REPORT

The challenge of a generation: the leap towards a high-income economy

April 15, 2019
About the International Commission for Equity, Growth, and Development

The “International Commission for Paraguay’s Growth, Equity and Development” (the Commission, hereafter), promoted by the Ministry of Finance, with the technical support of the World Bank, was set up to help understand the long-run socio-economic forces and growth challenges faced by Paraguay in a context of economic uncertainties and emerging trends in the global economy, review salient features of successful growth experiences in other countries, and provide a framework of policies and actions that can be useful to decision makers to implement a strategy to meet Paraguay’s ambition of more prosperous and equitable society.

The Commission’s goal has also been to help create a platform to discuss different development models, share knowledge and good practices based on successful international experiences, and stimulate debate on a proposed long-term growth strategy, which is comprehensive, inclusive and sustainable. In particular, it seeks to promote a state policy on growth, development and equity, where the roles and forms of cooperation between the public and private sectors are defined. The Commission is composed as follow:

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<td>CIT</td>
<td>Corporate Income Tax</td>
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<td>FDI</td>
<td>Foreign Direct Investment</td>
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<td>FEZ</td>
<td>Free Economic Zone</td>
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<td>GDP</td>
<td>Gross Domestic Product</td>
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<td>ICT</td>
<td>Information and Communication Technology</td>
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<td>INFONA</td>
<td>Instituto Nacional Forestal</td>
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<tr>
<td>IRACIS</td>
<td>Impuesto a la Renta Comercial, Industrial o de Servicios</td>
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<tr>
<td>IRAGRO</td>
<td>Impuesto a las Rentas de las Actividades Agropecuarias</td>
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<tr>
<td>LAC</td>
<td>Latin America and the Caribbean</td>
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<td>MADES</td>
<td>Ministerio del Medio Ambiente</td>
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<td>NDP</td>
<td>National Development Plan</td>
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<td>PIT</td>
<td>Personal Income Tax</td>
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<tr>
<td>PPP</td>
<td>Public-Private Partnership</td>
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<tr>
<td>SIRT</td>
<td>Sistema de Información de Recursos de la Tierra</td>
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<tr>
<td>SME</td>
<td>Small and Medium Enterprises</td>
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<td>SOE</td>
<td>State-Owned Enterprise</td>
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<td>VAT</td>
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Executive Summary

Paraguay has made considerable economic and social progress over the past fifteen years. The economy grew an average of 4.5 percent a year and more than one million people left poverty. With an income per capita of over US$5700, Paraguay stands today in the upper-middle-income country group. The country is blessed with a considerable endowment of natural resources, vast energy potential, ample fertile land, and a young population. If well-managed, these resources can contribute to economic growth and shared prosperity, giving Paraguay the opportunity to reach the level of high-income country within a generation.

Paraguay’s socio-economic structure is gradually transforming. The economy is moving away from agriculture towards services and, to a lesser degree, manufacturing. The socio-demographic structure, characterized by a young population, creates the potential for a “demographic dividend,” and the emergence of a middle class in urban centers provides positive socio-economic externalities. If well-sustained, these transformations will likely have a profound impact on the long-term prosperity of the Paraguayan people and will positively affect the economy and society.

With such potential, the risk today is complacency. There is uncertainty over the capacity of the current economic model to adapt to a fast-changing global economic environment, and going forward, to effectively translate growth into shared prosperity. Other economies with a level of development similar to that of Paraguay were not able to escape the “middle-income trap” in the past: they experienced a slow and imperceptible decline of their economic models while remaining unable to address new challenges and meet society’s changing aspirations.

It is critical to begin the process of upgrading the current economic model now to ensure that an economic and social convergence toward a high-income standard of living takes place within a generation. The experiences of successful countries that have graduated from middle-income status show that a long and sustained growth can only be achieved with a profound transformation of the country’s economic and social structure. This transformation is dependent upon strong and effective institutions that enable markets to function while addressing uncertainty, strengthening coordination, and fostering innovation. Human capital must increase through skills formation and capacity enhancement to allow the economy to produce more complex goods and services.

The task at hand is to begin to steer the process of creation of quality opportunities and rising productivity throughout the economy. A broad-based economic model is required to reduce the volatility resulting from an undiversified growth path and would help preserve valuable natural resources. It would also help to better integrate the economy, both internally and with the rest of the world, and better position it to benefit from globally-available knowledge, ideas, and markets.

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1 Upper middle-income countries are those countries with a GNI per capita between US$3,896 and above US$12,055
2 The threshold of the high-income country group is a GNI per capita above US$12,055
The current government has the opportunity lay the foundation to set in motion a long-term strategy toward broader, more equitable, and more sustainable growth on which for future administrations could build on. Delaying action, on the other hand, could jeopardize the vision outlined in the National Development Plan (NDP) for 2030 and put at risk the sustainability and positive effects of the current economic and social transformation. To fail to act would compound the long-term costs of inequality, economic concentration, natural resources depletion, and environmental degradation.

If high growth is not maintained and does not become more inclusive and sustainable, the current socio-economic and environmental challenges and its diminishing marginal returns could become a threat to growth and social cohesion: Traditional agriculture may grow further isolated and rely even more on the expansion of the agricultural frontier at the expense of forests and water to compensate the diminishing returns of land yields. Macroeconomic volatility and commodity dependency may continue or even increase, poverty would remain high and inequality would widen. Regional disparities within the country may widen and urban centers may expand in a disorderly fashion dominated by informality and congestion. Young people, women, and Guaraní speakers would likely continue to find mostly informal, less productive, low-skilled jobs. Deficiencies in skills and education could become more notable.

Against this backdrop, The “International Commission for Paraguay’s Growth, Equity and Development” (the Commission, hereafter) was set up to help understand the long-run socio-economic forces and growth challenges faced by Paraguay in a context of economic uncertainties and emerging trends in the global economy, review salient features of successful growth experiences in other countries, and provide a framework of policy and actions for decision makers to use in implementing a strategy to meet Paraguay’s vision of a more prosperous and equitable society.

To achieve its mandate, the Commission engaged in a consultative process through a number of events organized in Paraguay over the past two years in which the authorities, the private sector, and the civil society discussed a range of cross-cutting issues related to growth and development. This report is the result of that process and reflects active discussions among the members of the Commission. The report focuses on the points of consensus that emerged in those discussions and highlights seven priority areas that the Commission has determined are critical to support a socio-economic transformation towards a high-income economy with a resilient middle-class, and to avoid the middle-income trap. The seven priority areas are:

1. A substantial transformation of the education system and skill development at all levels. While the average level of educational attainment has been increasing, gaps remain in terms of

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3 The Commission would like to thank the World Bank, and Stefano Curto in particular, for technical support and secretariat function who coordinated every aspect of the work of the Commission, the workshops, the outreach strategy, publication of the report, and numerous working papers.
secondary and tertiary education coverage, income and regional disparities, and the overall quality of the education system. Parental attention to children progress, discipline and motivation is also important to multiply the effect of an improved school system. The efficiency of the education system in terms of coverage and quality—particularly for public schools—must improve now when more resources have been made available. It is also key to narrow the wide gaps in overall education quality across regions and between public and private education. The transition from school to work requires attention to ensure a strong connection between education and the improvement of skills and abilities needed for a flexible and innovative economy. This must involve secondary schools and universities, vocational and trade schools, and training centers for the workforce. Creating quality opportunities is not only necessary for broad-based growth, as it helps a larger share of the population to contribute to economic growth, but also for expanding the middle class and reducing poverty. Emerging experiences in Latin America and beyond are providing examples of how to move toward broad-based delivery of the basic competencies needed to adapt and contribute in a world increasingly subject to major technological disruptions.

2. **Development of a healthy business and investment climate to create broad-based growth, business opportunities, and quality jobs.** Improvements in the quality of supporting environments, good economic governance, strong legal framework, and uniformity of the application of the law are all critical to increase quality jobs and business opportunities. The most productive economic activities must not remain isolated in enclaves, but rather integrated and connected to value chains at home and abroad. It is necessary to develop appropriate financial services to enable enterprises to expand, to finance production, and to address companies’ capacity deficiencies. Efforts should be made to cultivate suitable opportunities to bring in FDI, given its potential to provide finance, technology, managerial capacity, and access to markets. Ideally, FDI should come into Paraguay because of the country’s robust institutions and legal framework, rather than potentially distortive tax incentives, as this ensures that it is appropriate for the country’s needs. Finally, an important characteristic of robust and competitive economies is a strong, modern, and formal small and medium enterprise (SME) sector. Allowing new industries to emerge, compete, and expand will help translate economic growth into more productive jobs and poverty reduction. Therefore, market power and other barriers to entry should be reduced, and the relevant government agencies should be given the legal powers and technical expertise to enforce competition.

3. **Strengthening connectivity to improve competitiveness and resource allocation in the tradable sector beyond agriculture.** Because of its strategic location in the South America continent but also because of being land-locked, the prioritization of public investment and the development of modalities to engage private actors in the improvement of connectivity and logistics are essential. This is especially critical given the large gaps in infrastructure and limited public resources. But enhanced connectivity should go beyond physical infrastructure to focus on strengthening institutions that facilitate trade in goods and services and the flow of ideas and people. Connectivity strategy should be designed with not only the agriculture sector in mind, but
also new industries and services. In addition, new trade must be accompanied by effective customs administration to avoid contraband and increase tax collection.

4. **Creating a healthy urban environment to generate quality opportunities to support broad-based growth and a middle-class society.** Given the continuous shift of job opportunities from rural to urban areas, it is essential to focus on creating urban environments that foster quality growth and positive overall quality of life. Healthy urban environments will propel transformation and mitigate negative externalities from agglomeration, such as congestion and informality. The urban economy should be the foundation of the new economy: open, inclusive, and sophisticated, to provide more quality jobs and opportunities. The capacity and integrity of the local and urban authorities and their working relationship with the central government are central to the process of creating a framework to facilitate sustainable urban development. Extensive work is underway in other countries to address traditional critical urban problems, including the use of emerging modern technologies. This work can provide guidance to Paraguay about policy options, particularly those related to increasing citizen security and reducing crime in urban centers.

5. **Implementing a strategy for the sustainable management of natural resources to address a market failure that is detrimental to long-term growth.** Paraguay’s natural resources are threatened by land degradation and forest loss due to the expansion of the agricultural frontier and the use of wood for fuel. Climate change exacerbates this already challenging situation. Agriculture’s impact on the environment can be mitigated by increasing diversification, value added, and quality of products along with addressing the challenges of deforestation. In addition, traditional agriculture, which is traditionally very poor, should be better integrated to increase productivity and use of resources. It is also important to ensure an adequate net social contribution of the sector in terms of tax revenue, given its environmental impact and the necessary investments in transport infrastructure. In terms of electricity, a major rethink of the current approach is needed for the economy to benefit more from the massive investment in hydropower generation. Institutional deficiencies must be addressed that have affected development and competitiveness through preventing progress on electricity transmission and distribution, right-pricing, and quality of service. A strong power sector should be the foundation of the new economy: open, inclusive, and sophisticated.

6. **Strengthening macroeconomic resilience to economic volatility and natural shocks.** Paraguay’s past achievements in macroeconomic policy should be sustained through increased countercyclical capacity. This entails consolidating credibility in monetary and exchange policy, further developing macroprudential policy, and institutionalizing a disciplined, countercyclical fiscal policy. This should include the introduction of a stabilization fund and associated countercyclical fiscal rules, greater reliance on automatic stabilizers, enhanced direct taxation, and reductions in public wages and other fixed expenditures. Paraguay will also benefit from actively seeking to achieve investment-grade rating for its public debt. In parallel, long-term work is needed to build a resilient, diversified, and well-connected economy, to reduce vulnerabilities.
from the global economy and climate-related shocks. The identification and proper assessment of risks to economic stability will inform immediate action, before weaknesses emerge, as in the case of pensions.

7. **Enhancing the capabilities of the state.** The model of a small state with emphasis on private sector-led growth has served the country moderately well. But going forward, a growing and more complex economy requires enhanced state capabilities. International experience shows that countries that have managed to reach high-income level are characterized by strong capacities to produce high-quality public goods and services that support not only the expansion and modernization of the economy, but also the strengthening of individual liberties, social equity, and the proper functioning of democracies. Although it is difficult to provide the wide range of these public services with excessively small states, what matters is the efficiency and effectiveness of the state. In this context, strong attention should be paid to integrity and transparency, capacity to promptly and effectively address challenges and policy trade-offs, capacity to implement efficient processes for policy formulation, public service delivery, and a discipline in the management of difficult budget constraints. All these characteristics are needed to advance the other six priority areas noted above, that include strong fiscal and monetary institutions, well governed state-owned enterprises (SOEs), a fair and effective judicial system, a strong anticorruption stance, and open, fair and competitive market conditions. In many middle-income countries, the challenges lie not only in regulatory deficiencies but also in limited managerial capacity to implement. A well-developed and transparent system for assessing public expenditure would help the government identify projects that have the highest social and economic impact, prioritize among them, provide detail on their expected costs, and guide the execution to avoid waste of valuable and scarce public resources.

The above seven priorities are consistent with the lessons learned by countries that have succeeded in avoiding the middle-income trap and gaining access to the high-income country group. These countries are well-connected to the global economy, have advanced in delivering quality and broad-based education, invest in the transformation of urban environments, and exhibit the capacity to address challenges and change course when circumstances have required. They have also shown the capacity to move upwards in terms of technological sophistication, with a levelled playing field across and within sectors that helps spur innovation and productivity. Their abilities to generate quality jobs have provided their populations with further incentives to acquire knowledge and skills. The strength of their institutions has grown over time.

The Commission underscores that these seven priority areas should not be perceived as separate self-standing initiatives, but as parallel coordinated actions that work coherently together and reinforce each other. For instance, the focus on improving connectivity (3), when developed fully, can have an impact on the allocation of resources if an even platform for entry and competition is provided (2) and a strong urban environment enables the emergence of sectors able to compete in the global economy (4). The dynamics generated will have a profound impact on education by
shifting demand for jobs and providing a strong incentive for investments in education and the acquisition of skills (1).

To this end, the following overarching goals and guiding principles should direct the design and implementation of actions under the seven priority areas and serve to mobilize society to support them:

➢ **An outward-looking mindset and a commitment to strong interconnectivity with the rest of the world.** Outward orientation that goes beyond agriculture is key in the short run and long term. Attention to the opportunities and resources that global markets offer will serve to guide the structural transformation that the country needs. A sector producing tradable goods and services in international markets increases the strength of the economy, improves its resilience, and lays the foundation for sustained growth driven by increasing productivity. International experience shows that the tradable sector is also associated with more learning and technological adoption and diffusion. The actions taken under the seven priority areas should aim at and be designed with this overarching goal in mind.

➢ **Focus on inclusion and resilience.** Given that most of the population remains either poor or vulnerable, emphasis on inclusion and resilience is key to translate growth into long-lasting development results. The emphasis on inclusion centers on a broad-based effort to raise levels of education and foster quality jobs and opportunities for all, extending the reach of the formal economy and removing constraints to participation. Managing and containing vulnerability includes attention to both reduce exogenous shocks and mitigate their impact on households and individuals in case they do materialize.

➢ **Strong institutional integrity and public sector culture.** Progress in the seven priorities mentioned above requires strong institutional integrity and public sector culture, both at the level of the national state (the executive, legislative and judicial powers) and at the level of local and municipal governments. The state must be a stalwart defender of the rule of law, and lead by example. High levels of perceived corruption, combined with the belief of the population that not enough has been done about it, can compromise the legitimacy of public institutions. Clear rules and fair enforcement are the foundation for establishing consensus and a successful social contract with the population, particularly the buy-in of the middle class. In this context, it is important to tackle all instances of mismanagement, wrongdoing, and corruption at every level. Beyond being upright and transparent, the state must avoid waste and mismanagement and take care not to absorb critical resources needed for development. Careful planning should go into a substantive reform of the civil service and justice system, making sure to avoid state capture by private interests.

➢ **Maintain an open and pragmatic implementation.** Initiatives and strategies need to be adjusted and fine-tuned based on results and feedback during implementation. In this context, the involvement of stakeholders is of paramount importance. Civil society, private economic agents, and beneficiaries can all provide the initial buy-in but also the needed momentum to sustain efforts. A permanent independent Growth Council could be considered, along the lines
of the productivity councils of Australia, the UK, and the US. These are valuable examples of independent and permanent bodies that have contributed to public debate and policy formulation for the design and adaptation of major reforms and the identification of lessons learned from implementation. It is also important to quickly move forward with implementation and deliver results on the ground by focusing attention on the most critical actions, their associated costs, and on the coordination of different players within the public and private sectors. A “Delivery Unit” within the President’s office could play a leading role in monitoring, supporting and accelerating implementation of initiatives and strategies.
<table>
<thead>
<tr>
<th>Priority Areas</th>
<th>Proposed Actions</th>
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| Education and Skills           | ➢ Implement a comprehensive education strategy with a focus on skills development.  
                                | ➢ Develop a culture of measuring outcomes and focus on efficiency.  
                                | ➢ Revise the current criteria for resource allocation and focus on local delivery.                                                              |
| Business Climate               | ➢ Implement a strategy to improve the overall business climate and to level the playing field across and within sectors.  
                                | ➢ Implement a holistic approach to FDI.  
                                | ➢ Implement a comprehensive framework to support strong and formal SMEs.                                                                       |
| Connectivity                   | ➢ Update the National Logistics Strategy.  
                                | ➢ Improve business regulations for cross-border transactions.  
                                | ➢ Implement a sound PPP framework.                                                                                                             |
| Urbanization                   | ➢ Implement a comprehensive urban development policy and planning.  
                                | ➢ Develop a culture of monitoring and the use of modern technologies.                                                                           |
| Natural Resources Management   | **Agriculture**  
                                | ➢ Increase the domestic value added and integrate traditional agriculture to increase opportunities.  
                                | ➢ Establish a single agency regarding land cadaster, registry, and title and strengthen the capacity of environmental regulators.  
<pre><code>                            | ➢ Review the overall taxation on the agricultural sector with the view of reducing distortion, improving equity and generating resources. |
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<tr>
<td>➢ Implement a comprehensive regulatory reform of the electricity sector</td>
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<td>➢ Overhaul the operational model of ANDE, while protecting the poor and vulnerable from tariff increases.</td>
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<tr>
<td>➢ Prepare for the renegotiation of the bi-national treaties.</td>
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<td>➢ Strengthen the capacity for countercyclical action by revising the current fiscal rules, building automatic stabilizers, and establishing more effective social protection.</td>
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<td>➢ Enhance the buoyancy of the tax system with emphasis on equity and efficiency.</td>
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<td>➢ Implement integrated agriculture risk management.</td>
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<td>➢ Enhance integrity and accountability by strengthening anticorruption policies to tackle all instances of mismanagement and corruption.</td>
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<td>➢ Strengthen the capacity to design public policies and implement and monitor them.</td>
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<tr>
<td>➢ Establish a permanent independent Growth Council to raise public awareness and a Delivery Unit within the President’s office to oversee implementation.</td>
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Past Achievements, Recent Progress and Remaining Challenges

Income and Poverty

Income per capita has increased steadily since 2000. The economy grew at 4.5 percent over the 2004–2017 period. Growth has been volatile because of the impact of recurrent shifts in weather patterns on agricultural and electricity production, which are key sectors of the economy and exports. Given the relatively high rate of population growth of 1.2 percent per year, Paraguay has experienced only moderate convergence in income per capita with high-income countries. Paraguay’s GDP per capita has grown faster than the LAC average only during the last five years, reducing the gap accumulated in the previous decade. With a GDP per capita of about US$5700, Paraguay is now an upper-middle-income country.

Poverty and inequality have been reduced, but they remain high. Poverty reduction in Paraguay has been exceptional, as has been the rise of the middle class. Since 2003, poverty rates measured at US$5.5 2011 purchasing power parity have fallen by 50 percent—more than the average reduction in LAC during the same period. In 2017, urban poverty bottomed out at 20 percent, while rural poverty stood at 36 percent. Over one million people left the poverty ranks, with these gains concentrated during the 2003–2013 period. The GINI coefficient dropped from .55 in 2003 to .48 in 2015, although it fluctuated during that period far more than in the other LAC countries. Moreover, per capita rural income declined between 2013–2016, with social transfers partially mitigating the impact on poverty. Despite these achievements, however, over 60 percent of the population are either poor or are at risk of falling back into poverty.

Moreover, not all Paraguayans have experienced gains: gender, age, location, and education matter. Poverty rates across different geographical areas have not converged, although gains in poverty reduction have been both in rural and urban areas. Women, youth, and the less educated are more likely to be working in informal occupations, with lower incomes and higher risks of being poor. Women get paid less, on average, than men for a similar job. The indigenous population and those who speak only Guarani are highly excluded. The poor suffer the most from the fluctuations in income and the volatility of the economy.

Education

A relatively more educated population is now entering the labor force. Each new generation has been receiving increasingly more years of schooling. The average level of education for the age 20–24 cohort was estimated at 10.9 years in 2010, 3.6 more years than those who were over 25 years of age. After pre-school (five years and older) through secondary school education became compulsory in 2010, enrollment ratios increased across the board.

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4 The middle class is defined as the share of the population with an income between US$10 and US$50 a day. The middle-class bracket can be further split into lower middle class and upper middle class to provide more granular information about its distribution.
The returns to education are high. Having a tertiary degree significantly increases a worker’s probability of having a formal job—especially in the public sector—and even a secondary degree increases the likelihood markedly. Earnings are also increasing substantially with the level of education. For example, tertiary graduates earn nearly double the wages of a worker lacking a primary degree and nearly a third more than those with an incomplete tertiary degree, even controlling for other characteristics such as formality. However, having education is not enough to access the formal market as other factors play a role.

Access to education remains a challenge, particularly in preschool and in upper secondary education. Options for childcare before the age of five are limited. School attendance during the primary years does not seem to depend on socio-economic status; but it does later: 88 percent of the highest quintiles attend secondary education, compared to 62 percent of the poorest households.

Above all, the overall quality of education is a serious concern. According to various student learning assessments, scores have not improved since 2006 and continue to lag behind regional averages. The most recent assessment (2018) confirm this finding: only 1 out of 10 children in the third grade can solve math problems adequate for their age. Concerns about the quality of education are heightened for rural communities, the indigenous population, and the poor. Also, there is a large gap in terms of quality between private and public education. Private education can contribute to perpetuating inequality, as well as a weakening of public education institutions. The risk in Paraguay and across Latin America is that when quality education is only available to the highest quintiles, existing patterns of inequality are preserved, the quantity and the quality of the labor force is reduced, and the economy remains below its full potential.

Public resources for education have increased, but efficiency is low. Public resources allocated for education have more than doubled over the last decade, reaching 3.4 percent of GDP in 2017. However, the allocation per pupil is lower than for other countries in the region. Moreover, the limited improvement in quality reveals that the increase in resources has resulted in a decline in expenditure efficiency.

Three contributing factors are impeding progress on education. First, implementation capacity is limited. For instance, the Plan Nacional de Educación 2024 currently under implementation does not provide detailed policy information to implement reforms. Second, the budget for education could be better allocated. For instance, some of the FONACIDE funds prioritize allocations to “affected” departments (Law 48/41), even if they have a lower number of students and are relatively wealthier. There are large variations in terms of basic infrastructure, with better infrastructure concentrated in urban areas and wealthier parts of the country. Third, the Teacher’s Professional Career has yet to be consolidated.
Health

Gains have been achieved in health outcomes, but progress has been slower than other countries. Life expectancy has reached 77.2 years, 74.7 for men and 80.2 for women. Infant mortality has dropped, but at 18.7 deaths/1000, remains high. The fertility rate has declined but still stands at around 2 births per woman. Access to services, including for the poor, has increased. Drinking water is available to 100 percent of the urban population and 94 percent of the rural population. Basic sanitation services are available to 96 percent of the urban and 78 percent of the rural population. However, households with water and sanitation services connected to safely managed networks are only available for 60 percent of the urban population and 41 percent of rural population.

There is considerable scope for improvement in service delivery. Primary health care provision is poor, which leads to an over-utilization of hospital services. Public budgeting does not match demand for services, and geographic availability of services is unevenly distributed. Out-of-pocket health expenditures are high and can be over 20 percent of the income of the poorest segments of the population, particularly for Guaraní-only speakers.

Institutional fragmentation is an important contributor to the low efficiency of health service delivery. The limited coordination between the two main providers of health services—Ministerio de Salud y Bienestar Social and the Instituto de Prevision Social—generates large inefficiencies, duplications and costs. For instance, the two programs lack cost-sharing agreements, which prevents IPS members from being reimbursed for the expenses associated with the universal service. Coordination in procurement between the two systems is also lacking, and there is duplication of services in selected geographical areas.

Economic Transformation

A gradual structural transformation of the economy is underway. The pace of transformation of the economy has been gradual. Agriculture has been and remains a major contributor to GDP, at almost 15 percent of GDP on average over the last decade. Industry, including construction and electricity, accounts for around 35 percent of GDP, and manufacturing makes up around 20 percent of GDP. The contribution of services to GDP has been expanding to reach almost 50 percent.

Exports remain highly concentrated in electricity and agriculture, but the sophistication of products has increased. Agriculture has been and remains a major contributor to exports, but modern agriculture has changed the composition of the basket. A notable development has been the increased weight of livestock production, which is now contributing around three percent of GDP.

The shifts in the allocation of labor have been larger. The share of the labor force employed in agriculture has decreased by a full 10 percentage points, from 28.8 percent in 2001 to 18.8 percent
in 2015, while the share of employment in services overall increased from 47.9 percent to around 57 percent over the same period. Most new jobs were added in the retail sector, followed by government services, manufacturing, other services, and construction. The share of public employment has increased from 6.4 percent in 2001 to 10 percent in 2015.

**Productivity**

Since 2009, aggregate labor productivity has increased considerably across the economy, fueled in part by improvements in the terms of trade. Agricultural productivity growth was the main driver of aggregate gains in the first part of the last decade, but other sectors caught up, leading to more widely shared productivity gains between 2008 and 2015. For example, transport, communications, financial, and other services had the strongest productivity growth (0.9 percent per year since 2008), followed by public administration (0.6 percent), construction (0.5 percent), and agriculture (0.4 percent). Manufacturing and utilities, in contrast, lost productivity.

**Considerable variation in productivity remains across and within sectors of the economy.** Within-sector labor productivity growth has averaged 2.3 percent per year in real terms, much higher than the observed between-sector productivity gains that occur when workers shift from less productive to more productive sectors. In agriculture, where a fifth of jobs reside, for instance, modern capital-intensive soy and beef production cohabits with less productive smallholder farmers.

**The potential to generate productivity gains through reallocation of labor from less to more productive sectors of the economy is considerable.** Most jobs in Paraguay are still found in traditional agriculture, retail, and other services—the three sectors with the lowest productivity, the lowest wages, and a high degree of informality. For instance, the productivity of labor in the trade and hospitality services, which employ 25 percent of the population, is 40 percent below the national average.

**Jobs**

**Job creation has outpaced with population growth.** With an employment-to-GDP elasticity of 0.55—in line with global norms—economic growth was able to translate into over 70,000 net new jobs annually between 2008 and 2015. At 2.7 percent per year, job creation indeed outpaced the labor force, which expanded by 2.5 percent annually over the past decade. Today, labor force participation in Paraguay is high at 70 percent, although female participation is lower than that of men.

**Real wages grew across the board—in all sectors and for most types of work status.** Since 2008, formal and informal wages rose by 3 percent per year in real terms, while self-employed (non-farmer) wages experienced 5 percent annual growth.
Informality has declined but remains extremely high. Between 2008 and 2015, more than twice the amount of formal jobs was added compared to informal jobs (in net terms); as a result, the informality rate fell by almost ten percentage points in less than seven years, to about 70 percent. The private sector added nearly 200,000 formal jobs, while the public sector added almost 100,000 formal jobs (equivalent to a more than 50 percent increase). Large formal firms have been responsible for adding the most private sector jobs since 2008.

Not all workers have been able to benefit from the increased demand in the formal economy. Young workers, women, and those with less education are still more likely to work informally. Workers in the bottom 40 percent of households are one-third more likely to be in informal work, and rural workers are about one-fourth more likely to be in informal work. Workers from Guaraní-speaking households also have a higher probability of being in the informal sector. Informal workers have difficulty transitioning into formal employment, as the formal labor market is quite rigid. Labor turnover in the formal sector is very low, reflecting more stable employment contracts, particularly in the public sector and large firms.

The continued dominance of informal, less productive, low-skilled jobs raises questions about the sustainability of the current economic model. Today, the small domestic market remains a constraint on diversification, and existing links to export markets are highly concentrated in capital-intensive agricultural products that provide little scope for spurring export-oriented employment. Government jobs generate about one-third of the formal jobs, absorbing a good share of the skilled population and shrinking the pool of the labor force available to innovate and create or enter businesses with high growth potential.

Focusing on the drivers of the creation of quality jobs and the continued shift towards formalization is of critical importance. More diversified economic activity would create jobs in a wider range of sectors, geographic locations, and skills to accommodate the diverse labor supply, especially higher-skilled workers. Cultivating the drivers of quality job creation would lead to improved quality jobs in agriculture and services, and better access to jobs for those workers who currently have fewer opportunities in the labor market, including women, youth, rural populations, and poor workers.

Investment and business environment

The weak links between the tradable sectors and employment generation is a major fault line in the economy that increases its vulnerability. The main drivers of economic growth, electricity and modern agriculture, are weakly connected to the rest of the economy. Capital-intensive agriculture and electricity exports generate limited employment opportunities, while job opportunities have been growing in cities for non-tradable goods and services. Alternative growth drivers in the tradable sector have yet to emerge strongly, and efforts to develop them have had only a limited impact.
The enabling environment for business to emerge and thrive is weak. While the overall 2018 Doing Business ranks Paraguay roughly in line with the LAC average, the ranking is the lowest for starting a business, at 148. The high costs of starting a business could help explain in part the high level of informality in Paraguay. The Global Competitiveness Index 2017–2018 places Paraguay at 112 out of 137 countries ranked. The individual rankings are particularly low in institutions (131), infrastructure (118), business sophistication (114), and innovation (127). The index identifies the most problematic factors for doing business as corruption, an inadequately educated workforce, an inefficient government bureaucracy and an inadequate supply of infrastructure.

Agriculture is fractured between a modern dynamic sector and a traditional subsistence approach. Modern capital-intensive farms contribute two-thirds of exports, while traditional agriculture is a labor-intensive sector with low productivity. Processing of agricultural goods for export has increased. Rural assets are highly concentrated, especially land: 70 percent of the land is owned by 1 percent of the owners. The sector is difficult to tax, raising questions about the net social contribution of the sector, given its environmental impact and accompanying investments in transport infrastructure.

A high degree of market concentration and an uneven playing field weaken the link between productivity, job creation, and growth. About two-thirds of formal firms and four-fifths of informal firms have labor productivity levels below the minimum wage. The commerce sector is the most dynamic, creating the highest share of jobs—formal and informal—between 2010–2014. But given the small size of the enterprises, its re-export orientation, and the high level of informality, the commerce sector does not have the capacity to stimulate sustained productivity growth.

The opportunities for economic diversification and the creation of quality jobs in Paraguay are constrained by a variety of factors that relate to or derive from its past development path. The high degree of market concentration and uneven playing field likely play a role in squeezing informal smaller players and preventing them to expand and formalize. Various factors contribute to the uneven playing field, including: access to technology and competencies, access to financing, payment practices, a biased or ineffective judiciary, and political connections. In many subsectors, the top four firms (measured by sales) account for more than half of all sales in their sub-sector, and in some cases 90 percent. Even more productive firms face constraints to expanding and generating employment.

The private sector is dominated by micro-sized firms with limited capacity to generate jobs. Most firms have less than 10 employees, even if they are formal. Nine out of ten formal firms are micro, generating only one-quarter of all formal work. To the contrary, firms with more than 100 workers constitute one percent of the total number of firms and generate two-fifths of formal employment. Smaller firms are less productive, pay lower wages, and create fewer jobs than medium and large firms. The largest firms are the most productive in all sectors, but especially in manufacturing, mining, utilities, and construction, suggesting a size threshold to increase
productivity. Young firms struggle to expand operations and create jobs, and the percentage of firms that remain small as they age is larger in Paraguay than in comparator countries. The evidence suggests that there is considerable market concentration in Paraguay.

**Formal firm creation is low in Paraguay.** Informal activity results from the inability of the current economic system to generate enough quality formal jobs. The current productivity structure remains rigid, with limited disruption, suggesting that strong formal and informal arrangements are hindering progress. Informal firms tend to be smaller and younger than formal firms, on average. However, a nontrivial percentage of informal firms is large. Many factors are affecting formalization: Labor law requires a 14 percent employer social contribution and 9 percent employee social contribution; these rates are an obstacle for firms with low productivity. The high degree of smuggling also indirectly penalizes formalization. Finally, women are more likely to work in commerce and services and tend to be excluded from the most productive formal jobs.

**The contribution of FDI has been limited.** Paraguay attracts limited foreign capital, with net FDI inflows just above 1 percent of GDP. Maquila fiscal incentives have been in place since 1990 (Law 60/90.), but the maquilas’ contribution to the economy and employment has been relatively small. In 2016, these firms exported $313 million. The projected indirect benefits of the scheme do not seem to have materialized, given the limited linkages with the domestic economy. Furthermore, the export processing zones and tax-free imports do not incentivize the use of domestic inputs, and non-maquila manufacturers struggle to compete.

**Urbanization**

**The urban economy is gaining importance.** While the pace of urbanization in Paraguay has been slower than in other LAC countries, 60 percent of the population is already living in urban centers as of 2017. Job growth has skewed to urban jobs, with urban areas creating three times the number of new rural jobs since 2001. Moreover, despite the historic prevalence of informal jobs in Paraguay, about four-fifths of urban jobs created since 2008 were formal. Because of such employment opportunities, urbanization pressures will persist in the coming years, especially as youth become increasingly mobile.

**As more and more youth migrate to the capital, pressure will increase on the private sector to create enough productive jobs, and on the public sector to provide quality services.** A good share of the informal sector is found in urban services that lag considerably behind national productivity averages. There is potential, therefore, for shifting labor from lower to higher productivity activities, if the urban environment favors competition, mobility of resources, and ease of investment. International experience shows that the quality of urban environments can amplify or dampen the impact of national policies, particularly with respect to the attractiveness of Paraguay to investors. Likewise, best local efforts can be thwarted by national policies.
Asuncion is currently not equipped to absorb such an inflow of newcomers. There are signs that the gains from agglomeration are not being realized in Paraguay in line with other Latin American countries. The urban population is concentrating primarily in Asuncion and the surrounding areas (2.5 million people), rather than spread throughout several competing urban centers. Deficient public service delivery in transport, health, education, and other basic services is colliding with a more demanding urban middle class. Greater Asuncion is the aggregate of five municipalities, which encumbers coordination in policy and implementation. At the same time, productive activities are dispersed and weakly connected, reducing the benefit of economies of agglomeration.

An opportunity exists to build on the existing network of small secondary cities. Fostering better links between the rural and urban economies and between domestic and external markets is central to reducing rather than exacerbating the gaps in productivity between regions and between population groups. Lagging regions and economically marginalized populations need greater access to productive work. In this context, a key objective is to harness the ongoing structural transformation out of agriculture into more productive work in a way that transforms the nature of jobs toward higher-value activities that are better connected to larger, more competitive domestic and external markets, and at the same time generates positive social spillovers that support inclusive development.

Infrastructure and Connectivity

Large infrastructure gaps remain. The stock of infrastructure in Paraguay lags behind that of countries at the same level of income. The stock of public capital stood at 44 percent of GDP in 2015, while in emerging markets it stood at 79 percent, and in LAC countries at 84. The gap in per capita terms has widened over the last 25 years. Moreover, infrastructure is unevenly distributed: it is stronger in electricity generation and in the services supporting agricultural exports. Recent efforts have aimed to close the infrastructure gaps, reflected in a higher ratio of public investment to GDP. But they have been constrained by limited resources and a focus on physical infrastructure, with less attention to supporting institutional capacity and operational frameworks. Attempts at launching a robust public-private partnership (PPP) agenda faltered.

Paraguay is weakly connected internally and to the rest of the world. In a global ranking of multi-dimensional connectivity, Paraguay ranks at 92 out of 133 countries in the world. The ranking is low for all components of the index; trade (95), FDI (80), migration (86), information and communication technology--ICT (85), airlines (84) and portfolio flows (108.) Paraguay ranks lower than the other countries in the region: Brazil (19), Argentina (37), and Uruguay (71.) Paraguay performs relatively better in the Logistics Performance Index; it ranks 74 out of 160 countries. Brazil ranks 56 and Argentina 61, while Uruguay ranks 85. Paraguay shares with its neighboring countries a relatively weak performance on logistics.
Paraguay relies mostly on land and river travel. The key arteries are 1,265 kilometers of the Paraná-Paraguay rivers waterways and 100,000 kilometers of the road network. The land corridors follow the key contours of the main agriculture areas and the need to connect with the river ports concentrated in the southeastern regions. Challenges are present both in roads and waterways, as well as where they connect. The soft-side of infrastructure also exhibits gaps: For instance, trading across borders is cumbersome.

The potential of the Paraná-Paraguay waterways is not fully realized. The waterways could mobilize more than the 7.5 million tons of cargo mobilized per year. The main constraint to fuller utilization is inadequate draft, which requires planned and frequent dredging at critical points along the river ports. Only around .02 percent of GDP is allocated to the maintenance of the waterways. Ad hoc dredging of the river prevents fleet renewal, and the higher turn-around time for barges increases costs. The impact on the quality of logistics is considerable.

Domestic transport relies on roads. The formal trucking industry serves large corporatized farms; the informal trucking sector serves the small farmers. The formal trucking firms tend to operate on paved national roads and corridors, which are in better condition and benefit from public spending, as investment in roads favors the national road network over investment in secondary and feeder roads, which are often the responsibility of local authorities. The result is that public-sector spending appears to benefit the large formal sector and modern agriculture, increasing the operating cost of informal operators that use poorly-maintained segments of the secondary road network.

The intersection of road and river transport is not smooth. Trade logistics and port development often conflict with city and urban developments; the port city of Asunción faces significant congestion linked to cargo traffic to and from ports. The proliferation of private ports along the river complicates the interface between the city and the port. Poor transport and logistics performance impacts most of Paraguay’s products. Although a dated statistic, excess costs along the ten main corridors were estimated to equal 1.88 percent of GDP (2005.) These excess costs occur throughout the supply chain. Small trucks are particularly affected by delays at ports and limited backhaul opportunities.

Natural Resources and Environment

Paraguay has not yet fully benefited from its abundant electricity resources. Electricity has contributed substantial revenues to the government budget from the two bi-national dams. However, the impact on economic activity has been curtailed because of institutional deficiencies that keep electricity tariffs low at the expense of the quality of the service, limiting the potential positive impact on industry and services. Losses in transmission and distribution are in the order of 31 percent, well above the average for Latin America (about 14 percent), while peak demand is growing at a sustained pace. Abundant and reliable electricity could have a transformative impact
on the economy, including the SME sector. Limited progress in extending the distribution network (or developing local sources of generation) has meant that consumption of wood for energy remains high.

The environment has paid a price from the current economic model, especially with the loss of forest cover. The expansion of the agricultural frontier and the use of wood as an energy source has punished the ecosystems. Of the Atlantic forest, 94 percent has disappeared; now pressure has shifted to the Chaco region, where 240,000 hectares of forest disappear every year. Climate change adds further challenges, with alterations in weather patterns and variability impacting the long-term prospects of agriculture and electricity generation. The technologies used in modern agriculture have yet to reflect best practices in terms of environmental impact.

**Macroeconomic Policy**

Paraguay is now a more resilient economy, but it remains vulnerable to shocks. Paraguay’s growth path has been accompanied by severe volatility driven by natural events and economic shocks. Vulnerability arises mainly from the reliance on a small basket of export goods that are exposed to volatile weather patterns and international prices. These shocks are propagated to the economy and public revenues through several chains. Impact mitigation is weak, as there are limited room for countercyclical fiscal policy and inadequate automatic stabilizers. Poor households and individuals are particularly vulnerable, and suffer the most from the impact of volatility, given their limited asset ownership and low access to temporary financing.

Recent policy efforts in macroeconomic management have yielded considerable progress, but progress on diversifying the economy is slow. Economic performance has begun to delink from Brazil and Argentina, a salient and notable achievement. Thanks to fiscal discipline, public debt is low compared to that of peer countries. Central Bank independence, inflation targeting, and a floating exchange rate are effective policies against external shocks. The rating of public debt is one notch below investment-grade (S&P and Fitch). Bonds have been issued in international capital markets at relatively good terms. These achievements are important foundations on which to build further policy and institutional strengthening, with the goal of a sound macroeconomic management framework.

Progress on insulating households and firms has been uneven. The two main social assistance programs have had a verifiable impact on poverty reduction and decreasing rural incomes. Some gains have been made with regards to financial inclusion, but the poor and those at risk of falling back into poverty remain quite vulnerable to shocks. Moving from social assistance to social protection is key to establish automatic stabilizers against shocks. Moving from indirect taxation to direct taxation is also critical to reduce the propagation of exogenous shocks.
The Role of the State

The state faces new emerging challenges. Past governments have sought to rely on markets and the private sector with minimal intervention. The result has been growth in modern agriculture, but also an uneven playing field, inadequate provision of public goods, and a weak environment for new industries to emerge. Governments have also not acted forcefully to foster the creation of effective markets, which has contributed to a high degree of informality. As the government seeks to close the institutional and policy gaps of the past and is confronted with the new challenges of supporting a more complex economy, it is necessary to rethink the role of the state.

The scope and capacity of the state have an important bearing on long-term growth. The relatively narrow scope for government and state action have contributed to the institutional and policy gaps, market failures, and uneven playing field that hinder long-term growth. Weak capacity is evidenced by the considerable number of initiatives that have been launched over the last several years and remain unimplemented (in transport, environment, forestry, and the business environment).

The scope and the reach of the state is also confronted with limited resources. Taxes stand at around 10 percent of GDP and social contributions at around 1 percent. The contribution of the two bi-national electricity projects fluctuates between 1.2 percent and 2.3 percent of GDP. Tax rates are low on income, business, and VAT, and the tax base is small. Also, rates are not consistent, favoring arbitrage to lower tax obligation. Conversely, social contribution rates are relatively high. Efforts at improving VAT collection by allowing deductions on personal income tax (PIT) obligations weaken the collection and the capacity of the state to enforce the tax law and strengthen the social contract.

Greater mobilization of resources goes hand in hand with parallel efforts to reduce public sector inefficiencies, waste, mismanagement, wrongdoing, and corruption. The belief by the population that the state is not doing enough to address these problems compromises the legitimacy of public institutions and undermines the social contract with the population, particularly the buy-in of the middle class. The relatively small tax base and large informality of the economy, despite low tax rates, is a clear symptom of such perception.

The large public-sector wage bill also constrains the ability to generate fiscal space for priority spending and investment, and the wage premium affects the labor markets. The government provides around one-third of the formal employment in the economy. The public wage bill in Paraguay averaged 8.6 percent of GDP in 2014–2016, exceeding LAC averages. High salaries are the main driver. The premium over the private sector grew from 17 percent in 2006 to 52 percent in 2016, distorting indirectly the labor market, especially formal activities. The premium has been increasing at all levels of skill, but the increase has been particularly steep for the lower skill levels.
This severe distortion in the labor market contributes to informality and inequality and is also a source of political patronage.

Social policy in Paraguay has made a very small contribution to reducing inequality and poverty. Given the size of the social program compared to the number of poor and vulnerable, fiscal policy action reduced inequality by a meager .009 GINI points in 2014. Most of the contribution came from two programs: Tekopora and Adultos mayores. The electricity subsidy also has an impact on the welfare of the poor, but the subsidies are mostly untargeted and therefore socially inefficient.
Towards the goal of a high-income economy with a resilient middle-class

The current prospects in the medium-term are promising for Paraguay. The economy has shown the ability to sustain the annual average growth of 3.7 percent necessary to offer new jobs to about 65,000 Paraguayans entering the labor force every year until 2030. The traditional drivers of economic growth, agriculture and energy, will continue to contribute to growth. The expanding urban centers will continue to expand and with them, economic activity. The forthcoming renegotiation of the bi-national energy generation agreements can increase revenue flows to the country considerably.

Given these prospects, the risk today is complacency with the current status quo. The current socio-economic and environmental challenges, if unattended, could also become threats to growth and social cohesion. The negative impact on the environment is likely to increase; the diminishing returns of land yields could accelerate; traditional agriculture may grow further isolated; and urban centers may expand in a disorderly fashion dominated by informality and congestion, negating the potential benefits of agglomeration. Weak connectivity, internal and external, can continue to limit the relevant scope of the market for economic activity. Regional disparities within the country may widen. Deficiencies in skills and education could become more notable. The trade-offs between service delivery and fiscal balance might sharpen. Finally, there are the traditional risks that have affected past growth and generated inordinate volatility: price of commodities, weather patterns, and fluctuations in the regional markets.

Moreover, the current prospects will likely fall short of reaching high-income status quickly and of the aspirations of a growing middle class. With a per capita income of US$5700, Paraguay will have to more than double its income per capita to reach high-income status. Doing so in less than a generation will require sustaining a growth rate above three percent each year, which will require clarity of purpose in the society and the state The experience of successful countries show that such long and sustained growth can only be achieved with structural transformation, supported by building strong and effective institutions that get markets to work, while addressing the challenges of uncertainty, coordination, and how to foster innovation. The capacity to produce more complex goods and services will have to increase, as will the skills and capacity of the population to produce them. Matching and continuous upgrading of skills and jobs are critical to making the transition to high-income status. Because the task is difficult, some have referred to the “middle-income trap,” reflecting the high risk of derailment.

There is an opportunity today to think about equity, growth, and development, setting in place a strategy to exploit emerging opportunities and tackle current challenges. The government has the opportunity over the next four years to set in motion a long-term strategy toward a broader and more equitable and sustainable growth, laying the foundation on which future administrations could build, fostering prosperity, and expanding economic opportunities for Paraguayan people.
In this context, the Commission presents in this report seven priority areas with associated policy and institutional actions that are critical to support Paraguay to successfully complete the socio-economic transformation in a generation. The seven priorities presented above are consistent with the lessons learned by the experience of countries that have succeeded in avoiding the middle-income trap and breaking into the high-income club. Delaying such a process runs the risk of going backwards. Other economies before Paraguay have been trapped in middle-income status, witnessing the slow and imperceptible decline of their economic models.

The Commission underscores that these seven priority areas should not be perceived as separate self-standing initiatives, but as parallel coordinated actions that work coherently together. To this end, the report places an emphasis on the four overarching goals and guiding principles that should direct the design and implementation of actions under the seven priority areas and permeate the mindset of policy making more generally. These overarching goals are (i) an outward-facing mindset and a commitment to strong interconnectivity with the rest of the world; (ii) a focus on inclusion and resilience; (iii) strong institutional integrity and public sector culture; (iii) an open and pragmatic implementation. The Korean experience provides an example of how these overarching goals can guide the design and implementation of a coherent development strategy (see box below).

Lessons from the Korean experience

The Korean experience provides an example of how the design and implementation of policy actions can be guided by these overarching goals and principles, creating a virtuous and mutually reinforcing nexus. In education, for instance, the country has overcome the seemingly insurmountable challenges typical of developing countries with insufficient public resources for education, a lack of appropriate educational infrastructure, a shortage of qualified teachers, and regional/gender disparities in education opportunities. Yet its public expenditure on education averaged only 3.4 percent of GDP between 1965 and 2005.

In this regard, Korea adopted a step-by-step approach to education investment, closely linked to the objectives of an outward-oriented strategy, inclusion and equal opportunities, and public sector culture while maintaining a pragmatic and flexible implementation to meet the changing environment:

When Korea started to pursue export-oriented industrialization strategies in the 1960s, Korean education policy shifted the focus from a vocational and technical education system at the secondary level to supplying enough semi-skilled workers to meet the increasing labor demand from export sectors in a timely manner. When the industrial policy focus shifted from capital-intensive heavy and chemical industry promotion toward innovation-driven growth in the 1980–90s, education investments shifted accordingly from secondary education to higher education, especially in science and technology.

At the same time, the Korean government adopted several legal provisions to maintain talented people in teaching professions in the public schools, effectively handling the shortage of qualified teachers, reducing regional disparities in education access, and addressing chronically overcrowded classrooms.
The cornerstone of this strategy was the Public Educational Official Act in 1953, which gave teachers at all education levels the status of public officials of the central government. This enabled the profession to thrive with skilled employees, competitive salaries, and job security, but also by providing good teachers with incentives to go to remote and disadvantaged areas, which improved equality of access to education across regions.

The Korean experience is one of many from which Paraguay could learn. Being a latecomer in joining the middle-income club provides some challenges but also a wealth of knowledge and lessons from good or bad experiences. The rest of the report, after a brief diagnostic, provides more details on the actions under each of the seven priority areas.

1. Education and Skills

Quality education and skill formation is the foundation of broad-based growth. The challenge is to deliver a foundational education platform which allows students to add the new skills needed to contribute to and benefit from the economy. Education reforms toward modern education systems have led economic and social transformations in many countries (e.g., Ireland, Poland, Finland, Korea) but implementation required sustained efforts over time and a high degree of social consensus. Consultations among key stakeholders are important during strategy development, as a certain degree of consensus is necessary to reduce the risk of reversals. Parenting also plays a critical role in complementing and reinforcing education systems by providing values, discipline and motivation.

To this end, a substantial transformation of the education system and skill development in Paraguay is needed at all levels. Resources allocated to education have increased. The challenge today in Paraguay is less about the availability of resources and more about improving the quality of education, which is a mounting concern, as Paraguay ranks well below its peers in many indicators. The pressure on quality is likely to continue over the long haul. With an expanding student population in the higher grades and an increase in access in the lower grades, the pressure on the existing infrastructure, teachers, and overall institutional capacity will continue. The challenge can only be addressed in a comprehensive manner, using resource allocation to address gaps, efficiency, and effectiveness of public action spending.

➢ Implementing a comprehensive education strategy with a focus on skills development. The strategy should address the remaining gaps in terms of coverage, particularly regarding secondary and tertiary education; disparities in access, particularly for students living in rural areas and the poor; and the overall quality of the education system. Efforts should be made in public and private education, and both should be subject to scrutiny and standards. The
transition from school to work requires special attention. Skill development should be the focus when designing the reforms, as skills conversion or improvement is needed to seize opportunities in an innovative and fast-changing world. In this context, attention should not only be on high schools and universities, but also vocational and trade schools and workforce training centers.

➢ **Developing a culture of measuring outcomes and a focus on efficiency.** Continuous educational upgrading of cohorts is needed to facilitate the transformation of the economy. Tracking outcomes and progress is critical to facilitate fine-tuning, as implementation of the strategy unfolds. Some critical variables must increase continuously: average number of years of schooling, quality indicators, access to early education, and the adequacy of technical education. Together with the aim of increasing student learning outcomes, a goal to improve the quality of educational inputs is needed, including efficiency-enhancing efforts on school infrastructure, teachers’ training, and school administration. Also, it is necessary to finalize the design and rollout the implementation of the Teacher’s Professional Career.

➢ **Revising the current criteria for resource allocation and focusing on the school as the unit of local delivery.** It is critical to revise the existing allocation formulas of public resources available for education, including the (FONACIDE) fund, to reduce the inefficiency and inequality in the allocation of resources. These efforts should be accompanied by a parallel revision of the roles and responsibilities of the various levels of government with regards to education. There are multiple examples in Latin America (Puebla in Mexico; Sobral and Ceara in Brazil) where major gains have been made at the city and school level. The focus on the school as the basic unit of delivery is of paramount importance, and gains in poor neighborhoods with limited resources are definitely possible. The focus should be on helping the laggards move back to the fold.

2. **Business Climate**

**Misallocation of resources, especially in favor of the non-tradable sectors, has been a major stumbling block for the transformation of Latin America.** Both the public and the private sectors contribute to the misallocation of resources; private economic agents allocate resources and make investments according to market signals, which may be distorted by public policy (or lack of it) and its implementation; and the allocation of public investment may suffer from a lack of clear prioritization and may respond to non-economic interests. The market power of enterprises and economic groups does also contribute to the misallocation of resources, especially when such power is obtained through political influence or privilege.

**Improving the investment climate and the rule of law in Paraguay are key to providing the right incentives for private business, in terms of investment, innovation, and expansion, particularly in**
the tradable sector. Improvements in the quality of the supporting environment, economic governance, legal framework, and uniformity in the application of the law are all critical to the rise of quality jobs and business opportunities. The state can and should play a key role to ensure that rules are fair and evenly applied and that distortions to competition (market power) are forcefully addressed. Such rules are essential to the allocation of investment resources, including FDI, which can bring a host of technologies, administrative capacity, financing, access to markets and, perhaps most important, employment. However, FDI injected into highly distorted environments can have very deleterious consequences. When FDI fits the needs and opportunities of the host country well, it can be a major contributor to economic growth and development, such as in East Asia and Eastern Europe.

➢ Implementing a strategy to improve the overall business climate and to level the playing field across and within sectors. The strategy should comprehensively address factors that contribute to the uneven playing field, including: business regulation, ineffective judiciary, and payment practices, as well as access to technology, skills, and finance. It is critical to enact the draft laws on business registration, movable property, and insolvency. Further, legislation should be drafted on contract enforcement and investor protection. It is necessary to pay attention to the development of appropriate financial services for the expansion of enterprises and production financing and to address companies’ capacity deficiencies. These initiatives will support the development and formalization of the SME sector and encourage FDI.

➢ Implementing a holistic approach to FDI. An assessment of the performance of the current policy framework in terms of fiscal costs and economic and social benefits, including tax incentives, maquila regime, and location privileges, should be the starting point to develop a more comprehensive framework to actively attract FDI that fits the country’s needs. The international experience of special economic zones and tax incentives shows that these measures work only in particular circumstances and must be complemented by appropriate supporting environments for attracting and retaining foreign capital. Enhancing education, connectivity, and the business environment can further increase the country’s relative attractiveness for FDI that works and has a good fit with the domestic economy. In seeking to mobilize FDI, care should be taken not to jeopardize domestic enterprises and entrepreneurship.

➢ Implementing a comprehensive framework to support strong and formal SMEs. Effectively implementing reforms requires complementing current initiatives with new, modern laws on specific programs (or sets of programs) tailored to SMEs and oriented at reducing barriers to entry, enhancing enterprise capabilities, and facilitating the adoption of technology. Legal powers and technical know-how should be given to government agencies to enforce competition and reduce barriers to entry. Fostering links between SMEs and larger and more complex value chains and improving access to technology and finance are also key to fostering a large formal and innovative SME sector in tradable activities.
3. Connectivity

**Economic transformation is closely linked to connectivity within a country and between that country and the rest of the world.** Connectivity goes beyond transport and logistics to include soft aspects of trade inside and outside a country, as well as flows of services, ideas, investments, and people. Barriers to connectivity impose heavy costs on development as they affect the allocation of resources and reduce the effectiveness of investments.

A strategic vision of how Paraguay fits within the region is essential to improve its competitiveness and resource allocation, given its strategic location and that it is land-locked. It is important that this vision is consistent with broadening the scope of economic opportunities. For instance, its location within the Southern Cone provides the opportunity to benefit from trade across countries. Additionally, waterways connectivity can contribute to Paraguay’s role as a transport hub.

Improving connectivity in Paraguay will require tackling many areas of both soft and hard infrastructure. Attention to connectivity must go beyond physical infrastructure to focus on improving the institutions that support trade in goods and services and the flow of ideas and people. Connectivity strategy should not only be designed with the agriculture sector in mind, but also new industries and services. Infrastructure in energy, telecommunications, and ICT are as important as roads. Strengthening capacity is also essential for success, as shown by the challenges and limited progress made so far in the implementation of a National Transport Strategy.

- **Updating the National Logistics Strategy.** The vision of a well-connected Paraguay in the region and the world can be achieved through a strategy that relies on multi-modal transport systems over the long term. The strategy should not only look at the main road network but also at upgrading and maintaining secondary roads to deliver transport options for all, including groups other than the main exporters. Improving the management of waterways will address the challenges of dredging and ports, where a lack of integrated policy has generated disorderly growth, with private producers often making their own investments to compensate for public infrastructure deficiencies. Given the large and affordable supply of electricity, a rail system would improve competitiveness of traditional exports and exploit new opportunities.

- **Improving business regulations on cross-border transactions.** The success of Paraguay’s insertion into global trade depends not only on the quality of its transportation network but also on “soft” aspects. These aspects include implementing a trade facilitation plan in line with the World Trade Organization (WTO) Trade Facilitation Agreement, and with the findings in the “Trading Across Borders” component of Doing Business. Improving the efficiency and effectiveness of customs administration is a crucial element to improve competitiveness,
reduce cost and red tape, avoid contraband, and increase tax collection. A few key actions include the implementation of a “Ventanilla Unica de Comercio Exterior,” the use of modern risk assessment techniques for inspection, and the application of automation and coordination to reduce the time required for each process.

- **Implementing a sound PPP framework.** Given limited fiscal resources, PPP can play a key role in infrastructure. However, a sound institutional framework is key to assure sustainability of investment and to reduce potential contingent liabilities. Paraguay can learn from the experiences in the region to avoid costly mistakes. Strengthening institutional capacity to create a dedicated multi-disciplinary team with the necessary resources and technical autonomy is an essential step in increasing the standardization of bidding processes and documents and in reducing discretion. It also important to structure an outreach strategy to bring in local private sector investors and domestic banks and pension fund institutions to support project financing and to develop financial instruments to catalyze private finance. A PPP approach should be tightly integrated with moving toward concessions.

4. **Urbanization**

Successful urbanization is a balancing act between the positive and negative externalities of agglomeration. On the one hand, urban centers are key drivers of change and transformation and generators of jobs opportunities. With the emergence of new technologies in communication and artificial intelligence, there is mounting interest and substantial work on the development of smart cities as environments that contribute to economic activity and improve the quality of life. But, the benefits of urbanization and the economies of agglomeration cannot be achieved without measures to combat negative externalities (such as congestion, criminality, low quality of service, informality) that limit the potential of a coherent vibrant economic space.

**Undertaking actions to enhance the attractiveness of the urban environments should be an urgent priority for Paraguay.** While urban centers are emerging as key economic drivers, informality is high, good jobs are scarce, and services deficient. Moreover, harvesting the potential of urbanization is more difficult when the population concentrates in one single urban center that is fractured administratively, such as Asuncion. Secondary cities in Paraguay could play an important role in attracting migratory flows and preventing overflow in and around Asuncion. A successful urbanization in the current institutional context would require a high degree of coordination between central and local authorities, a clear division of responsibilities, and access to finance, with rules on local taxation and transfers.
Implementing comprehensive urban development policy and planning. The first step of implementing a successful urban development strategy is to contain the negative externalities of agglomeration by improving the quality of urban services and infrastructure. Transport, water, and sanitation are deficient and deserve immediate attention. Furthermore, it is essential to address the flooding of the Paraguay River in Asuncion, which exacerbates health issues and pollution due to wastewater mixing with flood water. Electrification and ICT connectivity are also vital to support economic activity and improve the standard of living. Citizen security and the reduction of crime in urban centers is critical in this regard.

Developing a culture of monitoring and the use of modern technologies. The capacity and integrity of the local authorities and their working relationship with the central government are central to fostering an environment that is conducive to urban development in a sustainable manner. Extensive work is underway in other countries to address traditional critical urban challenges, including using emerging modern technologies. It is paramount for Paraguay to learn from these experiences and to provide local governments with modern technologies with the goal of improving urban governance, facilitating business, reducing crime and other externalities, and engaging the population directly.

5. Natural Resources Management

Implementing a strategy for the sustainable management of natural resources is essential to address an evident market failure that is detrimental to long-term growth. Paraguay’s natural resources are threatened by land degradation and forest loss due to the expansion of the agricultural frontier and the use of wood for fuel. Climate change further adds to the magnitude of the challenge. In this context, a multi-pronged agriculture strategy to intensify the knowledge content and sophistication of traditional primary exports, and to increasingly specialize in high-end market segments and products (such as non-GMO soy or sustainable beef), can boost profits, given the premium that global consumers are willing to pay for high-quality organic products that have been produced in sustainable manner. Attention should also be paid on the integration of traditional agriculture, where poverty pervades, and on ensuring an adequate net social contribution of the sector in terms of tax revenue, given its environmental impact and the investment in transport required. There is an urgent need to work on the environmental sustainability challenges of land degradation and forest loss, as well as on mitigating the impact of weather-related shocks such as floods and droughts.

At the same time, a major rethinking of the current approach on electricity is needed for the economy to benefit more from the massive investment in hydropower plants. Low electricity tariffs translated state-of-the-art electricity production into low quality of service, with electricity loss and interruptions, because of obsolete transmission and distribution networks. This impacted negatively the competitive position of the country. Reaping the benefits of clean, affordable, and
reliable energy should be a centerpiece of the strategy toward a more broad-based economic model and an important goal of the new Itaipu bilateral treaty.

**Agriculture**

- **Increasing the domestic value-added and integrating traditional agriculture to create more opportunities.** On soy, value can be increased by moving to a more integrated value chain and shifting to more natural resource-friendly practices. Precision technologies can help reduce the need for agrochemicals while increasing productivity and competitiveness. For beef, the opportunity also exists in accessing higher-value markets by “greening” the value chain and implementing a branding strategy. It is also important to foster the conditions for more equitable participation of small farmers in agricultural markets, targeting untapped opportunities to increase productivity and connect to markets. Moving in the direction of increasing local participation in value chains requires strong institutions that oversee compliance with international standards across the board—labs, quality control, and auditing. Innovation activities can be better integrated at the national and local levels through the work of SIGEST (Sistema Integrado de Gestión para el Desarrollo Agropecuario y Rural), which will help develop and implement technological packages as well as relevant extension of services. Finally, the atomization of small farms should be addressed by facilitating the emergence of associations and connecting them with middle and large farmers and agroindustry.

- **Establishing a single agency regarding land cadaster, registry, and title, and strengthening the capacity of environmental regulators.** The harmonization of cadaster and registry should be a priority. In the short term, it is important to develop a reliable and authoritative rural cadaster to address concerns about land property and governance. At the same time, land titling should be regularized by strengthening the agrarian registry SIRT (Sistema de Información de Recursos de la Tierra), which combines geo-referenced parcel information and socio-economic data. It is also important to strengthen the environmental ministry, MADES (Ministerio del Medio Ambiente), and the forestry institute, INFONA (Instituto Nacional Forestal), by defining a credible financing strategy for the implementation of the National Reforestation Program and reviving the use of Certificates of Environmental Services, which are based on the preparation of land use plans with tightened criteria and capacity to ensure environmental integrity.

- **Reviewing the overall taxation on the agricultural sector with the view of reducing distortion, improving equity, and generating resources.** Consistency in agricultural taxation should ensure a positive contribution from the sector to the budget while maintaining consistency in the structure of incentives. In this context, it may be useful to consider the integration of the income tax on commercial and industrial activities and services (IRACIS) and the income tax on agricultural activities (IRAGRO). Moreover, progress towards land registration would lay the foundation for a strong source of public revenues for the country through land taxation, which is less distortionary than other taxes, such as export taxes. It is also important to remove any
pervasive incentives of taxes that discriminate between products with different value-added, such as oil and raw products, and develop and implement a law on transfer pricing.

**Energy/Electricity**

- **Implementing a comprehensive regulatory reform of the electricity sector.** A comprehensive reform is necessary in the sector to address institutional deficiencies that have prevented progress on electricity transmission and distribution, right-pricing, and the quality of service. These limitations have affected development and competitiveness. It is imperative to separate regulation from operation and policy by creating an independent regulatory agency for electricity and allocating policy responsibility to the executive. The separation of roles would help reduce directionality in decision making, achieve a clearer institutional framework, allow for greater predictability and efficiency in operations, and ensure the adequate supply of energy in the long term. A regulatory authority of the sector would also help guarantee quality of service and ensure adequate attention to consumers’ concerns.

- **Overhauling the operational model of ANDE, while protecting the poor and vulnerable from tariff increase.** Changing the operational model and governance structure of the main public electricity company (ANDE) is also paramount. Building on the Código Arandú, which addressed the management of public enterprises, it is important to shift emphasis from control by processes and budget to a framework that provides greater autonomy for ANDE to manage its resources. Accompanying this autonomy must be strengthened accountability through objectives, results, and auditing, with the end goal of improved quality of service and expanded coverage. The pricing structure should also be updated regularly to allow full recovery of operations costs and investments in service improvements. Protecting the poor can best be achieved through social assistance, but, in the meantime, well-targeted progressive social tariffs can be considered as a transitory measure. Such measures should be applied in a transparent and efficient manner to clearly identify the cost subsidies.

- **Preparing for the renegotiation of the bi-national treaties.** The renegotiation of the Itaipú treaty is an opportunity not only to maximize royalties and compensation for electricity exports that currently reach 10 percent of public revenues, but also to redefine the role and responsibility of the energy sector in the economy. This should include a review of the current mechanisms for the use of royalties and compensation for electricity exports, taking into account development needs and capacity across departments. Above all, the renegotiation should keep in mind the opportunity costs of exporting electricity vis-a-vis the potential benefit of clean, affordable, and reliable energy in a more broad-based economic model.
6. Macroeconomic Resilience

A comprehensive risk management approach is essential in economies with highly volatile macroeconomic environments and a concentrated productive structure. Shocks, regardless of the source, can take the country off the growth path, especially when rigidities in the policy framework hinder rapid and appropriate responses. Macroeconomic management is a critical de-risking instrument to help the economy absorb shocks, rather than magnify their effects. Adequate management also contributes to the external evaluations that affect credit ratings and thus access to external resources, which in turn can be a complementary de-risking instrument. Efforts at building buffers and contingent instruments at the macro level need to be complemented with instruments at the household and the enterprise levels, all of which requires an adequately functioning financial system. In parallel, long-term efforts at building a resilient, diversified, and well-connected economy are needed to reduce vulnerabilities from the global economy and climate-related shocks.

There is an opportunity to build on recent achievements in macroeconomic policy and consolidate the gains that have been made by further strengthening macroeconomic resilience in Paraguay. The high awareness of natural and economic risks in Paraguay has led to considerable improvement in the macroeconomic framework as a response, which is reflected in international rankings of competitiveness. For instance, according to the 2017 World Competitiveness Report, Paraguay ranks 42 in the world with respect to macroeconomic management. Paraguay is now among the most resilient countries in emerging markets. Notable recent innovations have been the introduction of inflation targeting and the Fiscal Responsibility Law. However, some challenges in terms of vulnerability and the potential impact of exogenous shocks remain.

➢ Strengthening the capacity for countercyclical action by revising the current fiscal rules to build in automatic stabilizers and more effective social protection. Efforts towards greater countercyclical capacity are important given the concentrated productive structure. This requires efforts on several fronts, including the institutionalization of a more countercyclical fiscal rule, containment of rigid current expenditures, and the introduction of a stabilization fund that would not only increase fiscal space for investments but also generate fiscal savings that can be available when shocks materialize. The fund can be financed with the savings implicit in the fiscal rule and from increased royalties after the renegotiation of the treaties in 2023. At the same time, greater reliance on rigid expenditures would help reduce the transmission of shocks and mitigate their impact.

➢ Moving from the current system of social assistance toward social protection that is tailored to fluctuations in economic performance. This should be a priority, as part of an effort to rationalize and reduce fragmentation of the current system, which also relies on inefficient in-kind programs and cross-subsidization of the health program of the social security agency IPS (Instituto de Previsión Social) from its pension program. The fiscal sustainability of IPS health
as well as “cajas fiscales” need attention by developing options on pension reform to reduce fiscal risks and increase domestic savings. Finally, as higher public confidence in sound macroeconomics is achieved, the government should adopt a more intensive and proactive use of asymmetric reserve requirements and develop and deepen domestic financial markets to reduce dollarization.

➢ **Enhancing the buoyancy of the tax system with an emphasis on equity and efficiency.** The buoyancy of the tax system would benefit from targeted fine-tuning, such as the elimination of loopholes, ineffective incentives, and inconsistencies that provide opportunities for arbitrage. In parallel, it is key to increase the income tax contribution by raising the minimum PIT rate, strengthening VAT enforcement, and reducing PIT deductions from VAT. At the corporate level, reducing arbitrage among IRACIS and IRAGRO, the corporate income tax (CIT), the Free Economic Zone (FEZ), and Maquila.

➢ **Implementing a property tax with a differentiated land tax to help generate a more reliable source of public revenues for agriculture.** A property tax of this nature is less distortionary than other taxes, such as export taxes. It will also help with the challenge of unused and unproductive properties. In parallel, progress in tax administration advances such as the full implementation of electronic receipts for VAT and the use of new data management tools to enhance cross-checking can help with tax compliance and informality. It is important to accompany any efforts to increase revenue mobilization with improvements in the quality of allocation of public funds and the efficiency of public expenditure to strengthen the social contract.

➢ **Implementing integrated agriculture risk management.** To mitigate risks in the sector, it is important to operationalize the recently-created Agricultural Commodity Exchange to provide access to price-risk management instruments (such as forward contracts), and more important, to allow for price formation of locally-produced agriculture products by tracking and publishing volumes and prices sold. In this context, it is urgent to reform the Law on Financial Products to fully take advantage of such a mechanism. To cope with risks, it is important to strengthen risk transfer by a broad adoption of sophisticated risk financing instruments, such as weather derivatives, that reduce the impact of extreme adverse shocks when they materialize.

7. **State Capacity and Accountability**

Successful countries that escaped the middle-income trap share common institutional features, regardless of the size and role of their states. The role of the state among countries that have achieved high-income status appears to range substantially, from laissez-faire (for example Chile)
to interventionist (East Asia.). But, successful countries share common institutional characteristics, such as adopting clear and transparent procedures on policy making and the ability to address crises and correct course as needed. Their effectiveness has been grounded on a certain degree of consensus on fundamentals, which has protected policy agendas from the political cycle and facilitated progress in areas such as service delivery. They have been keen on maintaining integrity and good governance, with a simple and well-articulated functional structure of government supported by a committed and professional civil service. These countries have developed the capacity to create and sustain contestable markets, engaging economic actors in delivering solutions to national needs. The active approach of East Asian countries has been accompanied by time-bound commitments that have prevented a massive emergence of soft-budget constraints. Overall, there is a keen prioritization on developing state capabilities.

**Strengthening integrity, good governance, and capacity in Paraguay are critical to contribute to social cohesion and tackle growing complexity of the development process.** The institutional weakness of the state apparatus has in turn created a social environment where High levels of perceived corruption, wrongdoing and mismanagement continue to permeate public affairs, compromising the legitimacy of public institutions and undermining the social contract between the state and the citizens. Paraguay ranks 132 out of 180 countries on the 2018 Corruption Perception Index. Both the Global Competitiveness Index and the World Bank Enterprise Survey report corruption as most problematic factor for doing business in Paraguay. In this context, strong attention should be paid to: integrity and transparency, the capacity to promptly and effectively address challenges and policy trade-offs, the capacity to implement efficient processes for policy formulation, an emphasis on public service delivery, and a disciplined approach to the management of difficult budget constraints.

- **Enhancing integrity and accountability by strengthening anticorruption policies to tackle all instances of mismanagement and corruption.** Reducing regulatory and implementation gaps to strengthen the quality of institutions, the rule of law, property rights, the justice system, and the culture of the public sector, are the condition sine qua non for a well-functioning, competitive, and innovative market economy and for social cohesion. The state must lead by example by tackling all instances of mismanagement, wrongdoing and corruption at all levels. A substantive reform of the civil service and justice system should be prepared with care, with special effort to avoid state capture by private interests. Clear rules and fair enforcement accompanied by adequate financial and human resources are essential for the justice system to regulate business, handle disputes, and curb corruption and crime. Several policies that deal with transparency should be in place for accountability and citizen engagement, including providing access to information, open data programs, financial disclosure, and open contracting.

- **Strengthening the capacity to design, implement and monitoring public policies.** Established transparent procedures, supported by appropriate tools and highly qualified technical teams,
should guide policy making. The ability to track policy implementation and the ability to promptly and effectively remove constraints is essential, which can be done by developing a culture of assessing the impact of public policy. To do this and avoid waste of valuable and scarce public resources, a well-developed and transparent system for assessing public expenditure would help the government identify projects that have the highest social and economic impact; prioritize among them; provide detail on their expected costs and guide the execution. Building a professional civil service and undertaking strategic consolidation across state agencies and different levels of government is also crucial.

➢ Establishing a permanent independent Growth Council to raise public awareness on policy formulation and a Delivery Unit within the President’s office to prioritize and oversee the implementation of the policies and actions in support of the strategy. A permanent independent Growth Council could contribute to public debate and contestability for the design and adoption of major reforms and the identification of lessons learned from experience. A Delivery Unit within the President’s office could play a leading role in monitoring, supporting and accelerating implementation by focusing on the most critical actions, their associated costs, and the coordination of different players both within the public and private sector.
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