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**PROGRAM INFORMATION DOCUMENT (PID)**
**APPRAISAL STAGE**

October 28, 2016
Report No.: 110042

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| **Operation Name** | Strengthening Growth and Fiscal Policy Development Policy Operation |
| **Region** | AFRICA |
| **Country** | São Tomé and Príncipe |
| **Sector** | General energy sector (10%); Banking (20%); Central government administration (60%); Other domestic and international trade (10%) |
| **Operation ID** | P159010 |
| **Lending Instrument** | Development Policy Financing |
| **Borrower(s)** | Democratic Republic of São Tomé and Príncipe |
| **Implementing Agency** | Ministry of Finance, Trade and Blue Economy |
| **Date PID Prepared** | October 7, 2016 |
| **Estimated Date of Appraisal** | October 24, 2016 |
| **Estimated Date of Board Approval** | November 30, 2016 |
| **Corporate Review Decision** | Following the corporate review, the decision was taken to proceed with the preparation of the operation. |

## I. Country and Sector Background

**STP is a democratic, low-middle-income country with a high poverty rate.** STP is a multiparty democracy and unitary state with a population of nearly 200,000 people. It is divided into six districts plus the Autonomous Region of Príncipe (*Região Autónoma do Príncipe*). Gross national income per capita is estimated at US$3,160 in purchasing power parity (PPP) terms; gross domestic product (GDP) per capita is US$1,811. Around one-third of the population lives on less than US$1.9 PPP per day, and more than two-thirds of the population is poor, using a poverty line of US$3.1 PPP per day. Poverty is widespread in the country, but some districts such as Caué and Lembá have higher poverty incidence. Poverty is more of an urban phenomenon since many families migrated to the cities after independence and nationalization of the agricultural enterprises (*roças*). Unemployment was at 13.6 percent in 2012, last data available. Two sectors—agricultural and retail—provide for 50 percent of all jobs in the country.

**GDP growth has been stable, but it is heavily reliant on government spending and imports.** STP has grown at an average rate of 4.4 percent from 2009 to 2014.[1] Growth is driven largely by government spending, agriculture, and tourism. Agriculture is the traditional and long-standing economic activity in the country. While it has been explored on a commercial basis since colonial times, production has declined since independence and agriculture has not been a growth driver in STP, even though agricultural products, especially cocoa, constitute the bulk of

[1] The analysis contained in this Program Document is based on STP's current national account data. The National Statistics Office is currently rebasing and revising the data sources, which will likely change the figures reported here. However, early indications show that the main stylized facts presented here will not be affected.

STP's exports. Tourism is a natural comparative advantage and is already an important economic activity, but STP is far from the characterization of a tourism-dependent economy. Oil exploration has taken place since 2013, but commercial activity is not expected before 2020. Few goods are produced locally, leaving STP very dependent on imports, including the oil needed to generate power.

**Moreover, growth is vulnerable to several risk factors.** Apart from the inherent fragility that results from its small size, a number of risk factors create additional vulnerabilities. These include high risk of debt distress, recurrent fiscal deficits, low domestic resource mobilization, high current account deficits, banking sector problems, fiscal risks from state-owned enterprises (SOEs), inadequate public investment practices, costly and unreliable energy supply, and an inadequate framework for credit

**Progress on poverty reduction has been limited and poverty remains widespread in STP.** Growth has not been pro-poor because the most vulnerable population lacks the skills to access economic opportunities. Social protection (SP) policies have not been able to alleviate poverty and provide a path for the vulnerable population to grow out of poverty. Current programs are fragmented and underfunded and suffer from design and control issues. In this current scenario, it is unlikely that acceleration in growth will bring a significant reduction in poverty and boost shared prosperity.

## II. Operation Objectives

**The objective of this operation is to help the Government introduce growth-enabling reforms in the financial sector, business environment, and infrastructure; generate fiscal resources and savings; and improve quality of expenditures.** It is structured in two pillars. The first one supports policies aimed at reducing obstacles to growth, while the second puts together measures to generate fiscal space and increase quality of expenditures. Both pillars are also divided into two components. Despite the organization of the operation in pillars and components around specific sectors and themes, it is of a multisectoral nature and there are synergies between policy actions and triggers across the two pillars. For example, the support to reform on the property and mortgage registry will also benefit tax collection and the effort to improve loan collateral. Another example is the complementarity between financial inclusion and SP measures. Agent banking and mobile finance will allow more people to access the financial system, which in turn will make room for SP payments to be made through the banking system, allowing for better control and auditing of payments and beneficiaries.

### Pillar A: Introduce growth-enabling reforms in the financial sector, business environment, and infrastructure

**The first pillar of this operation supports policy reforms aimed to introduce growth-enabling reforms.** These reforms aim to address obstacles to growth such as inadequate banking sector supervision, poor framework for the credit market, and costly and unreliable energy supply. Since this operation cannot support all growth-enabling reforms, it has opted to focus on the ones that are most critical, fall within the World Bank expertise in STP, have a time line compatible with the series, and are supported by analytical work. All financial sector reforms are being supported in coordination with the IMF.

**Prior action 1:** The Recipient, through its National Assembly, has approved a banking resolution law (Medidas Especiais de Saneamento, Resolução e Liquidação de Instituções Bancárias) that provides the Central Bank with the power and authority necessary to deal effectively with distressed financial institutions by facilitating early intervention and providing additional policy instruments to address vulnerabilities.

**Prior action 2:** The Recipient, through its Central Bank, has created, operationalized and staffed a new directorate (Direcção de Sistemas de Pagamentos) to consolidate in the same unit all responsibilities related to oversight, policy formulation and development of the national payment system.

**Prior action 3:** The Recipient, through its Council of Ministers (Conselho de Ministros), has reduced legal fees (i.e. taxes and registry fees) associated with the registry of mortgages.

**Prior action 4:** The Recipient, through EMAE, has introduced a revised system of pre-paid energy services that will allow for accurate consumption metering and invoicing, as well as eliminating the risk of non-payment.

**Prior action 5:** The Recipient, through AGER, has mandated EMAE to: (i) establish a comprehensive customer complaint redress system, for the mediation of conflicts between citizens and EMAE, as well as representing the interests of the public, receiving feedback, complaints, information requests and suggestions for improvement of service; and (ii) send to AGER monthly reports of complaints received from customers.

**Pillar B: Generate fiscal resources and savings and improve the quality of public expenditure**

**The second pillar groups all policies aimed at generating fiscal resources and savings and improving the quality of public expenditure.** STP has a fragile fiscal position, evidenced by historical unbalanced budgets and a long-standing high risk of debt distress. Several factors are at the root of it: poor debt management practices, low domestic revenue mobilization, and inadequate surveillance of SOEs. The low level of revenues collected imposes a limit on expenditures financed by own sources, leaving large parts of the budget to be funded externally and thus subject to more volatility. One example is the SP policy. Not only does it suffer from lack of funding, but the resources spent on the past programs were not directed to the most vulnerable. In addition, poor Public Investment Management (PIM) practices have prevented the country from taking full advantage of the growth leveraging ability of capital expenditures. Short-term fiscal challenges are being addressed by the IMF program, while the DPO focus more on structural measures.

**Prior action 6:** The Recipient, through its Council of Ministries, has simplified the tax structure and updated the threshold values of tax brackets for presumptive income taxation.

## III. Rationale for Bank Involvement

**The proposed operation is aligned with the Government's program and objectives.** The operation supports mainly the first axis of the Government's strategy – economic growth and employment generation; however some support to the second axis – social cohesion and external credibility – is given though the support to the social protection policy. The growth enabling reforms supported by the DPO (Pillar 1) are foreseen in the first and third chapters of the first axis in the Government strategy. The Government document also dedicates a full chapter (chapter 2 of the first axis) to public finance, which is supported by the second pillar of the DPO. For example, the support to the single registry aligns with the listed Government action to continue the implementation of assistance and protection policies to extreme poor and vulnerable population. Another example is the support to the regulatory agency in implementing the provisions of the energy sector regulation, which is the first measure listed in the Government strategy for the energy sector. Finally, both the DPO series and the Government strategy have the ultimate objective of reducing poverty and promoting shared prosperity, which is reflected for instance in the policy actions supporting the new social protection policy.

**On balance, the macroeconomic framework in STP is adequate for development policy operations.** The macroeconomic policy framework is consistent with price stability due to the credible exchange rate peg in place for more than five years. The BCSTP has been undertaking efforts to improve monetary policy tools, support solid credit growth and reinforce its commitment to price stability. Fiscal policy has been the main fragility of the macroeconomic framework, with persistent budget deficits. This is being addressed by the Government under the ECF through limits to current expenditures, improved domestic revenue mobilization and settling of government arrears. External imbalances are more of a structural nature given STP's insularity and lack of established comparative advantage. Nonetheless, the Government has been taking measures to secure Balance of Payments financing in the short term through grants and concessional loans and supporting economic activities such as agriculture and tourism that can increase export earnings. The overall macroeconomic outlook is positive, but risks related to the country's small size, openness and limited engines of growth remain. Given this characterization, the macroeconomic policy in STP is deemed adequate**.**

## IV. Tentative financing

| Source: | | ($m.) |
|---|---|---|
| BORROWER/RECIPIENT | | 0.00 |
| International Development Association (IDA) | | 5.00 |
| Borrower/Recipient | | 0.00 |
| IBRD | | |
| Others (specifiy) | | |
| | Total | 5.00 |

## V. Tranches *(if applicable)*

| | ($m.) |
|---|---|
| First Tranche | |
| Second Tranche | |
| Etc. | |
| Total | |

## VI. Institutional and Implementation Arrangements

**The Ministry of Finance, Trade and Blue Economy will be responsible for the overall implementation of the proposed operation.** It will coordinate actions under the DPO program and report progress to relevant ministries and public agencies. The ministry has experience in coordinating and implementing DPO programs as demonstrated by the successful implementation of the past operations.

**The results framework is based on standard and widely available indicators.** The results framework was built trying to avoid higher outcome indicators that are influenced by factors outside the control of the operation. Preference was given to indicators that are already produced and reported by the authorities using their own proprietary systems. To the extent possible, the operation is also being monitored by indicators that are calculated by external sources and allow for international benchmarking such as the Doing Business indicators.

## VII. Risks and Risk Mitigation

**The overall risk of the operation is Substantial.** The overall rating is derived from the Substantial ratings of the main risk categories of the operation, which are political and governance, macroeconomic, and institutional capacity for implementation and sustainability.

**Political and governance risk is Substantial.** Governance, rather than political risk, is the major source of risk to the operation in the first category. The ruling party enjoys an absolute majority in the legislative. Thus, political support to the reforms is guaranteed. Governance is a greater risk because transparency, accountability, and participation practices in STP are below the world average, even though they are superior to the African standards in some aspects. One clear example of governance risk is the possibility that STP enters into debt contracts that breach its international agreements once more, not only derailing reforms on PIM and debt management but also the whole macro framework in which the operation is built upon.

**Macroeconomic risks are also substantial.** As discussed earlier, despite the fairly good economic performance, there are several vulnerabilities to growth. Sources of macroeconomic risk to the operation include lower economic activity, increase in oil prices, and higher inflation. For example, lower than expected economic activity might reduce the revenue gains from tax reforms. The external environment through exchange rate movements might affect debt sustainability. An increase in oil prices will exert pressure on EMAE’s finance and on the budget, reducing the fiscal space that might be generated by the second pillar of the operation. Aggravation of problems in the banking sector might derail the BCSTP’s effort to improve access to finance and bank supervision. Macroeconomic risks are being closely monitored by the World Bank and the existence of an IMF program serves as a safeguard against inconsistent policy responses. In addition, the Government has a good track record on monetary and external policy that provides additional comfort in the event of a crisis.

**Institutional Capacity for Implementation and Sustainability is also rated as Substantial.**

Institutional capacity is a binding constraint in STP and a major risk to the operation because it might prevent the authorities from carrying out and effectively implementing the reforms in the agreed time frame. The Government does not have the capacity to implement most of the reforms by itself. Thus, a lack of support from the World Bank and other donors might hamper the reforms. Technical assistance to address the institutional capacity risk is in place for all policies supported in the financial sector. The energy operation and the associated trust funds include several technical assistance components. Lastly, a new institutional strengthening operation will be prepared to support fiscal policy and SP

## VIII. Poverty and Social Impacts and Environment Aspects

### Poverty and Social Impacts

**The proposed DPO series will have a positive social impact on poverty reduction, however the net impact is uncertain.** The most relevant and direct impact comes from the implementation of the SP policy framework. The new PENPS, as discussed above, is better targeted, benefiting the extreme poor population in STP. The utilization of a poverty map is behind the better targeting and the undertaking of a new household survey will not only allow the updating of this map but also better monitoring of the SP programs. Positive effects are also expected from the policies supported on access to finance and from overall growth-enabling reforms. The poverty and social impacts from the reforms in the energy sector are mixed and uncertain. On one hand, it will allow greater access to energy for poor households, however the reform of tariffs and subsidies, together with improved management of EMAE, might impose higher payments on part of the population. The World Bank, through its energy sector project and support to the new household survey, is collecting data that will allow the tariff and subsidy reform to be designed in a way to reduce adverse impacts on poverty.

**The support given to policy actions on revenue mobilization has a clear distributional impact.** The changes promoted tend to include more people in the tax base but also make it more progressive. However, given that household data is outdated and not of the highest quality, an incidence analysis of the proposed reforms could not be carried out. Such exercises will be made possible by the new household survey and can be carried out in future poverty assessments or public expenditure reviews. Another impact of the tax policy and administration reforms is the increase in domestic resources, which if directed to SP, will ensure the effectiveness of the new SP framework.

**Policy support to the financial sector and business environment in this operation has a small poverty and distributional impact.** The policies supported in the first operation are geared more to support the foundations of the financial sector, which will allow in the following operations for increased access to finance and thus a greater impact on poverty reduction.

### Environmental Aspects

**The proposed DPO series has neutral environmental impacts.** The policies supported in the financial sector, business regulation, and fiscal policy tend to have very small and indirect impacts on the environment, leading to an overall neutral impact. Support to the SP policy can have a small indirect positive impact to the extent that it moves vulnerable population away from economic practices that are harmful to the environment. The same can be said for the policy support to the energy sector to the extent that the population not previously covered by the energy grid will stop using fuels such as wood that are harmful to the environment. The regulatory framework foresees the need for environmental impact assessments and strategic environmental assessments, but limited capacity prevents the country to reap the full benefits of the framework.

## IX. Contact point

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