, however, Congress has not acted on the framework Law of Public-Private Alliances, despite wide national consultation of the Law and its provisions by the Executive prior to its submission to Congress. Government is still pressing for its enactment during the second half of this calendar year.

Efforts are also underway to establish partnerships with the private sector to improve management of key infrastructure such as airports and ports. In late 2004, a management committee comprised of users (including airlines, cargo companies, the tourism agency etc.) and representatives of the civil aviation authority for better management of the main international airport (La Aurora). In addition, Government has made substantial progress

in implementation of a well-designed program of upgrading and expansion of the nation's main airport facilities in accordance with an approved master plan, which is fully in line with recommendations of a Bank-supported PPIAF study of air transport needs and international safety and security norms. Action is also underway to upgrade Guatemala's USFAA ranking to Category I through a program of strengthening the civil aviation authority, including security measures. This would enable direct flights (both cargo and passenger) to U.S. destinations by Guatemalan carriers. Government's efforts with respect to seaports during 2005 and early 2006 focused on upgrading their security certification to international standards (prior action for DPL I). With this achieved, the focus has now been on improving the efficiency of operations at Puerto Santo Tomas, the country's publicly-run main Atlantic sea port, through establishment of a new private dock for cruise ships (construction now underway) and development of plans for a privately-operated cargo handling and warehouse facility at the port.

Another priority for Government is the diffusion of information technologies (ICTs) and telecommunications to previously un-served rural municipalities. Guatemala made huge strides in access to telephones due to privatization and liberalization reforms program implemented by the end of the 1990s. The number of fixed lines has risen from 400,000 to one million; and cellular phones, from 30,000 to 1.2 million. The Berger administration is committed to stimulating further private sector investment in telecommunications and ICTs by updating the legal and regulatory framework to make it consistent with DR-CAFTA, to take into account market and technological innovations and to encourage the use of ICTs to improve governance, delivery of services and increase the competitiveness of Guatemala's economy. In order to address the growing urban-rural "digital divide", a rural access strategy has been adopted that uses output-based aid (OBA) mechanisms aimed at fostering private sector provision to each municipality of at least one internet access point that enables local governments, NGOs, and private sector operators broad band access to the internet and to ensure that all rural localities have at least one public payphone. Implementation of the rural access strategy is already underway and the strategy is being incorporated into a broader Information Society Strategy which aims at determining priorities for the national broad-band internet network. The effort is being supported by the Bank under the Rural Economic Program and by WBI.

E. Financial Sector Strengthening

Continuing to strengthen, and deepen the reach of, the financial system is a major priority for the government, building on the significant progress made since the banking crisis of 2001. Legislation passed in the wake of the crisis and complementary regulation addressed a number of deficiencies in the framework for (a) the conduct of monetary and financial policy, including the capitalization of the Central Bank and the modernization of payments systems and (b) the prudential regulation and supervision of financial intermediaries moving them closer to international standards, including reforms for strengthening the legal and institutional capacity of the Superintendence of Banks (SoB) to engage in risk-based supervision of financial institutions and financial groups and creating an orderly market exit mechanism. These reforms aimed at: enhancing financial stability and solvency, lowering incentives to engage in excessive risk-taking activities, improving risk management, improving the quality and availability of financial information, increasing access to financing, and preventing money laundering to reduce illegal activities and comply with international norms. The Berger administration has continued to implement these legal and institutional changes, with increasingly important progress in areas that typically take several years to implement (such as full-fledged risk-based supervision). In addition, it supports consolidation of the banking system through restructuring or closure of insolvent banks, and through mergers and acquisitions (with increased interest from regional and other international players most recently), using the exit mechanism of the 2002 banking law and supporting instruments.

42. The reforms and implementation thus far have contributed to making the financial system better able to withstand external shocks and facilitate growth, although some vulnerabilities remain. Guatemala's financial sector has strengthened substantially since 2000 due to improvements in the prudential regulatory framework and stepped-up onsite inspections, provisions levels are still low and related party lending high. The SoB has completed the registration of financial groups, including offshore banks, in accordance with provisions of the banking 2002 law, while making progress in their supervision and overall assessment and supervision of risks. In addition, the SoB has been taking steps towards implementation of Basel II-like supervision (analysis of bank

risks and implementation of risk-based consolidated supervision) including: (i) undertaking major restructuring of the SoB to enhance integration of onsite and offsite supervision and increase coordination among supervisors of different components of financial groups, (ii) changing procedures and basis for supervision away from a compliance-based approach, (iii) requiring the creation of risk management units at banks and promoting improvements in risk analysis, (iv) preparing a revised risk-based consolidated supervision manual, and improving cooperation and exchange of information with other SoBs, (v) mapping of economic groups, beyond registered financial groups, to enable broader analysis of their risks and inter-linkages, (vi) improving the availability and quality of information at its credit registry, (vii) institutionalizing financial institution risk assessment through analysis of economic sectors and scenario modeling and (viii) completing consultations on revised accounting manuals for financial institutions, more in line with international norms. Guatemala is also implementing a significantly strengthened anti-money laundering (AML) regime. In July 2004 it was taken off the list of non-cooperative countries of the Financial Action Task Force (prior action for DPL I) and in 2005 passed the Law Against Funding of Terrorism, which makes it a crime to fund terrorist activities. Also, it has increasingly participated in regional efforts to jointly assess the supervision of other countries' AML/CFT system, reflecting its improved capacity to analyze and supervise these areas.

The focus is now on completing the modernization of the financial sector legal framework, operations and increasing access to financial services, including to SMEs. The Government has recently submitted to Congress a package of laws, supported under the Bank's FSAL, as follows: (i) the Microfinance Law, which would allow the strongest non-bank financial intermediaries (currently NGOs) focusing on this sector to operate as lenders under regulation and supervision by the SoB;[2] (ii) the Law of Movable Guarantees, which is intended to facilitate the use and repossession of non-traditional collateral, to promote access to finance; and (iii) the Insurance Sector Law, which will modernize the legal and supervisory framework of insurance companies broadening the availability and access of financial products, which could eventually include specialized products to address the larger exposure of Guatemalan firms to weather-related disasters. In addition, laws have been submitted to facilitate the consolidation of the banking system through the removal of tax impediments to sale of Bank assets, and a law of "Reciprocal Guarantees", which would set the basis for the establishment of associations that would provide collateral for its member companies to facilitate access to credit. This package of financial sector laws aims to increase prudent lending to groups and enterprises which have generally been excluded from bank financing, such as MSMEs. In terms of financial sector operations, Banguat has been modernizing the institutional and supervisory framework for the functioning of payments systems. A major step has been the full implementation of the Real Time Gross-Settlement Systems (RTGS) in effect since January 2006. The new system is substantially increasing the efficiency and accuracy of financial sector transactions.

F. Enhancing Capacity for Priority Spending

A key element of the Government's growth and poverty agenda is the objective of increasing public spending in key areas such as human development (education, health and nutrition) and on rural economic and social infrastructure, an area where good progress has been made to date. Notably, the Berger Administration in 2004, reduced by one-third the size of the military and began a step-wise effort to direct a greater share of the budget to social programs. Social expenditures (Peace Accords definition) rose from 5% of GDP in 2004, to 5.4% in 2005 and a further increase, to 5.9%, has been budgeted for 2006. This level would imply expenditures on the social sectors of around half of total public spending and over half of total revenues. 78% of the increase in social spending has been directed to education (excluding tertiary level), health and social assistance. The effort to reorder expenditure priorities is especially commendable in light of the high proportion (about 41%) of legally mandated earmarks, which leave very little room for maneuver. In addition, there has been a concerted effort to increase investment spending vis a vis recurrent spending. Between 2004 and 2005, investment expenditures increased by 18% in nominal terms while the corresponding increase in recurrent spending was 8.6%, close to the level of inflation.

[2] This is expected to have positive demonstration effects over smaller NGOs also focusing on microfinance, which will remain self-regulated but for which institutional and legal reforms are also underway. Other complementary efforts to improve the legal, institutional and supervisory efforts could be expected to emerge regarding credit cooperatives, which are very important players in the provision of microfinance and housing products.

In addition, Government is committed to strengthening budgetary processes in order to increase the efficiency and effectiveness of core ministries, through adoption of a results-based and multi-annual approach to budgeting. The Government took a significant leap towards enhanced planning and accountability in key sectors with the introduction in 2005 of agreements among MOF, SEGEPLAN and four major Ministries (Education, Health, Agriculture and Infrastructure, Communications and Housing) to move towards this new budgeting framework. The process has been undertaken under a well-designed plan that has resulted in the early communication of institutional budget ceilings to improve the formulation process within a formal medium-term expenditure framework. To validate and sustain what is, by nature, a long-term endeavour, a gradual approach is being adopted. The 2006 budget included results-based allocations for key programs in two of the four pilot Ministries—Education and Public Health, with extension of the approach to all four pilot Ministries for the 2007 budget cycle. A monitoring and evaluation (M&E) system is also being developed, in part with assistance from a Bank IDF grant.

In addition to the above efforts to strengthen the efficiency and quality of public spending, the Government is continuing its efforts to vigorously attack corruption and improve the transparency of public expenditures (with support from the Bank's Integrated Financial Management Project). This, inter alia, should help build confidence in the fiduciary role of the Government in the use of public funds and, consequently, reduce opposition to a new tax effort. This is discussed further below, in the section on transparency and public sector management.

G. Public Expenditure Transparency and Management

One of the fundamentals of the administration's Vamos Guatemala! Plan is to improve governance and credibility of public sector management and institutions, as means of forging higher levels of trust between government and the public (in part as the ground work to counter objections to increased taxes) and in enhancing investment climate. Important steps have been taken in that regard, such as the creation of the Office of the Commissioner for Transparency, the issuance of norms for access to public information in the executive branch, the legalization and thorough implementation of a public procurement transparency portal (Guatecompras), the continued expansion of the public financial management and public investment systems, and efforts to clean up customs administration.

At the center of financial management reform is the continued development of the integrated financial management system (SIAF), which is considered an example of good practice in the region in terms of a successful IFMS. SIAF is operating in 70 public sector entities of the central government (from 63 when DPL 1 was appraised). It incorporates modern processes and systems in the core areas of budgeting, treasury, accounting, as well as in other areas such as human resource management. The ongoing development of a management system (SIGES) has the objective of establishing automatic linkages between the core financial modules and the supporting administrative systems (e.g., procurement and registers of fixed assets).

The relevance of SIAF

An integrated financial management system with comprehensive coverage has implications for public expenditure management at four main levels: (i) it contributes to fiscal discipline by providing timely and reliable information on budget execution and by enforcing expenditure limits in accordance with approved budgets and cash flows; (ii) increases operational efficiency by expediting and standardizing processes; (iii) supports internal and external controls through transactional safeguards and audit trails; and (iv) contributes to transparency by facilitating the publication of budget execution reports and other fiscal reports.

An ambitious objective of the government's reform program is to implement a financial management system throughout Guatemala's 332 municipalities, complementing basic tools for budgeting, accounting, and treasury with additional modules in areas such as civil registry, services administration and property tax for pertinent local governments. A simple version for budget recording *(SIAFITO-MUNI)* was installed in 317 municipalities during 2003 and 2004. A more robust version *(SIAF-MUNI)* has been in deployment since 2005 and has replaced the simplified version in a number of municipalities. This new version is now in operation in over 110 municipalities (from 46 when the DPL series was appraised), and the two largest ones (Guatemala and Quetzaltenango) have

adopted the central government's version of the system. This progress significantly exceeds what was anticipated at the time of DPL I, when it was estimated that about 40 additional municipalities would transition from SIAFITO to SIAF-MUNI in the year between the two operations.

Looking ahead, the Ministry of Finance is planning to further increase operational coverage of SIAF to at least 7 additional central government entities and of SIAF-MUNI to at least 40 additional municipalities in the short term. While the DPL program supports these selective actions, it should be noted that these are framed in a larger action plan adopted by the Ministry for improvement of public financial management. Through these measures, the comprehensiveness and availability of public information on fiscal and budgetary performance will be increased, carrying unquantifiable benefits such as facilitating external scrutiny and analysis, which in turn enhance the government's financial accountability framework.

The government e-procurement system (Guatecompras) is now in use by 104 public sector procuring agencies of the central government, and over 260 municipalities. Through an executive decree, social funds, trust funds and NGOs using public funds are required by law to use Guatecompras, and the recent CAFTA Implementation Law modifies the National Procurement Law making it mandatory for all government entities. Moreover, an interface of Guatecompras and SIAF has been achieved through the implementation of SIGES. It is expected that further development of the system will take place in the context of a comprehensive strategic plan for e-procurement, product classification and information standards and use of data for procurement planning.

Going forward, the procurement policy formulation and oversight responsibilities, including leadership for implementing and monitoring the reform, need strengthening. Currently, capacity building initiatives are not well coordinated, the development of key implementing tools (e.g. bidding documents and procedures) is lagging, and there have been no in-depth assessments of the government's procurement strategy or the supplying markets to support the introduction of new contracting approaches and cost reduction programs. At the executing entity level, in government entities, most institutional procuring units are non existent or have poor capacity. It is expected that short-term priority will be given to the strengthening of the procurement regulatory body (DNCAE) and to the creation or strengthening of the institutional procurement units.

III. OPERATION OBJECTIVES

The objective of this loan is to support Guatemala's progress in promoting more equitable, broad-based growth.. Given the design of the Bank's CAS and the DPL series within Government's own *Vamos Guatemala!* plan, there is strong client ownership of the DPL agenda, namely:

- promoting equitable growth and strengthening the investment climate
- enhancing capacity for increased public spending in priority sectors
- improving public expenditure transparency and management

Following the medium-term framework laid out in DPL I—underpinned by the substantial body of analytical work carried out by the Bank in partnership with the Government of Guatemala, the design of key prior actions, triggers and indicators for DPL II support progress in each of the above three areas.

IV. RATIONALE FOR BANK INVOLVEMENT

In addition to supporting Guatemala's efforts in restoring broad-based growth and macroeconomic stability, the key rationale for this DPL is to assist the country in its development strategy. Financing provided by this DPL will help support specific Government development efforts in: (i) taking advantage of expanding trade opportunities and ensuring that SMEs can share in those opportunities, (ii) strengthening the climate for both domestic and foreign investment and business, (iii) modernizing property rights, (iv) addressing infrastructure bottlenecks to growth, (v) continuing to strengthen and deepen the financial sector, (vi) enhancing the capacity for

efficient and effective poverty-oriented public spending–especially for education and health, and (vii) strengthening public sector management and transparency.

TENTATIVE FINANCING

Source:	($m.)
BORROWER	0
INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT	100
Total	100

IV. INSTITUTIONAL AND IMPLEMENTATION ARRANGEMENTS

The government of Guatemala and the Bank have agreed to monitor progress in the DPL program regularly, including at the annual reviews of CAS progress, when revisions to the scale and timing of the Bank's lending program can be undertaken. Discussions will be held with the Ministry of Finance, the main counterpart agency for the loan, who will be in charge of M&E for the loan and for collecting from the appropriate sources the data necessary to assess implementation progress. Other agencies that will play an important role in this process are the Central Bank (for financial sector issues), the Ministry of Economy and the Commission for Competitiveness (for trade and investment climate issues), the SAT (for tax administration issues), the RIC (for cadastre and land titling issues) and the Office of the Commissioner for the Government's Plan.

V. BENEFITS AND RISKS

The expected benefits from this loan include: 1) promoting equitable growth and strengthening the investment climate, 2) enhancing capacity for increased public spending in priority sectors**,** 3) improving public expenditure transparency and management.

Continued strong performance by the Government is subject to three main risks during the implementation of the DPL series: (i) political gridlock, given a divided Congress, (ii) societal tensions related to the country's post-conflict status, and (iii) exogenous shocks, related either to natural disasters or a deteriorating external environment.

VIII. POVERTY AND SOCIAL IMPACTS AND ENVIRONMENT ASPECTS

The actions supported by this DPL are not expected to have any adverse distributional impact in the medium-term. To the extent that the measures have played a role in Government's ability to maintain social spending levels, their impact on income distribution is expected to have been positive. This is confirmed by public expenditure incidence analysis undertaken in the context of the GUAPA which indicates that public social expenditures (Peace Accords definition) are generally pro-poor. Likewise, a FY 05 PSIA on the distributive impact of fiscal reforms supported by the DPL series, found the reforms to be mildly progressive. With respect to the social impact of CAFTA, the Bank's regional report "DR-CAFTA: Challenges and Opportunities for Central America" found that about 84% of the Guatemalan population are net consumers who would benefit from price reductions as a result of increased competition. Once DR-CAFTA is in effect (expected in the second half of 2006), the agreement grants long grace periods and slow tariff phase outs (7 to 20 years) for sensitive agricultural activities. However, the Bank's report concluded that some groups of poor rural households engaged in these agricultural activities may require assistance during a transition to increased competition. To better understand the circumstances of the specific groups who may be affected, PSIA work currently underway is concentrating on analyzing the likely impact of the agreement on Guatemala's indigenous population. Preliminary findings of the analysis suggest that most indigenous people are net consumers and would benefit from lower prices. Only a small minority relying heavily on maize production would be adversely affected. To the extent that tariffs on maize are due to phase out gradually over a 20 year period, mitigating measures would be part of the policy dialogue for future DPLs and other Bank interventions in Guatemala.

The specific policies supported by this DPL operation are not expected to entail significant impacts on the environment, forests or other natural resources. However, to the extent that measures supported by the DPL

program are successful, over time, in attracting new investment (including in infrastructure) and trade expansion, there will be a need to strengthen Guatemala's national institutional capacity to identify and address environmental policy and regulatory issues. With this in mind, a strategic Country Environmental Analysis (CEA) is currently being undertaken (and nearing completion) which is helping to identify cost-effective approaches to closing gaps in institutional capacity and the regulatory framework for environmental protection. These will be the subject of discussion with Government over the next months.

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