

INTERNATIONAL DEVELOPMENT ASSOCIATION AND
INTERNATIONAL MONETARY FUND

NICARAGUA

**Poverty Reduction Strategy Paper Annual Progress Report
Joint Staff Assessment**

Prepared by the Staffs of the International Development Association and
the International Monetary Fund

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1. **The first annual Poverty Reduction Strategy Paper¹ (PRSP) Progress Report of the Government of Nicaragua presents a frank review and analysis of the government's implementation of the PRSP to date.** This first-year Progress Report (henceforth the Report) expresses the new government's² endorsement of the PRSP presented to the Boards of IDA and the IMF on September 25, 2001 and September 19, 2001, respectively. The Report expresses the new government's commitment to reducing poverty and improving welfare under adverse international circumstances and considerable internal political tensions. The Report involved consultations within government, with civil society and with bilateral and multilateral donors. The Report addresses six key implementation areas: (i) revision of the medium-term macroeconomic framework; (ii) progress in poverty reduction; (iii) implementation of policies and programs under the four pillars and three cross-cutting themes of the PRSP;³ (iv) progress in targets and intermediate indicators, selected on the basis of the Millennium Development Goals (MDGs); (v) enhancement of public expenditure management instruments; and (vi) impact analysis.

¹ *Estrategia Reforzada de Crecimiento Económico y Reducción de Pobreza*, Government of Nicaragua, July 2001.

² The Bolaños administration took office in January 2002.

³ The four pillars are: (i) broad-based economic growth; (ii) investment in human capital; (iii) better protection of vulnerable groups; and (iv) institutional strengthening and good governance. The three cross-cutting themes address the country's ecological vulnerability, social inequality, and the need for greater decentralization.

I. OVERALL ASSESSMENT OF THE REPORT

2. **The Report is well-balanced on progress made as well as on limitations encountered in implementing the strategy in Nicaragua.** In particular, the revised medium-term macroeconomic framework is realistic and gradually converges to medium-term PRSP objectives. The Report shows considerable progress in achieving PRSP goals linked to MDG goals, and identifies remaining challenges. While showing that targets and intermediate indicators have been met in many areas, the Report recognizes that sustaining this progress in the future may be difficult. The Report also analyzes the reasons why some outcomes were not achieved and proposes remedial actions. It also describes improvements made in public expenditure management (see section II.E below).
3. **The preparation of the Report incorporated consultations within government and with civil society. Report preparation also included sessions with bilateral and multilateral donors.** The PRSP emerged from an intensive consultation process that deepened previous processes of national consultation. These culminated with the creation of the CONPES in early 1999, the primary channel of consultations between the government and civil society on social and economic strategy, including PRSP preparation.⁴ The Report describes consultations within CONPES and discussions with donors. It also describes new institutional arrangements within the public sector for PRSP implementation, consultation and monitoring (see section II.G).
4. **The Report acknowledges specific areas where implementation bottlenecks have occurred.** In particular, the Report raises concerns about the lack of progress in realigning donor assistance to support the PRSP. It describes the government-led efforts to improve foreign aid coordination that culminated in a Cooperation Forum in June 2002. However, since the slowdown in donor financing in 2001 was partly due to slippages in program implementation and growing governance concerns, the new government needs to restore donor confidence, including through more transparent and reliable public expenditure management mechanisms.
5. **Given the substantial deviations from the envisaged macroeconomic framework in the last quarter of 2001, a track-record of satisfactory implementation still needs to be established in order to meet the floating completion point condition. In addition, further efforts are needed to accelerate and improve implementation of the PRSP in other areas.** In particular, agencies concerned with the first pillar for broad-based growth

⁴ CONPES, created to advise the President on the formulation and evaluation of social and economic programs, brings together representatives of political parties, the business community, labor unions, churches, universities, and a network of national NGOs. It was given the added responsibility of liaising with civil society and other stakeholders to provide feedback for the preparation of the PRSP and to build ownership for the poverty reduction strategy.

still need to move forward from strategy to action plans, incorporating criteria for potentially excluded population groups. Building on the positive track-record established so far this year, especially in the areas of prudent macroeconomic management and the fight against corruption, will be crucial for the credibility of the government's strategy on addressing PRSP implementation bottlenecks to be presented to donors at the January 2003 Consultative Group meeting. Some key institutional reforms have suffered difficulties and/or delays in implementation. This reflects, in part, the difficult political situation, which has held up implementation of civil service and pension reforms. Similarly, further advancement in land security has suffered delays mainly due to judicial polarization. Institutional reforms, particularly in the social sectors, are advancing slowly. A National Social Protection Policy is urgently needed for better implementation of the third pillar of the strategy—protection of vulnerable groups—; initial work would need to be accelerated as this is also a trigger for HIPC completion point. The PRSP process in Nicaragua of linking and monitoring measurable outputs and outcomes to policy and program selection has been initiated by some but not all line ministries and government agencies. Local stakeholders have been involved to a certain extent, mainly through consultation of municipal budgets (see section II.G).

II. PROGRESS IN IMPLEMENTATION OF THE POVERTY REDUCTION STRATEGY

A. Medium-Term Macroeconomic Framework

6. **After the sharp deviations in 2001 from the original framework, the revised medium-term macroeconomic framework gradually converges back toward the original PRSP objectives in terms of economic growth, inflation and the external position.**

However, the levels of GDP and per capita GDP will remain lower than initially envisaged.⁵ Although the prospects for poverty reduction in the immediate years are not so favorable, the targets for poverty reduction from 2005 to 2015 could still be achieved if annual per capita real GDP growth is at least two percentage points from 2003 onwards (see section II.B). Success in implementing the components of the strategy will ensure that the poor can benefit from future economy recovery. The framework also reflects the authorities' goals to restore fiscal and external sustainability, increase spending on poverty-reducing programs in line with HIPC relief, accelerate the implementation of structural reforms directed at higher efficiency of public spending, and boost foreign and domestic private investment. In particular, attaining projected levels of spending on poverty-reducing programs will depend importantly on both future economic recovery as well as continued support from donors.

7. **PRSP analysis of the sources of broad-based and labor-intensive growth is somewhat limited; which was already noted in the previous JSA.** The government is partly addressing these concerns through the focus on clusters development (extending the

⁵ The PRSP targets for GDP were 3.7 percent in 2002, 4.5 percent in 2003 and 5 percent in 2004. The PRSP Progress Report revises these to 1 percent, 3 percent and 4.5 percent, respectively.

previous four poles to seven), but a specific action plan with targets, policy and programmatic actions, identified responsible agencies and partners, sources of financing and potential markets remain to be developed. Zones with high growth potential may not necessarily be the ones with a high concentration of poor and extremely poor population, and the report should mention how these tradeoffs will be addressed. The government should refrain from picking winners in the private sector and from distorting incentives for the financial system. In addition, given the high vulnerability of the economy to external shocks (natural disasters, terms of trade), an important aspect of the growth strategy would be how to increase the economy's resilience to external shocks (for example through export diversification and improved market access). The staffs would therefore urge the authorities to focus the next report on a strengthened analysis of the sources of growth and related policy actions.

8. **The revised medium-term fiscal framework aims at placing the public sector finances on a sustainable path.** To date, there has been good progress in implementing corrective measures both on the expenditure and the revenue sides. Reaching the medium-term objective however also hinges critically on implementation of a second stage of the tax reform in 2003, further strengthening tax administration, and a substantial reduction in overall primary spending. The efficiency of public investment is being increased through improved project selection criteria and a stronger focus on poverty-reducing spending. This is evidenced in the budget revision adopted by the National Assembly in mid-2002 as well as the draft 2003 budget proposal submitted to the assembly in October 2002.

9. **The government's strategy to strengthen the financial system should be more specific.** This was identified in the PRSP as one of the obstacles to higher growth, and is indeed a key element of the authorities' program. The revised macroeconomic framework appropriately takes into account the full extent of the domestic debt problem (which was not fully appreciated at the time the PRSP was finalized). In addition, implementation of the recovery plan for assets acquired from intervened banks, enforcement of the existing prudential regulations, and strengthening of supervision—all on the government's agenda—will also be critical to reducing the banking sector's vulnerabilities.

10. **The medium-term concessional financing assumptions appear realistic,** in view of the improved outlook for support from the World Bank, the IMF, and other donors of the government's program. In addition, a larger share of the external financing is directed towards the financing of the poverty-reduction strategy than envisaged in the PRSP.

B. Poverty Reduction

11. **Nicaragua has a solid basis for updating progress in poverty reduction.** Nicaragua has continued the collection of systematic information on poverty and living conditions. In particular, two recent 2001 nationwide surveys (the Living Standards Measurement Survey (LSMS) and the Demographic and Health Survey (DHS)) have permitted a continuation and deepening of the analysis initiated by the series of LSMS carried out in 1993, 1998, and post-Hurricane Mitch in 1999, and the DHS of 1998. These

surveys have ascertained a positive trend decline in the incidence of poverty and extreme poverty in urban and rural areas, with an acceleration between 1998 and 2001.

12. **Restoration of sustained economic growth will be critical to continue progress in the reduction of poverty.** The Report clearly conveys the significant progress made over the last decade in reducing poverty, and establishes the considerable responsiveness of poverty reduction in Nicaragua to economic growth. The decline in the population living in poverty falls from 50.3 percent in 1993 to 47.9 percent in 1998 and to 45.8 percent in 2001, while that in extreme poverty goes from 19.4 to 17.3 and to 15.1 percent for those years. The prospects for poverty reduction in the immediate future are not so favorable. Many of the factors that contributed to reducing poverty and achieving other PRSP and MDG goals over the last decade—pacification of the countryside, favorable terms of trade, and job creation in agriculture—as well as, more recently, the post-Mitch reconstruction boom, came to an end in 2001. Future progress in rural growth, where most of the poor are concentrated, will require new impetus to sustained agricultural growth accompanied by substantial productivity gains and specialization, attraction of private investments and increased access to international markets. The Report presents a technically sound analysis on alternative scenarios for extreme poverty reduction, identifying the critical role of resuming per capita economic growth for continued advancement in this PRSP goal. Furthermore, the Report estimates that achieving the PRSP goal of extreme poverty reduction by 2005 would require annual per capita real GDP growth of at least two percentage points from 2003 onwards. Given current population growth estimates, this implies about a five- percent GDP growth. The Report expresses concern about risks and challenges to the outlook for economic growth. However, it does not elaborate on the implementation steps for strengthening the First Pillar of the Strategy on Broad-based Economic Growth. A discussion of the economic risks and vulnerabilities, as well as the elaboration of some alternative macroeconomic scenarios leading to higher and/or lower per capita GDP growth could further strengthen the understanding of these links and help identify realistic growth strategies.

C. Implementation of Policies and Programs

13. **Implementation of the strategy has taken place in the context of considerable economic and political difficulties.** The Report presents a frank assessment of achievements and challenges in implementing the strategy, including how a previous PRGF program went off track in early 2001, presidential elections in November 2001, and the efforts of the new government that took office in January 2002. The political transition and a sharp deterioration in the terms of trade have exacerbated domestic vulnerabilities and social tensions, reducing available resources in the public as well as the private sectors, and complicated implementation of the strategy against the background of an already weak institutional capacity. Nonetheless, the new government has moved quickly to address the economic imbalances and already established a track record of policy implementation.

14. **Implementing the strategy will require a strong commitment from implementing agencies to specific actions and measurable outputs.** The first pillar of the strategy—broad-based economic growth—is still very limited, with the role of rural development

addressed only marginally. For the second pillar of the strategy—investment in human capital—the passage of the Education Participation Law and the General Law for Health in early 2002 constitutes the long-awaited legal framework to advance the implementation of the reform agendas. However, greater precision is required in defining policies and program actions necessary to achieve the output targets and intermediate indicators established in the strategy. Planning departments within each related ministry and government agency need to define and commit to such action plans. The third pillar—protection of vulnerable groups—urgently requires a National Social Protection Policy. This policy is yet to be defined with clear goals, targets and intermediate indicators, time lines, and funding requirements. In addition, Nicaragua’s social protection strategy should not limit its action plan only to the third pillar of the strategy—better protection for vulnerable groups—but should also broaden its understanding of social protection by incorporating social risk management, such as responses to socio-economic crisis and natural disasters. For the fourth pillar of the strategy—good governance—important progress has already been made in public expenditure administration (reviewed in section II.E below). Among the three original cross-cutting themes—environmental vulnerability, social equity and decentralization—social equity is not addressed in the Report. Important progress has been made on environmental vulnerability, including the approval of Nicaragua’s Environmental Plan and initial activities by the recently established National System for Disaster Prevention, Mitigation and Response (SNPMAD). Progress with decentralization is incipient, but a municipal fund (FONDEM) has been established for transfers from public resources and donations, and a unified system for municipal planning is now in place.

D. Targets and Intermediate Indicators

15. **Substantial progress has been made in reaching PRSP targets and intermediate indicators, albeit only partly attributable to implementation of the strategy.** The Report provides a comprehensive assessment of progress in PRSP targets and intermediate indicators. In particular, the Report clearly establishes links between PRSP and MDG goals. Progress towards achieving the PRSP and MDG goals has generally been satisfactory, but performance of intermediate indicators is mixed. The Report identifies this as a challenge for sustaining future progress. However, it is silent with respect to identifying contributing factors, and prioritizing actions and resources for this purpose.

16. **Cost-effectiveness, appropriate prioritization, and targeting of PRSP project interventions remain to be addressed.** The rising share of spending on poverty depicted by the share of PRSP spending in total and in central government expenditure demonstrates the authorities’ commitment to the PRSP strategy. However, further efforts on several fronts are needed at sectoral levels, especially education, health, and water and sanitation. In primary education, efforts are needed to increase coverage, internal efficiency and quality. The recently approved EFA-FTI will support required actions in primary education. In health, further progress is needed to advance key elements of the implementation of the reform agenda that would enhance impact of investments in equipment, infrastructure and human resources; such as, hospital autonomy, financial decentralization, performance-based management, and monitoring/evaluation. Maternal and child health indicators are mixed,

with stagnant progress in institutional births and incidence of diarrhea and upper respiratory infections. Water and sanitation goals were achieved, but original targets were very modest. Water coverage at the national level is relatively high, but rural water coverage is much lower, and both are progressing slowly. Sanitation seems to exceed the goal, but more than one-half of latrines are untreated.

E. Public Expenditure Management

17. **Progress has been made in setting up a tracking mechanism for HIPC debt relief.** The authorities have taken two important steps since July 2001 to transform the existing Social Supplementary Fund (FSS) into a more transparent tracking mechanism for channeling HIPC debt relief savings toward poverty-reducing programs: they have (i) developed new operating guidelines for the FSS that were approved by the FSS Coordinating Committee in September 2002, and (ii) expanded the membership of the FSS Coordinating Board by Presidential decree to include the Ministry of Agriculture, the Ministry of the Family and a representative of the Economic and Social Planning Council (CONPES). The new operating guidelines were broadly consulted with the donor community and CONPES, and provide an appropriate basis for a transparent tracking of funds. Also, the inclusion of a civil society representative (from CONPES) on the FSS Coordinating Board is considered a positive step in promoting greater transparency. However, the process of implementing the tracking process itself has been slow. Even though Nicaragua has been receiving interim relief under the HIPC Initiative since January 2001 from the World Bank and other donors reports on the use of those funds have not yet been made available. The staffs look forward to the presentation of regular reports from SECEP on the use of HIPC funds and the evolution of overall poverty reducing spending, as indicated in the Progress Report. In addition, given that the FSS has been designated as the HIPC tracking mechanism, it is important to ensure that the savings provided under the HIPC initiative are only eligible to be used for the financing of the poverty reducing programs identified in the PRSP and tracked through the FSS mechanism.

18. **Progress has been made in strengthening the public investment planning process, and the authorities are encouraged to develop a medium-term expenditure framework.** The National System of Public Investment (SNIP) was significantly strengthened with the Presidential decree issued in July 2001 that establishes its administrative guidelines. Under these guidelines, all new public investment projects are required to have a prior technical and economic evaluation by the SNIP to determine that the project is consistent with the government's development policies and priorities, and satisfies certain economic efficiency criteria. Other important steps taken to strengthen the SNIP include developing its information systems on public investment projects, creating regionally decentralized investment planning units, and inviting civil society to participate in the public investment planning process. The staffs welcome the government's intentions to improve its medium-term public investment planning and would like to encourage consideration of introducing a medium-term expenditure framework. In that context, it is recommended that SNIP calculate the recurrent expenditure implications of the existing investment program, as an important first step toward developing such a framework.

19. **The program to strengthen public sector financial management has advanced significantly with the implementation of the Integrated Financial and Administrative Management System (SIGFA) across the central government.** Implementation of this program has reduced the time required for processing financial and budgetary information, and permits a more accurate monitoring of public expenditures. The planned installation of working stations in the Comptroller General's Office to audit the public accounts online will represent a further important step in strengthening public expenditure management. Significant progress also has been made in setting up a single account in the Treasury to monitor the flow of public funds. More remains to be done, however, as many funds—especially those in the form of project-specific donations—continue to be channeled directly to public sector institutions through the banking system, bypassing the single account system. The staffs fully support the Authorities' request for assistance from the international donor community to institutionalize the use of the single treasury account, independent of the source of financing, with the aim of promoting greater accountability and transparency in the use of public funds, and facilitating the task of donor coordination.

20. **Further work is needed in setting up an effective poverty indicators monitoring and program evaluation system.** A National System to Monitor Poverty Indicators (SINASIP) has been designed with the help of consultants, but more work is needed to set up this system and render it operational in a resource-constrained environment. Execution of SINASIP has been delayed greatly due to an exhaustive number of indicators to be monitored for all 151 municipalities, and the complexity of recommended institutional coordination arrangements. Further simplification of SINASIP, with a step-wise approach that would initially monitor mainly PRSP goals and intermediate indicators, would yield a more practical and manageable system. This monitoring function can then be strengthened by defining criteria for better-targeting and geographical allocation of resources, and for project selection and evaluation. The staffs attach particular importance to a well-functioning poverty monitoring system in the context of Nicaragua's overall poverty reducing effort, and regard it as a core responsibility of the SECEP. Important program evaluations are currently taking place in the rural development and social sectors. The staffs look forward to the implementation of measures to restructure and reorient existing programs on the basis of these evaluations, with a view toward obtaining efficiency gains and raising the poverty-reducing impact of public programs.

F. Impact Analysis

21. **Staffs encourage the authorities to continue advancing the policy-relevant empirical analyses, Poverty and Social Impact Analysis (PSIA), outlined in the Report.** The Report identifies four areas of potential social, political and economic impact in the future: strengthening of the first pillar of the strategy by focusing on clusters development, fight against corruption, the national education plan and basic education, and fiscal reform. Although the Report summarizes their main policy and programmatic issues, it contains a very preliminary identification of probable causal links but not yet an evaluation of their poverty and social impact. The Report indicates that a PSIA will be completed after the upcoming Consultative Group meeting in January 2003 and after one year of implementation

into the PRGF. However, since the PSIA involves an ex-ante impact evaluation of key measures contemplated in the strategy supported by a PSAC and PRGF, the staffs recommend that the PSIA be initiated as soon as possible so that its findings can accompany the next PRSP progress report.

G. Consultation

22. **PRSP implementation efforts have broadened participation and the local level has been involved to a certain extent.** A presidential decree on March 2002 entailed a dual reform to CONPES, eliminating government representation with the intention of strengthening independence and autonomy of civil society deliberations and recommendations, and incorporating of women, youth, autonomous regions, and media representation. Although the decree signified that new authorities endorsed CONPES, the reduced government presence led to a less fluid dialogue between government and civil society. PRSP implementation has incorporated new institutional arrangements within the public sector, such as consultation and monitoring; these include workshops within ministries at the central level and with departmental delegates, particularly for education and health. The SNIP has also undertaken workshops at the departmental level on public investment for the strategy and its decentralization with departmental delegates and civil society organizations. Similarly, the National Council for Sustainable Development (CONADES) has undertaken discussion forums at most departments, yielding proposals for improving the legal framework for natural resource management and indigenous rights. The program for supporting the implementation of the strategy (PAI), supported by the IDB, initiated in 2002 piloting of integrated workplans (PTIs) in eleven municipalities; involving program prioritization, increased local ownership and social auditing.

23. **Further efforts are needed for building systematic participation at the local level to implement the PRSP; which was a key recommendation of the previous JSA.** The local level has been involved to a certain extent through consultation of municipal budgets. However, progress beyond occasional consultation at this level is still awaited, in particular through building systematic participation and ownership. Institutionalizing participation will be key to ensure successful implementation of the strategy. Ensuring consistency of local demands with supply of projects would also strengthen ownership of the strategy at local level. The program for coordination of the implementation, monitoring and participative evaluation of the strategy (PASE), currently under design, contains several of these elements; with the intention of linking the national, departmental and municipal levels of government with civil society.

H. Risks to the Strategy

24. **The staffs consider that the strategy is subject to several important political, institutional and economic risks,** even with likely PSAC and PRGF support.

- The implementation of the PRSP faces significant political risks given the evident tension between supporters of the current and previous Administrations. These

tensions could lead to affect decision-making in the National Assembly and prevent the passage of legislation needed to implement the PRSP agenda.

- Important institutional risks to program implementation are posed by weaknesses in the courts and supreme audit agency. The absence of a well-functioning judicial system would undermine private sector confidence and limit the impact of efforts to reduce poverty through faster growth.
- Important economic risks to program implementation come from both external and internal sources. On the external side, Nicaragua remains very vulnerable to natural disasters (*el Niño*, *hurricanes*, *earthquakes*) and to terms of trade shocks (*further coffee price declines*, *oil price increases*), which could derail a new PRGF program and stall progress under the HIPC Initiative.
- Two major risks on the internal side concern the fragility of the financial system, which keeps the country vulnerable to financial crises triggered by external shocks or corporate governance deficiencies, and the related risk of a rapidly expanding domestic debt which threatens to undermine fiscal austerity efforts. The weak status of land tenure security represents the other important source of domestic debt expansion, while constituting a source of political risk in its own right. An associated risk is posed by a lack of clarity in the Administration's indigenous policy.

25. The PRSP Progress Report does not evaluate these risks. The staffs recommend that the authorities analyze these risks, and prepare and implement action plans to mitigate and/or avoid them.

III. CONCLUSION

26. **The Report presents a coherent medium-term macroeconomic framework and credible efforts towards supporting sustainable implementation of the strategy**, consistent with the attainment of poverty reduction targets. The renewed focus on stimulating broad-based growth and instituting legality are key elements for increasing the likelihood of success of the strategy.

27. **The staffs consider, however, that satisfactory implementation of the PRSP targets within the revised macroeconomic framework still needs to be established.** In addition, work is needed in several areas to ensure sustained progress in the future, and advancement in their implementation should be provided in the next progress report, especially in: (i) pursuing government-led efforts to realign donor assistance to support the PRSP; (ii) defining the implementation steps for the first pillar of the strategy emphasizing broad-based and labor-intensive growth, including a clear action plan; (iii) elaborating a full PSIA on key government measures, such as the fiscal reform, trade liberalization, and education for all initiative; (iv) further strengthening of both fiscal and financial management systems; (v) continuing to advance the implementation of institutional reforms, particularly

in the social sectors; and (vi) deepening participation and ownership of implementation and monitoring of the strategy, particularly within line ministries and at the local level.

28. The staffs of the World Bank and the IMF consider that the country's efforts toward implementation of the strategy provide sufficient evidence of its continuing commitment to poverty reduction, and, furthermore, that the strategy inserted in the new medium-term macroeconomic framework provides an appropriate framework for IDA and IMF concessional assistance. The staffs recommend that the respective Executive Directors of the World Bank and the IMF reach the same conclusion.