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Program Information Document (PID)

Concept Stage | Date Prepared/Updated: 25-Apr-2019| Report No: PIDC26182

BASIC INFORMATION

A. Basic Project Data

Country	Project ID	Project Name	Parent Project ID (if any)
Sao Tome and Principe	P164321	THIRD STRENGTHENING GROWTH AND FISCAL POLICY DEVELOPMENT POLICY FINANCING (P164321)	P161707
Region	**Estimated Board Date**	**Practice Area (Lead)**	**Financing Instrument**
AFRICA	Sep 20, 2019	Macroeconomics, Trade and Investment	Development Policy Financing
Borrower(s)	**Implementing Agency**		
Ministry of Planning, Finance, and Blue Economy	Ministry of Planning, Finance, and Blue Economy		

Proposed Development Objective(s)

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.

Financing (in US$, Millions)

SUMMARY

Total Financing	5.00

DETAILS

Total World Bank Group Financing	5.00
World Bank Lending	5.00

Decision

The review did authorize the preparation to continue

B. Introduction and Context

Country Context

The proposed Third Strengthening Growth and Fiscal Policy Development Policy Financing aims to support *São Tomé and Príncipe* (STP) in its efforts to foster private-sector-led growth by supporting reforms that target the financial sector, business environment, and infrastructure, as well as ensuring macroeconomic stability to promote growth and poverty reduction. This proposed operation, in the amount of SDR X million (equivalent to US$5 million), is the third in a programmatic series of three development policy operations (DPOs). The objective of the 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 the quality of public expenditures. The reforms in the proposed operation are aligned with the International Monetary Fund's (IMF) new Extended Credit Facility (ECF), which is expected to be presented to the IMF Executive Board in June 2019.

STP is a low middle-income and small island country that faces challenges typical of small states. It consists of two main islands in the Gulf of Guinea, has a surface area of 1,001 sq. km, and is administratively divided into six districts, in addition to the Autonomous Region of Príncipe (*Região Autonóma do Príncipe*, RAP). STP is a multiparty democracy and a unitary state, and its total population is approximately 200,000 people, with 42.6 percent of the population at or below the age of fourteen. In 2016, the country's per capita gross national income was estimated at US$3,250 in purchasing power parity (PPP), and its per capita gross domestic product (GDP) was US$1,714. As a small island country, STP is characterized by: (i) a small population, (ii) a small land area, (iii) remoteness; and (iv) a high fixed cost of public goods—all factors that affect the country's public capacity, trade, fiscal accounts, and human development.

Poverty reduction has been stagnant in STP since 2000. Despite methodological issues, there is consensus that the country's poverty incidence did not significantly change between the last two household surveys (2000 and 2010). Preliminary figures from the 2017 household survey point to a slight increase in poverty. According to recent WB estimates, around one-third of the country's population lives on less than US$1.9 PPP per day, and more than two-thirds of the population is classified as poor, using a poverty line of US$3.2 PPP per day. Urban areas and southern districts such as *Caué* and *Lembá* have higher levels of poverty incidence. Moreover, STP's total fertility rate is 4.5 births per woman, and its adolescent fertility rate is 96.3 per 1,000 women aged 15-19. Income concentration, as measured by the Gini index, was 30.8 in 2010, and the unemployment rate was 9.1 percent in 2017.

Economic growth, which has been overly reliant on public expenditure, has been declining due to declining government funding (external grants and own-source revenues), and more recently due to the energy crisis. The country's GDP growth rate slowed from an average of 4.9 percent in 2010-15 to 2.7 percent in 2018. In the same period, public investments dropped from an average of 22.1 percent of GDP to 9.0 percent, while grants declined from an average of 15.3 percent of GDP to 8.2 percent. Tax revenues also declined, losing three percentage points of GDP from the average in 2010-15 to 2018. As a result, public debt increased significantly until 2015, being above 100 percent of GDP in 2018, propelled by increased domestic debt in the form of arrears from both the government and state-owned enterprises (SOEs). While the agriculture and tourism sectors—where most private-sector-led growth originates—have recently grown, they have not been able to replace the government as the economy's main growth driver. The combination of a weak private sector and strained public sector has reduced economic growth, resulting in energy outages, a liquidity crunch, and bank exposure to public sector.

The new administration of STP has reiterated its commitment to make the private sector the country's leading driver of economic growth. The new administration, which took office in late 2018, has acknowledged that STP's macroeconomic situation is delicate, the public sector is bloated, and future growth will have to be led by the private sector. This operation aims to address this challenge by supporting reforms that will enable higher levels of private-sector growth and restore macroeconomic stability. For example, financial sector reforms aim to reduce risks from another bank crisis while providing companies and consumers with tools to have access to more credit. Also, energy reforms aim to increase the supply of low-cost and reliable energy, relieving private companies from the burden of relying on power generators. Finally, fiscal measures aim to increase tax revenue and improve public investment spending and the efficiency of SOEs, which will help policymakers achieve balanced budgets and provide the public services needed to increase private-sector growth.

The macroeconomic situation remains challenging. The government has acknowledged the severity of the country's current macroeconomic situation. The approved 2019 budget promotes fiscal consolidation of more than 1 percentage point of GDP. STP's central bank (*Banco Central de São Tomé e Príncipe*, BCSTP) has also introduced new monetary policy tools to shore up liquidity, and it has tapped into its credit line with the Bank of Portugal. Moreover, a new IMF program is being negotiated with the GoSTP and is expected to be presented to the IMF's Board of Directors in June 2019. The new 3-year program will be extended under the ECF modality and total US$19 million. It will focus on fiscal consolidation and monetary tightening to support the country's currency peg. A more definitive assessment of the adequacy of the macroeconomic framework is deferred until the details of the government's macroeconomic stabilization program are firmed up and agreed with the IMF.

The risk of the proposed operation is high due to (i) political and governance, (ii) macroeconomic, (iii) fiduciary, and (iv) institutional capacity for implementation and sustainability risks. These risks emanate from the short tenure of the current government, its coalition nature, the need for support from Parliament to implement some reforms, vulnerability to domestic and external shocks and their potential impact on program objectives, and the complex design of the operation.

The operation is aligned with the WB's Maximizing Finance for Development (MFD) framework and the recently adopted Africa Regional Strategy. The operation supports MFD-enabling reforms, including achieving macro-financial stability; improving the business climate; implementing SOE reforms; and regulating the energy sector. It is also aligned the Africa Regional Strategy, as it aims to create sustainable and inclusive growth (through increased domestic resource mobilization, improved public investment management, and higher financial inclusion) and strengthen human capital (by expanding social protection coverage).

Relationship to CPF

This operation reflects the priorities and objectives of the WB's Country Partnership Strategy (CPS) FY2014-18 (Report No. 83144), which has been extended to FY2020. The CPS supported STP's Second Poverty Reduction Strategy Paper (PRSP II, 2012-2016), which focused on ways to boost growth and job creation to achieve poverty reduction. The CPS was extended for two years to incorporate the results of the Performance and Learning Review (PLR) and the NDP 2017-2021. The previous two focus areas have been streamlined and aligned with the new government's priorities and now focus on: (i) supporting macroeconomic stability and inclusive growth; and (ii) strengthening human capacity and reducing vulnerability. Objectives under the first focus area include: (i) increased fiscal revenue and improved quality of public expenditures; (ii) strengthened governance of SOEs and extractive industries and improved transparency; (iii) improved performance of the infrastructure sector (i.e., ICT, energy, and transport); and (iv) an improved business environment, focusing on the tourism sector and SMEs. Objectives under the second focus area include: (i) enhanced education quality and skills; (ii) improved poverty targeting and access to social safety nets; and (iii) increased adaptive capacity of coastal communities. Gender, partnerships, and capacity building are elements that cut across all the proposed engagements.

The DPO series will contribute to both focus areas of the CPS. For instance, the operation's prior action on banking supervision will strengthen the stability of the financial sector, which is aligned with the first CPF focus area to support macroeconomic stability. Reforms of the property registry and prior actions on payment systems and financial inclusion will help improve the business environment and support inclusive growth. Also, the prior action on VAT will increase fiscal revenue and help achieve a more sustained budget balance position, while prior actions focusing on the SOE sector and PIM will improve the quality of public expenditures and strengthen SOE governance and transparency. Moreover, energy-related reforms will support the long-term structural improvement of the EMAE and the energy sector. They will also foster macroeconomic stability by containing the SOEs' losses and associated fiscal risks in the short term. Finally, the prior action on social protection is closely related to the objective of increasing access to social safety nets under the CPS' second focus area by streamlining social protection programs, expanding coverage, and improving the targeting of the social protection policy framework.

The DPO will also directly and indirectly contribute to the WB Group's twin goals. The revision of the social protection policy framework and the expansion of fiscal space (through measures to increase revenue mobilization) would allow for an improvement in the targeting and coverage of social protection programs. Policies supported by the operation are likely to boost shared prosperity. Also, the revised social protection policy will focus not only on the extreme poor but also on other poor and vulnerable groups. Moreover, policy changes to improve the credit market are expected to increase access to credit and market opportunities for households in the bottom part of the income distribution. Finally, affordable and increased access to energy are also associated with reduced poverty and greater shared prosperity.

This DPF series complements and leverages lending projects under the CPS and is informed by the WB's analytical work. In the energy sector, the WB is supporting an investment financing project (P157096) that will increase the reliability of the power supply, help reduce the cost of energy, improve the management of the utility company, and strengthen the regulatory framework. The DPF operation will support policymakers to improve regulations in the energy sector and the management and oversight of SOEs. Furthermore, the WB Social Protection and Skills Development project (P163008) will support the operationalization of the GoSTP's core social protection delivery systems and strengthen its capacity to ensure the effective management of safety net programs. Several DPO reforms are also supported by the WB's Institutional Capacity (P162129) and FIRST (P159937) projects, including reforms focusing on the financial sector, the property registry, the VAT, and SOEs. Also, the DPF series is supported by ongoing and recently completed advisory services and analytics in social protection (P149534) and the financial sector (P150418). Other WB reports that inform the DPO series include the latest PER (P161140), which focuses on STP's tax policy and administration, SOEs, and PIM, and the ongoing country economic memorandum (P164180).

C. Proposed Development Objective(s)

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.

Key Results

In line with these objectives, the key expected results of this operation are as follows. For Pillar 1, are expected that all banks comply with the minimum capital adequacy ratio; an increase in the share of the population with access to formal financial services; a higher share of real estate properties and mortgages registered and digitized in the public notary registry; a decrease in the amount of overdue customer bills at EMAE, a decrease in EMAE's non-technical losses; and a reduced number of customer complaints received by EMAE.

For Pillar 2, are expected an increase in tax revenues (as a share of GDP); a higher percentage share of performance targets achieved by the SOEs; an increase in the share of ongoing and finalized projects that are included in the National Investment Portfolio Database; and a higher number of beneficiaries enrolled in the three core social protection programs and receiving regular payments.

D. Concept Description

The objective of the proposed DPO is to support the implementation of growth-enabling reforms in the financial sector, business environment, and infrastructure; generate fiscal resources and savings, and improve the quality of public expenditures. These reforms will address the main the obstacles to economic development in STP and are expected to promote financial development and inclusion, attract investors, develop more efficient and accessible infrastructure, and foster fiscal sustainability and private-sector-led growth in the medium term. The operation is organized around two pillars, each including several policy actions:

- **Pillar A:** Introduce growth-enabling reforms in the financial sector, business environment and infrastructure. Policies under this pillar aim to support the BCSTP to effectively address vulnerabilities in the financial sector by improving bank supervision and financial soundness. They also aim to develop a national payment system and the microfinance sector, as well as improve the registry of properties, which will increase the availability of credit, accelerate financial inclusion, and improve the tourism sector. Additionally, pillar A will support policies aimed at expanding infrastructures and improving public service delivery.

- **Pillar B:** Generate fiscal resources and savings and improve the quality of public expenditures. This pillar includes policies aimed at strengthening fiscal sustainability and protecting poor and vulnerable households.

E. Poverty and Social Impacts and Environmental Aspects

Poverty and Social Impacts

The proposed DPO is expected to have an overall positive impact on the country' social development and poverty reduction efforts. The prior actions with the most relevant impact on poverty reduction and social development are the implementation of the VAT (Prior Action #8) and the introduction of a cash-transfer program that targets the most vulnerable population (Prior Action #11). Given that cash transfers to poor households clearly contribute to poverty reduction, the analysis at the concept stage will focus on the introduction of the VAT. Going forward, the poverty and social impact analysis will be expanded to include the relevant impacts from all prior actions.

While the introduction of the VAT will not affect income concentration, it will increase the poverty headcount between 1.5 and 3.0 percentage points. The simulation of the impact of the VAT was done by taking into account direct and indirect effects using consumption data from the 2017 household survey. It reveals the VAT will not affect income concentration, as measured by the Gini coefficient, in a significative way, even when different set of exemptions are introduced. However, the implementation of the VAT does increase the poverty headcount by approximately 3.0 percentage points, although this impact can be mitigated by exempting food, small producers, and health and education expenditures (exempting health and education spending will be more significant in urban areas). Also, the analysis shows that 51 percent of the VAT collection will be paid by the richest decile of the population.

Environmental Impacts

Specific policies supported by the DPO series are not expected to have a significant negative effect on STP's forests, water resources, habitats, or other natural resources. The country has a legal and institutional framework to manage and respond to environmental challenges. The General Directorate of Environment (DGE), under the Ministry of Infrastructure, Natural Resources and Environment (MIRNA), is the central institution responsible for environmental management. It oversees all projects expected to have a potential positive or negative impact on the environment. Even though an institutional and legal framework is in place, the inconsistent monitoring, compliance, and enforcement of environmental laws and regulations are of concern, and some prior actions to be implemented under this DPF are likely to have environmental effects and therefore need to be scrutinized and closely supervised.

A reduction in the cost of energy and an increase in the share of renewable energy can bring environmental benefits (Prior Action #6). Energy sector reforms that include replacing fossil fuels and fuel wood extraction with renewable energy could reduce deforestation, lower local pollution, and reduce greenhouse gas (GHG) emissions. The Least-Cost Development Plan, which has identified hydropower as a priority source of energy to attain National Development Contribution targets, will guide stakeholders in how to develop sub-sector plans that meet the country's energy and development needs at the least cost to the economy and environment. New energy investments will also be subject to environmental and social impact assessments, and a compliance monitoring mechanism will put in place to ensure that investors comply with regulations and properly manage potential environmental risks and impacts.

The SOE reform plan aims to strengthen the EMAE, ENASA, and ENAPORT and make it possible for authorities to evaluate their social, environmental, fiscal, and economic impact on STP (Prior Action #9). A scorecard will be developed for SOEs, which will capture KPIs that go beyond financial results and risks to consider the risk and impact of other indicators like social, welfare, human, and environmental capital.

Harmonizing the National Planning System Law with planning and budgeting tools is likely to have a positive impact on environmental governance in STP (Prior Action #10). It could also contribute to: (i) faster processing of environmental impact assessments (EIAs), which are required for investment planning; (ii) more efficient management of environmental and social issues associated with public investment projects; and (iii) the inclusion of environmental, and where required, social and economic information into the decision-making process of investment projects. The harmonization will be especially important in order to secure the necessary funding for EIAs to make a difference in the investment planning process.

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APPROVAL

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