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INTERNATIONAL DEVELOPMENT ASSOCIATION

PROGRAM DOCUMENT

FOR A PROPOSED GRANT

IN THE AMOUNT OF SDR 46.6 MILLION (US$65.0 MILLION EQUIVALENT)

TO THE REPUBLIC OF MADAGASCAR

FOR THE

PUBLIC FINANCE SUSTAINABILITY AND INVESTMENT
DEVELOPMENT POLICY FINANCING OPERATION

October 26, 2016

Macroeconomics and Fiscal Management Global Practice
Africa Region

THE REPUBLIC OF MADAGASCAR

GOVERNMENT FISCAL YEAR

January 1 – December 31

CURRENCY EQUIVALENT

(Exchange Rate Effective as of September 30, 2016)
Currency Unit = Ariary
US$1 = Ariary 3161
US$1 = SDR 0.71642989

ABBREVIATIONS AND ACRONYMS

AfDB	African Development Bank
AGOA	African Growth and Opportunities Act
BOP	Balance of Payments
CBM	Central Bank of Madagascar
COMESA	Common Market for Eastern and Southern Africa
CNM	*Commission Nationale des Marchés* (National Commission for Public Procurement)
CPF	Country Partnership Framework
CSBF	*Commission de Supervision Bancaire et Financière* (Commission for Banking and Financial Supervision)
DPO	Development Policy Operation
DPF	Development Policy Financing
DSA	Debt Sustainability Analysis
ESIA	Environmental and Social Impact Assessment
ECF	Extended Credit Facility
FID	Intervention Fund for Development
FSAP	Financial Sector Assessment Program
FY	Fiscal Year
GDP	Gross Domestic Product
IDA	International Development Association
IEG	Independent Evaluation Group
IMF	International Monetary Fund
IPF	Investment Project Financing
JIRAMA	State-Owned Electricity and Water Company (Jiro sy Rano Malagasy)
MFB	Ministry of Finance and Budget
MGA	Malagasy Ariary
NDP	National Development Plan
NEO	National Environment Office
NEP	New Energy Policy
NGO	Non-Governmental Organization
PEFA	Public Expenditure and Financial Accountability
PFM	Public Finance Management
PIM	Public Investment management
PPP	Public Private Partnership
PV	Present Value
RCF	Rapid Credit Facility
SCD	Systematic Country Diagnostic
SDR	Special Drawing Rights
SOE	State-Owned Enterprise
SMP	Staff-Monitored Program
SSA	Sub-Saharan Africa

TA	Technical Assistance
US$	United States Dollar
VAT	Value Added Tax

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THE REPUBLIC OF MADAGASCAR

PUBLIC FINANCE SUSTAINABILITY AND INVESTMENT DEVELOPMENT POLICY FINANCING OPERATION

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SUMMARY OF PROPOSED GRANT AND PROGRAM

THE REPUBLIC OF MADAGASCAR

PUBLIC FINANCE SUSTAINABILITY AND INVESTMENT DEVELOPMENT POLICY FINANCING OPERATION

Borrower	Republic of Madagascar
Implementation Agency	Ministry of Finance and Budget
Financing Data	IDA grant: SDR 46.6 million (US$65.0 million equivalent).
Operation Type	First in a programmatic series of two operations – single tranche
Pillars of the Operation And Program Development Objective(s)	The program development objectives of the proposed operation are to strengthen Madagascar's fiscal framework and enhance the environment for investment. This operation has two pillars: (i) strengthening the fiscal framework and (ii) improving the environment for investment.
Result Indicators: (Baseline: 2015 unless otherwise noted; Target 2019)	Indicator 1. Revenue effort increased Baseline: 10.4 percent of GDP (2015); Target: 12 percent of GDP (2019) Indicator 2. Share of transfers in total expenditure Baseline: 22.5 percent (2015); Target: 15 percent (2019) Indicator 3. Share of priority spending Baseline: 0.7 percent of GDP (2015); Target: 1.3 percent of GDP (2019) Indicator 4. Share of large investment projects subject to appraisal Baseline: 0 (2015); Target: 30 percent (2019) Indicator 5. Share of power generation contracts awarded competitively and published Baseline: 0 (2015); Target: 70 (2019) Indicator 6. Percentage of cases randomly allocated Baseline: 0 (2015); Target: 100 (2019) Indicator 7. Number of days to resolve a commercial dispute Baseline: 871 (2015); Target: below 365 (2019) Indicator 8. Extent of risk based supervision Baseline: no risk based supervision (2015); Target: risk based supervision in place (2019)
Overall risk rating	Substantial
Climate and disaster risks *(required for IDA countries)*	Are there short and long term climate and disaster risks relevant to the operation (as identified as part of the SORT environmental and social risk rating)? Yes ☐ No ☒
Operation ID	P160866

IDA PROGRAM DOCUMENT FOR A PROPOSED GRANT TO THE REPUBLIC OF MADAGASCAR

1. INTRODUCTION AND COUNTRY CONTEXT

1. **This program document proposes a Public Finance Sustainability and Investment Development Policy Financing (DPF) for the Republic of Madagascar** for the amount of SDR 46.6 million (US$65.0 million equivalent). The proposed DPF, the first operation in a programmatic series of two, will support a reform program that seeks to strengthen Madagascar's fiscal framework and enhance the environment for investment.

2. **Madagascar is beginning to recover from several years of instability, but remains beset by political fragility**. The country returned to constitutional order when a duly-elected government took office in 2014, after a five-year long political crisis. The crisis had devastating effects on the economy, poverty and social outcomes. The return to constitutionality was an event welcomed by all, but only the first step towards putting the country back on track for sustainable development. Tangible progress has been made since: a new National Development Plan (NDP) has been elaborated and efforts are being made to strengthen economic management and promote private-sector led growth. Constitutionally-mandated local elections were held peacefully in July 2015. The country has, however, encountered difficulties in moving ahead in unison to implement the new development strategy. The executive, legislative and judiciary branches have yet to settle on constructive working arrangements. Intra-elite power struggles, which have always been a feature of Malagasy politics, have not abated, distracting the attention and energy of political leaders, and threatening at times to derail the fragile recovery process.

3. **The country suffers one of the highest levels of poverty in Africa, with extreme poverty having increased in recent years**. Extreme poverty[1] rose from 68.7 percent in 2001 to 82.0 percent of the population in 2010 and then fell slightly to 77.8 percent in 2012 (the latest data available). Inequality in Madagascar is similar to that of other low-income countries, but it diminished strongly between 2001 and 2012. The Gini coefficient was 0.41 in 2012, similar to the low-income country average of 0.40. The poverty gap, at approximately 40 percent (2010 figures) is substantially worse than the mean for Sub-Saharan Africa (SSA) of 16.5 percent, reflecting the depth of Madagascar's poverty.

4. **Progress towards political stability and poverty reduction requires Madagascar to build momentum in confronting its immense economic and development challenges.** Years of political uncertainty and weak governance have adversely affected Madagascar's fiscal and economic management frameworks. Tax revenue collection is improving gradually, but at 10.1 percent of gross domestic product (GDP) remains one of the lowest in the world. Own revenue barely covers a minimum functioning of the administration and civil service salaries. Transfers to underperforming state enterprises and payments for accumulating arrears have crowded out priority spending and narrowed the scope for public investment in the economy. With these challenges, Madagascar has been unable to meet its potential for growth, which at 3.1 percent in 2015, is barely above the rate of population growth. In the absence of reliable electricity supply, sound financial institutions and a good setting for commerce, attaining the goals of the NDP will be difficult.

5. **Despite the challenges, Madagascar has been building momentum in pursuing a reform agenda for economic recovery.** The authorities made progress in implementing a series of macroeconomic and structural policy reforms under two consecutive International Monetary Fund (IMF) Rapid Credit facility

[1] Per capita consumption under US$1.9 purchasing power parity 2011 – Purchasing Power Parity – per day.

(RCF) programs, followed by a six-month IMF staff-monitored program. Satisfactory performance under these frameworks paved the way for a three-year extended credit facility (ECF) program, which started in July 2016. Reform momentum was further supported by two World Bank Development Policy Operations (DPO), the Reengagement DPO in 2014 and the Resilience DPO in 2015[2]. These programs delivered support at a critical juncture, and provided space for the authorities to build consensus around a medium-term program. This programmatic DPF series seeks to support the implementation of the NDP. It is also closely aligned with the IMF ECF program, and reflects close collaboration with the Fund on the policy reform agenda.

6. **The first DPF in the series has two pillars, the first of which is focused on fiscal reforms**. The political crisis has resulted in years of underinvestment as public spending on social services and investments were cut to maintain macroeconomic stability, while demand for spending on non-priority expenditures rose. Therefore, the reform agenda focuses on creating fiscal space by increasing revenues and lowering the costs of subsidies. Key reforms under this pillar include tightening the customs exemption regime, introducing performance contracts for customs agents and establishing tighter customs screening procedures to stem revenue leakages. This pillar also supports the transition to flexible fuel pricing to reduce the costs of regressive fuel subsidies that represented a significant burden to the budget, while only producing negligible benefits for the poor. These measures are complemented by controls to clean up the roster of pensioners from ineligible beneficiaries. These measures are expected to contribute to increase fiscal space by 2.3 percent of GDP from higher revenues and lower non-priority spending until 2018.

7. **The second pillar seeks to enhance the environment for economic growth.** It identifies the recovery of the electricity sector, an improved business environment and a stable banking sector as key channels for stimulating investment and growth. Reforms under this pillar include ex ante procurement controls of the electricity utility's (JIRAMA, *Jiro sy Rano Malagasy*[3]) expensive power purchase agreements, which have been one of the main drivers of its operational inefficiency. This pillar also includes measures to strengthen commercial justice and a focus on ensuring the stability of the financial sector through improved central bank supervision of large financial institutions. These reforms support the implementation of Madagascar's NDP. They also contribute to reducing poverty and increasing shared prosperity. The fiscal management reforms will enhance the budget's ability to allocate resources to investment and boost Madagascar's growth. Similarly, the electricity, business environment and banking sector reforms are expected to stimulate investments and the creation of jobs.

8. **However, implementation of this DPF is subject to a number of risks, reflecting the challenging governance environment and the ambitious nature of the selected reforms.** The legacy of the political crises has led to deep rooted governance problems, where significant vested interests benefit from the status quo. These dynamics may intensify in the run-up to the 2018 presidential elections. However, while the risks to implementation are high, the government has signaled commitment to pursuing an ambitious reform agenda, which this DPF series is supporting. For example, expenditures on non-priority items, such as subsidies to JIRAMA and the pension funds have started to contract as a share of the budget.[4] These risks have been factored into the design of this programmatic DPF series and a number of mitigating factors have been developed. For example, the World Bank will work closely with the IMF and other partners to ensure key reform measures stay at the top of the policy agenda. Further, technical assistance provided by the World Bank and other partners will help strengthen institutional capacity in a post-crisis environment.

[2] Support was also provided by other donors (the African Development Bank, France, and the European Union provided policy based support) to reinforce Madagascar's progress.
[3] State-Owned Electricity and Water Company (Jiro sy Rano Malagasy).
[4] Transfers and subsidies declined from 3.4 percent to 3.2 percent of GDP between 2015 and 2016.

2. MACROECONOMIC POLICY FRAMEWORK

9. **Economic performance deteriorated slightly in 2015 due to adverse weather-related shocks in the agriculture sector, and was offset somewhat by growth in the tertiary sector**. GDP growth declined to 3.1 percent from 3.3 percent in 2014, barely outpacing population growth. Low commodity prices slowed the mining sector's contribution to growth. Although the sector's growth remains positive in real terms, as Ambatovy, the largest mining operation in the country approaches full production, the export value had declined between 2014 and 2015 due to the drop in world prices of nickel, and this downward trend continues into 2016 (Figures 1 and 2). Sluggish private sector investment contributed further to the reduction in growth. Private investments represented 9.6 percent of GDP in 2015, down from 11.6 percent in 2014. An unfavorable operating environment for the private sector, and for tourism in particular, was caused by the political uncertainty during the first semester of 2015 and the strikes at the two state-owned enterprises, JIRAMA and Air Madagascar.

Figure 1: Sectoral contributions to growth by sector (%), 2013 – 2015

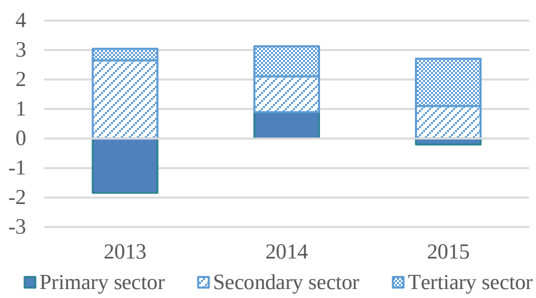
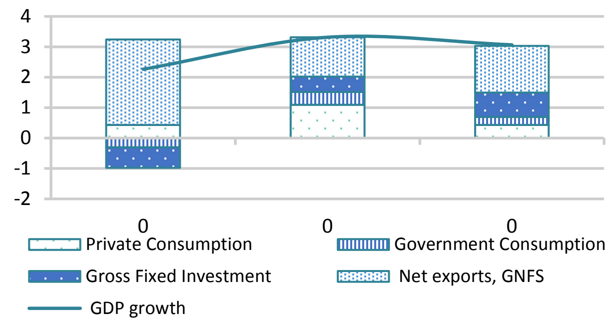


Figure 2: Contributions to growth by expenditure (%), 2013 – 2015



Source: National institute of Statistics (October, 2016)

10. **The pattern of growth in Madagascar has become regressive, yielding increasing rates of poverty.** Madagascar enjoyed a period of declining inequality between 2001 and 2005, when growth in consumption was largest amongst the poor. These trends, which are a measure of shared prosperity, deteriorated subsequently. Growth was regressive between 2005 and 2012 as consumption growth amongst the richer segments of society outpaced the rest. Throughout these periods, increases in the consumption levels of poor were low and insufficient to reverse the trend of growing extreme poverty. A fragile and low-productivity agricultural sector is a key driver of poverty, which is concentrated amongst the rural population.

11. **After rising inflation in 2014 and 2015 price levels have stabilized lately.** As of August 2016, inflation stood at 6.7 percent after 7.6 percent in December 2015. The inflation rate was moderated partly because the global fall in oil prices is finally translating into lower fuel prices for consumers. In addition, an increase in the price of vanilla is boosting export earnings and has halted the depreciation of the Ariary in the second quarter of 2016. In the past two years, a continuously depreciating Ariary (26 percent depreciation between June 2014 and June 2016) had contributed to higher food and non-food prices.

12. **Budget execution faced significant challenges in 2015 as modest revenues growth was offset by swelling transfer costs, but began improving in 2016.** The fiscal deficit increased to 3.7 percent of GDP in 2015 from 2.4 percent in 2014. Tax revenue rose slightly from 9.9 percent of GDP in 2014 to 10.1 percent last year. However, demands in spending outpaced the growth in revenues, due to increased subsidies to JIRAMA and to fund pensions, as well as the rising costs of arrears[5]. The authorities passed a revised budget during the course of the year to shore-up public finances by introducing revenue measures and

[5] JIRAMA increasingly relied on diesel-powered generators.

scaling back spending, including a lower capital budget. The supplementary budget law of 2015 was adopted only in November 2015, causing disruptions in spending, with 40 percent of non-wage current expenditure being committed in December 2015 alone. The authorities continued to step-up fiscal adjustment reforms in 2016 with support under an IMF program, the World Bank and other development partners. The wage bill stabilized by end 2015 and tax revenue collection accelerated in the first half of 2016.

Table 1: Madagascar: Selected Economic and Financial Indicators

	2014	2015	2016	2017	2018	2019
	Act.	Est.	Projection			
Real sector						
Real GDP growth	3.3	3.1	4.1	4.5	4.8	5.0
GDP per capita growth	0.5	0.3	1.3	1.7	2.0	2.2
Inflation, consumer prices (annual %, end of year)	6.0	7.6	7.1	7.1	6.3	5.9
Public Finance (% GDP)						
Revenues, excluding Grants	10.1	10.4	11.0	11.2	11.7	12.2
of which: Tax Revenues	9.9	10.1	10.8	11.0	11.5	12.0
Grants	2.3	1.5	2.7	2.7	1.5	1.3
Total spending (commitment basis)	14.7	15.1	16.2	18.3	17.6	18.0
of which: Capital spending	3.9	3.5	5.3	8.0	7.6	8.1
Overall balance (cash basis)	-2.4	-3.7	-3.7	-5.1	-5.0	-4.7
Total public debt	35.8	41.0	41.1	42.2	43.0	43.8
Monetary accounts (annual % change)						
Money Supply (M2)	9.8	15.7	19.2	13.8	13.4	13.2
Net Foreign Assets	17.0	21.3	21.5	9.1	7.5	7.5
Net Domestic Assets	8.3	11.4	15.9	14.7	15.2	14.7
of which: Credit to the Private Sector	18.6	15.3	11.0	13.7	16.0	15.2
External sector (% of GDP)						
Exports of goods	20.6	21.0	22.1	21.7	21.6	21.9
Imports of goods	25.7	24.4	26.4	27.7	28.0	28.1
Current account balance	-0.3	-1.9	-1.7	-3.7	-4.2	-4.2
Foreign Direct Investment	2.4	4.3	5.1	5.3	5.5	5.4
Overall Balance	0.2	0.7	1.5	0.7	0.2	-1.4
Foreign Reserves (months of imports)	3	3	3	3	4	4

Source: Ministry of Finance, Central Bank of Madagascar, WB and IMF staff projections, October 2016

13. **Madagascar cut spending on social services and investment to maintain macroeconomic stability during the crisis, but the composition of the budget is starting to improve.** Public spending on education declined during the years of instability as government resources dwindled, which pushed up out-of-pocket expenditures borne by households or limited access. Similarly, government allocations to health and nutrition are inadequate and have declined since the crisis. Large recurrent costs and low revenues are the underlying causes but have recently shown some signs of improvement. The wage bill, which is the largest item of budgetary expenditure, has been declining as a share of the budget from 38 percent in 2013 to 36 percent of spending in 2015. Non-salary recurrent spending, dominated by transfers to entities such as

JIRAMA and the pension funds, has also started to contract as a share of the budget. This has allowed the composition of spending to gradually begin changing in favor of domestic capital expenditure (up from 0.6 to 1 percent of GDP between 2013 and 2015) and social sectors.

Table 2: Fiscal Operations of the Central Government (% of GDP)

	2013	2014	2015	2016	2017	2018	2019
	Act.	Act.	Est.		Proj.		
Total revenues and grants	10.9	12.4	11.8	13.7	13.9	13.1	13.6
Tax revenues	9.3	9.9	10.1	10.8	11.0	11.5	12.0
Non-tax revenues	0.3	0.2	0.3	0.2	0.2	0.2	0.2
Grants	1.3	2.3	1.5	2.7	2.7	1.5	1.3
Total expenditure	14.9	14.7	15.1	16.2	18.3	17.6	18.0
Current expenditure o.w :	11.8	10.8	11.7	11.0	10.3	10.0	9.9
Wages	5.7	5.6	5.5	5.7	5.6	5.3	5.1
Goods and services	0.6	0.9	0.5	0.7	0.8	1.1	1.2
Transfers and subsidies	4.1	3.2	3.4	3.2	2.7	2.5	2.4
Interest	0.7	0.6	0.8	0.9	0.9	1.0	1.0
Capital expenditures	3.1	3.9	3.5	5.3	8.0	7.6	8.1
Domesticaly financed	0.6	1.2	1.0	1.5	1.9	2.4	3.0
Externaly financed	2.5	2.8	2.5	3.7	6.1	5.2	5.1
Primary balance	-	-	-1.3	0.1	0.1	0.2	0.3
Overall balance (commit. Basis)	-4.0	-2.3	-3.3	-2.5	-4.4	-4.4	-4.4
Arrears variation (+ = accumulation)	2.0	-0.1	-0.5	-1.2	-0.7	-0.5	-0.3
Overall balance (cash basis)	-2.0	-2.4	-3.7	-3.7	-5.1	-5.0	-4.7
General government financing	2.0	2.4	3.7	3.7	4.7	4.0	2.3
External (net)	1.0	1.2	2.2	2.1	3.6	3.2	1.6
Domestic (net)	1.0	1.2	1.6	1.6	1.1	0.8	0.7
Financing gap	0.0	0.0	0.0	0.0	-0.4	-1.0	-2.4

Source: Ministry of Finance, WB and IMF staff projections (October 2016).

14. **The authorities have been strengthening arrears management in an effort to sustainably deal with liabilities accumulated during the political crisis**. As of April 2016, the stock of arrears to the five main creditors, Ambatovy and four petroleum companies (Total, Vivo, Jovenna and Galana) stood at Malagasy Ariary (MGA) 678 billion (approx. US$211million). This amount reflects the efforts made by the authorities to reduce the arrears, from close to MGA 1 trillion (approximately US$312 million) at the end of 2015. The reduction has been achieved through a combination of cash payments and issuance of special bonds. While the efforts to honor the government's commitments and reduce the stock of arrears are commendable, the payment schedule is adding pressure to the already constrained ability of the government to pay: it has fallen back on the arrears clearance schedule agreed with the creditors in 2014, and accumulated new arrears in 2015. To reverse this trend, the government has reached a restructuring agreement with Ambatovy, the largest creditor, in 2016 and intends to reach a similar agreement with the

petroleum companies to extend its repayment schedules. It is also tackling Value Added Taxes (VAT) arrears management. The creation of an escrow account dedicated to VAT refunds at the Central Bank of Madagascar (CBM) is beginning to expedite the refund process. The government has also removed pump fuel subsidies, a source of potential further arrears accumulation.

15. **The current account deficit widened from 0.3 percent of GDP in 2014 to 1.9 percent in 2015.** Lower commodity prices for nickel and cobalt reduced exports, whilst the import bill benefited from lower oil prices. Much of the increase in the current account deficit was driven by lower transfers in 2015 (both donor grants and remittances) and an increase in dividend outflows. In 2015, the external position was supported by a 45-percent increase in foreign direct investment and the recovery of donor lending flows after reengagement with the Malagasy authorities. These inflows supported an overall improvement in the external position, which allowed the CBM to accumulate international reserves, which rose from US$778 million at end-2014 to US$831 million at end-2015.

16. **Madagascar officially maintains a flexible exchange rate.** Central bank interventions have typically sought to smooth large exchange rate fluctuations and meet foreign reserve targets. Concerns relating to a potential depreciation of the Ariary in 2015 induced the CBM to engage in buy-back operations, which have been discontinued since September 2015, allowing the Ariary to adjust and be better aligned with market rates. This has also supported the accumulation of central bank foreign exchange reserves, up from US$831 million at end 2015 to US$860 million by July 2016. The CBM has also been taking steps to strengthen the monetary policy framework through improved liquidity management and reforms to strengthen the operational framework for monetary policy implementation. This includes the publication of quarterly T-bill auction calendars, the addition of central bank deposit auctions to the list of acceptable collateral, and a revised central bank act[6] that reduces the ceiling on statutory advances to the budget and strengthens the corporate governance of the bank.

Table 3: Balance of Payments (BOP) financing requirements and sources (in million US$)

	2015	2016	2017	2018	2019
	Prel. Est.	Projections			
Total financing requirements	859	1,003	1,365	1,365	1,416
Current account deficit	186	158	386	459	491
Net repayment of private sector debt	173	166	167	159	157
Repayment of government debt	39	70	73	78	94
Gross reserves accumulation (+ = increase)	90	141	114	110	121
IMF repayments	17	15	12	8	4
Other (inc. unrepatriated export revenues)	354	454	614	550	549
Available financing	859	1,002	1,321	1,255	1,136
Foreign direct and portfolio investment	436	482	527	576	604
Budgetary support	134	112	70	70	25
Project support	246	364	635	520	418
Project grants	130	195	263	162	159
Project drawings	116	169	371	358	259
IMF: RCF and ECF arrangement	43	44	89	89	89
External financing gap	0	0	44	110	280

[6] Submitted to parliament in June 2016.

Source: Central Bank of Madagascar and IMF staff projections (October 2016)

17. **The Malagasy financial sector, particularly the banking sector, has shown a remarkable resilience in times of crisis, but very limited progress has been made in terms of financial deepening and inclusion.** The banking sector is limited in both scale and scope with a high sector concentration and a narrow product offering: as such it is not in a position to support the investment required to generate the economic growth necessary to pull the country out of the fragility trap. Banks have been traditionally risk averse in their lending practices and favored a business model based on charging high real interest rates and fees on loans to a limited clientele. Financial soundness indicators show an underlying robustness of the banking sector with a solid capital adequacy and high profitability. The capital adequacy ratio is high (i.e. around 12.3 percent in March 2016, well above the required minimum of 8 percent), although declining recently in the context of relatively rapid credit growth. Banks are highly profitable, mostly due to high spreads between loan and deposit rates and a comfortable fee income. Liquidity in aggregate has been ample at most times but unevenly distributed, with the larger banks holding most of the excess reserves, and subject to strong seasonality. Non-performing loan ratio remains elevated (around 10 percent at March 2016).

18. **Although the banking system has withstood recent shocks, it is still exposed to substantial risk and providing access to finance to only a small fraction of the population.** Although the financial sector maintained stability through the political crisis, external stress tests conducted as part of the Financial Sector Assessment Framework (FSAP, 2015) highlight significant risks related to concentration, vulnerability to macroeconomic volatility and a weak institutional framework. The banking sector portfolio is concentrated in the government and in a few large firms. Given the difficulty in enforcing creditor rights and realizing collateral, default rates are relatively high. Financial sector supervision is insufficiently risk based. In addition, the FSAP noted that the level of financial inclusion is low. Domestic deposits and credit to the private sector have not grown significantly since 2005. Less than 9 percent of the adult population has an account with a financial institution, much lower than the averages for SSA and in low-income countries. Long-term financing is largely unavailable. The microfinance sector’s assets stand at 1.5 percent of GDP and is constrained by weak governance and profitability.

2.1 MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

19. **The pace of economic recovery is expected to accelerate gradually along with the implementation of the NDP**. Contributing factors to accelerated growth are recovery of agriculture as the sector recovers from recent weather shocks, and gradual pick-up in commodity prices supporting prospects in the mining sector. An expected recovery in the garment sector (export processing) will also support growth with the resumption of the country’s eligibility to the African Growth and Opportunities Act (AGOA). Construction and public works linked to preparations for the Francophonie and COMESA summits, which Madagascar will host in late 2016, will add a further boost. This growth outlook is subject to risk from weather-related shocks and political uncertainty or tensions.

20. **The outlook for the external sector is positive with a gradually increasing projected surplus in the balance of payments, which would allow the CBM to continue building up international reserves**. Commodity prices are projected to begin recovering from 2017, which will boost mining exports. The prospects for AGOA-linked exports are also a bright spot in the forecast, and the tourism sector is expected to recover as the rehabilitation of Air Madagascar progresses. Imports of capital goods are likely to increase when investments pick up, which are expected to be offset by a higher inflow of external financing. Central bank reserves, which stood at US$831 million by end 2015 (equivalent to 2.9 months of import cover), are expect to increase gradually but steadily to reach 3.6 months of import cover by 2019.

21. **The authorities have committed to strengthen fiscal policy through a focus on revenue mobilization, expenditure savings and a more sustainable arrears management strategy.** The revised budget for 2016 sets these objectives in motion by presenting measures to raise the revenue target to 11 percent of GDP (from 10.4 in 2015) and realize savings in the current budget. These measures, together with support from donor financing, will increase the investment budget from 3.5 percent of GDP in 2015 to 5.3 percent in 2016, the highest level since 2008. This trajectory is set to continue in the medium term. Revenues are expected to increase by 0.5 percent of GDP per year to reach 12 percent of GDP in 2019. The public sector wage bill is expected to stabilize at around 5.5 percent of GDP whilst subsidy and state owned enterprise reforms reduce the cost of transfers. Air Madagascar is expected to turn in operational profits in 2017 thanks to its ongoing restructuring (with World Bank assistance[7]). The government is committed to containing transfers to JIRAMA by reducing its losses through strengthened management, the introduction of smart meters, and rehabilitating its aging infrastructure (with World Bank assistance). The authorities have also increased electricity tariffs by 15 percent in 2016 in order to improve cost recovery[8]. The subsidies on the pump price of fuel were removed as government began adjusting prices on a monthly basis to reflect market movements beginning in March 2016 (with World Bank assistance). The cleanup of the civil service roster continues, and the preparations for an overhaul of the civil service management system are underway with assistance from the European Union.

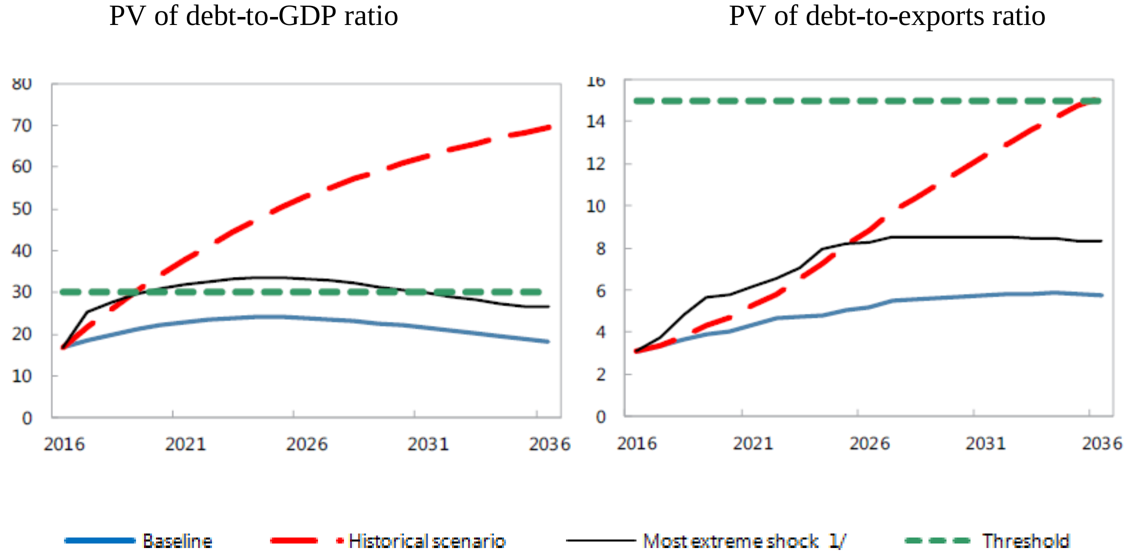
22. **The fiscal adjustment reform agenda is critical to the authorities' goals of increasing investment and growth, but is subject to risks.** The primary deficit is expected to shrink to 0.2 percent of GDP by 2018, placing public finances on a better trajectory. But this outlook is fragile and subject to risk. Efforts to strengthen revenue mobilization will have to be vigorous in order to counteract expected losses as Madagascar pursues trade integration through COMESA and its trade agreement with the European Union. Slow growth and progress in revenue reforms would make this difficult. Spending pressures in the near term are expected to mount as Madagascar hosts the summit of the Francophonie in November 2016, and may augment in the medium term as the run-up to the 2018 election cycle approaches.

23. **The authorities' investment ambitions are also subject to financing risks**. The projected fiscal and external financing gaps consist mainly of unidentified external support (budget and project support – including project loans) to fund the projected acceleration in domestic and external investment. Expected increases in the volume of donor support in the post-reengagement era, especially as Madagascar builds momentum in implementing the NDP, are expected to finance this gap. Potential shortfalls in these flows would be offset by a slower pace of growth in the public investment program.

24. **Madagascar's risk of debt distress remained "moderate" as of the joint IMF-WB debt sustainability analysis (DSA) for 2016**. The public debt to GDP ratio stood at 41percent at end-2015, with the majority of external debt being concessional. The DSA found that Madagascar's debt levels are sustainable, although stress tests found that the outlook is vulnerable to weak fiscal revenue mobilization, exchange rate shocks, and contingent liabilities from state owned enterprises (Figure 3). Debt management capacity to manage these risks has been enhanced steadily through training and technical assistance. The implementing decrees for the law on public debt (2014) have been issued[9] and the debt management medium term strategy was published in December 2015. Madagascar's financing needs will continue to be significant in the medium term. Ensuring debt risks remain contained while the country's development needs are addressed will require that loan-funded expenditures are strategic, are appraised, and are consistent with a prudent debt management strategy.

[7] Technical assistance is being provided through the World Bank Integrated Growth Poles project in Madagascar.
[8] Cost recovery rate is at 60 percent.
[9] With support from the Madagascar Resilience DPO (Credit No. 5752-MG).

Figure 3: Present Value (PV) of debt to export and GDP, 2016–2036[10]



Source: Joint World Bank-IMF DSA, 2016.

25. **Overall, Madagascar's macroeconomic policy framework is adequate for the proposed operation**. This assessment is based on the established track record in implementing reforms to strengthening macroeconomic management since reengagement with the international community in 2014. The authorities achieved satisfactory performance under two IMF RCF programs and a six month staff monitoring program between 2014 and 2016. A follow-up ECF program has been secured which is expected to support macroeconomic management over the next three years. The government remains committed to prudent monetary policy. Although fiscal risks are considerable, measures to place the fiscal position on a sustainable trajectory are underway, with support from several technical assistances provided by the World Bank and the other partners. Low revenues and costly transfers are two of the main sources of fiscal imbalance, and are core areas of focus for this DPF and the IMF ECF. Remaining risks include slippage in politically sensitive reforms such as electricity and flexible fuel pricing, resistance from vested interests and delays in economic recovery if recently restored political stability is interrupted. The assessment of the macroeconomic outlook in this operation is aligned with that under the IMF's ECF program.

2.2 IMF RELATIONS

26. **The IMF Board approved a three-year ECF for Madagascar in the amount of SDR 220 in July 2016.** Satisfactory performance under a six-month staff monitored program and two RCF programs previously paved the way for the ECF. The program aims at reinforcing macroeconomic stability and promoting sustainable and inclusive growth. Its main areas of focus are: (i) promoting robust and inclusive growth; (ii) expanding fiscal space for investment and social spending; (iii) improving governance; and (iv) building capacity to support macroeconomic policy implementation and financial sector development. The World Bank maintains a close working relationship with the IMF, with regular collaboration across policy issues between the two institutions.

[10] The most extreme stress test is the test that yields the highest ratio on or before 2024. In both cases it corresponds to a non-debt flows shock.

3. THE GOVERNMENT'S PROGRAM

27. **The government's program in the period between 2015 and 2019 is outlined in the NDP** endorsed by the Cabinet at end-2014 in order to reach "development through inclusive and sustainable growth, taking into account the spatial dimension". The document recognizes the need to achieve short-term priority actions and structural reforms in response to the country's fragility and persistent poverty.

28. **The NDP has five strategic pillars:**

i. Governance, rule of law, security, decentralization, democracy and national solidarity,
ii. Macroeconomic stability preservation and development support,
iii. Inclusive growth and territorial anchorage of development,
iv. Adequate human capital for the development process, and
v. Preserving natural capital and enhancement of disaster risk resilience.

29. **The government has started to implement the NDP and has developed sectoral strategies, including ones covering the sectors supported by this operation.** A new public financial management (PFM) reform strategy is being developed for the period 2016-2019 and is planned to be approved by Cabinet by December 2016. The objective is to consolidate the reforms in PFM management, strengthen their efficiency and facilitate execution monitoring. This strategy follows the implementation of the interim PFM strategy in 2014-2015 and addresses more structural reforms related to revenue management, public investment management, arrears clearance, and public private partnership frameworks.

30. **The Letter of New Energy Policy of Madagascar (NEP) covering the 2015-2019 period targets to increase access to electricity from 14 percent in 2010 to 70 percent of households in 2030.** The NEP is oriented along five priority axes: (i) valorization of natural capital and environment preservation; (ii) access to sustainable energy for all; (iii) ensuring security and independence in energy for the country; (iv) adaptation and enhancement of the regulatory, institutional, and business environment framework; and (v) securing financing of energy needs.

31. **The fiscal spaces generated by the reforms in these strategies should help the government in financing its policies in the social sectors**. In 2015, the government adopted the National Policy for Social Protection with the goal of reducing the number of population living below extreme poverty by 15 percent in 2030. The policy lays out the government's ambitions in different facets of social sectors including the expansion of the coverage of social safety nets, improvement in the access to basic social services (basic education, basic health services, water and sanitation and housings), protection of vulnerable people, and extension of contributory schemes to people living in remote areas and to those working in the informal sector.

4. THE PROPOSED OPERATION

4.1 LINK TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION

32. **The program development objectives of the proposed operation are to strengthen Madagascar's fiscal framework and enhance the environment for investment.** The proposed operation is the first in a series of two programmatic operations aimed at accompanying the government's efforts to accelerate Madagascar's recovery. It supports the "macroeconomic stability" pillar of the government's NDP most directly, and the "inclusive growth" pillar indirectly. The two pillars were selected as the priority foundations for overcoming the country's main challenges to reducing poverty. To conduct appropriate pro-poor policies, economic growth and fiscal space for the government are necessary. The other three pillars, "governance" "human capital development" and "natural resources and resilience against catastrophes" are

supported by complementary investment and technical assistance operations, and possibly by a second series of development policy operation focused on inclusive and resilient growth.

33. **The program focuses on two pressing constraints for implementing the NDP: limited fiscal space for investment and a weak environment for growth.** The Madagascar Systematic Country Diagnostic (SCD), disclosed on August 25, 2015 and the NDP both highlight a large infrastructure gap and a weak business environment as important constraints to growth. Higher investment will be necessary to accelerate growth. However, Madagascar's government raises too few own resources to increase investments substantially, and relies on external aid. Meanwhile, the limited revenue base has been increasingly absorbed by growing subsidy and transfer needs to inefficient state owned enterprises, fuel subsidies, and the public pension schemes. The prospects for growth are squeezed further by a weak environment for the private sector. The private sector, which had made the bulk of investments in the past, has been affected negatively by years of political instability and uncertainty. Hence, this DPF is built around two pillars. The first pillar seeks to strengthen the fiscal framework by mobilizing revenues, lowering the cost of transfers and improving public investment management. The second pillar aims to enhance the environment for investment by supporting better management in the electricity sector, sound commercial justice and a stable financial sector. This package of reforms is expected to be complimented by a planned second DPO series for Madagascar that will focus on structural reforms in key sectors.

34. **Governance and transparency, key constraints raised by the SCD, are mainstreamed through the reform program.** The SCD highlighted Madagascar's weak governance, vested interests, and low transparency as important contributors to fragility and low growth. This DPF is cognizant of these constraints and seeks to mainstream measures that contribute in addressing them through the reform program. Transparency and reporting are strengthened by instituting the publication of an annual tax expenditure statement to disclose, and better manage the volume of exemptions awarded by the government. Similarly, the quarterly publication of the cost of electricity supplied to JIRAMA and the adoption of standard power purchase agreements will increase transparency in the electricity sector. Commercial justice reforms seek to tackle corruption in the court system. The program also supports better governance in the management of public finances through strengthened audit (with the pension reforms) and tighter procurement controls (with the electricity reforms).

35. **This operation builds on the lessons emerging from previous DPOs.** The Reengagement DPO, approved on December 18, 2014, focused on politically feasible reforms that can build a momentum for future changes, as recommended by *World Development Report (2011), Conflict, Security and Development* and an Independent Evaluation Group (IEG) report on engaging with fragile states.[11] The scope and complexity of the Reengagement DPO were kept modest and in line with a realistic assessment of the political economy constraints. It focused on improving transparency, better debt and arrears management, and encouraging an increase in fiscal space for development spending. The Resilience DPO made further advances in transparency and fiscal management by strengthening budget reporting and tightening payroll management for widening fiscal space. This operation draws on the key lessons learnt from the previous DPOs, including the need to design a reform program supported by technical assistance, and project support where needed, to balance an ambitious program with capacity constraints. The program also draws on lessons learnt around the need to maintain coordinated policy dialogue, and the importance of integrating governance and transparency in the agenda.

36. **This DPF series builds on the momentum in advancing Madagascar's development agenda and will deepen results by taking a programmatic approach.** It continues to support the expansion of fiscal space to widen the scope for public investment and service delivery. To achieve this, it introduces a focus

[11] *World Bank Group Assistance to Low-Income Fragile and Conflict-Affected States: An IEG Evaluation* (2013).

on mobilizing revenues and tackling the large budgetary cost of transfers. It will also support reforms to strengthen public investment management. Boosting private investment is likewise a key pillar of this operation through a series of reforms targeted at enhancing the environment for investment and growth. These include a focus on performance in the electricity sector, reforming commercial justice and promoting a stable banking sector. Lastly, transparency continues to be a priority under this DPF as better reporting and disclosure are mainstreamed through the reform program.

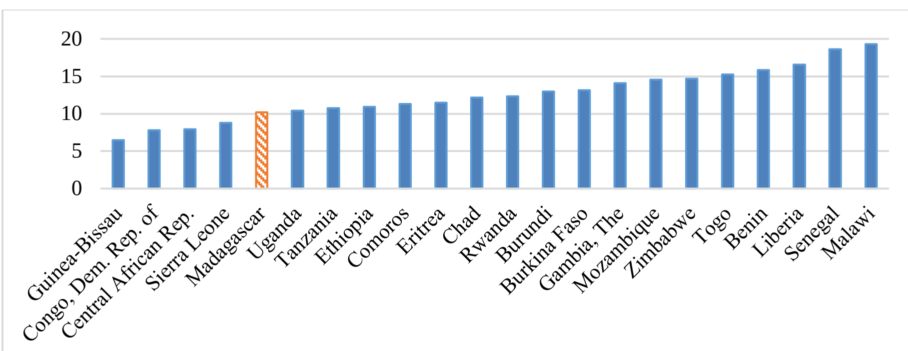
4.2 PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS

Pillar A: Strengthening the fiscal framework

Increasing tax revenues

37. **Rationale**. Weak revenue mobilization is one of the main challenges facing the Government of Madagascar. Poor revenue administration and widespread evasion, especially through customs, have placed the revenue effort well below the average for low income and fragile countries (Figure 4). Customs authorities collect almost 50 percent of tax revenues. In 2014 and 2015, the administration granted custom exemptions equivalent to 11 percent of tax revenues, mostly under special regimes such as the Large Mining Laws and Export Processing Zones. Ad hoc exemptions are also sizeable, and combined with the limited capacity in revenue administration, are an easy-entry point for exemption abuse and false declarations. An analysis of customs mirror data[12] estimates the losses related to undervaluation and misclassification of imports to be equivalent to 30 percent of total non-oil revenues collected by customs in 2014. This first operation in the series focuses on customs reforms given the high potential of increasing revenues from fighting fraud at customs and the need to stabilize revenue in light of forthcoming pressures on customs revenue from trade integration processes.[13] The focus also reflects the higher readiness of customs authorities which has been able to develop a detailed action plan of reforms based on data availability and advanced preparedness to reform. Reforms on tax and customs administrations are benefitting from technical assistance by the World Bank and the IMF.

Figure 4: Madagascar's tax effort in regional comparison (% of GDP - average 2004-13)



Source: IMF (World Economic Outlook database), (August 2016)

38. **Reforms**. In order to strengthen revenue collections at customs and narrow tax leakages, the customs administration revised the customs code and introduced an expedited customs clearance process based on objective measures for large importers (prior action). The revision of the Custom Codes and the *Arrêté*

[12] World Bank (2016)
[13] Mainly through Madagascar's Economic Partnership Agreement with the European Union and its membership of the Common Market for Eastern and Southern Africa.

d'application sur le régime d'exonérations des droits et taxes à l'importation aim to specify the implementation conditions of exemptions in order to mitigate the risk of abuse and delimit the exemptible items [14]. The expedited customs clearance, a new risk-based screening procedure, requires the administration to monitor import companies closely and to screen them based on their risk profile in line with international good practices for customs administration. It is a measure aimed at fast-tracking processing for low risk importers with a good track record, and to free up capacity to step up ex-ante controls of high risk consignments. The eligibility to the expedited clearance process is measured based on six criteria related to the operator's implication in tax litigation (magnitude and frequency), tax settlement (share of outstanding and celerity of payment), and share of forward declaration and the speed of withdrawal of goods from customs warehouse. The customs administration has also rolled-out performance based contracts for customs agents in the port of Toamasina[15] to induce improved efficiency and stringency in the application of the control and inspection procedures (prior action). The contracts provide incentives for inspectors to clamp down on fraud and specifies transparent sanction mechanisms in cases of non-performance.

- **Prior action 1:** The Recipient has, through its Ministry of Finance and Budget, issued an *Arrêté portant exonération des droits et taxes à l'importation* that restricts the scope of the customs exemption regime in the Customs Code dated May 4, 2016 (N° 10416/2016/MFB/SG/DGD).
- **Prior action 2:** The Recipient has, through two decisions of its General Directorate of Customs dated November 6, 2015 and September 19, 2016 respectively: (a) adopted an expedited custom clearance process based on objective measures for large importers, and (b) established a practice of performance contracts for customs inspectors at the port of *Toamasina*.

39. **Trigger 1.** These DPF 1 prior actions will be followed by reforms to further tighten the management of the exemption regime and increasing its transparency by commencing the publication of the first annual tax expenditure statement by the Ministry of Finance and Budget (MFB). This reform will apply to both customs and other tax categories. Overall, tax expenditures were estimated at 2.9 percent of GDP in 2013. In addition to the inventory of existing tax expenditure, the report would include an evaluation of the achievement of the intended social and economic impacts of these measures.

40. **Results**. The revenue management reforms supported by this DPF series are expected to contribute to the Government's overall objective of increasing revenue effort by 0.5 percent of GPD per year, with support from the IMF ECF program. The World Bank public sector modernization project (P150116) also supports the achievement of this objective by providing technical assistance to the Customs and the Tax administration, including building the tax administration's capacity and tightening the management of tax expenditures. The IMF also provides technical assistance on Tax and Customs administration.

Reducing the cost of non-targeted expenditures

41. **Rationale**. Sizeable allocations to transfers and subsidies has emerged as a characteristic of the Madagascan budget in recent years, setting significant demands on a strained budget. At 3.4 percent of GDP in 2015, transfers and subsidies represent almost 30 percent of current expenditure. This trend is

[14] These exemptions are related to: grants to officials and decentralized territorial collectivities, international conventions ratified by Madagascar, provisions of *Accord de Florence* and Nairobi protocols, bilateral treaties, imports by some Non-Governmental Organizations, cargos to Red Cross, to hospitals, to charity entities, and to organisms fighting against major endemic diseases, non-commercial cargos, urgency aids, imports under specific legislations, decision of the Council of Government and reimport.
[15] All the fifteen inspectors of the port of Toamasina account for approximately 30 percent of total fiscal revenues. There is a plan to extend those contracts to other ports or customs offices.

largely attributable to structural inefficiencies in expenditure management. The costs of (i) administered fuel prices; (ii) a mismanaged civil service pension program; and (iii) transfers to inefficient state owned enterprises (SOEs) factor heavily amongst these (Figure 5).

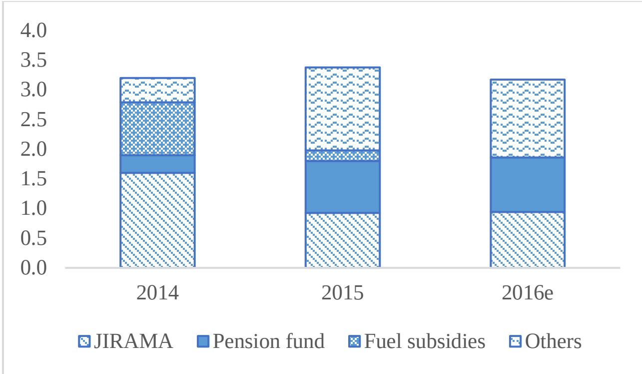
(i) Fuel subsidies: Madagascar adopted a subsidy mechanism for fuel prices at the pump after setting ceilings on the pump prices of gasoline, kerosene and diesel in 2010. The mechanism, which compensated suppliers for the difference between their costs and fixed fuel prices at the pump, exposed the budget to significant outlays. Reference prices have generally been higher than pump prices, causing fuel subsidies to reach an average of 1.2 percent of GDP in 2013 and 2014. Fuel subsidies quickly became a fiscal burden that the government could ill afford, and has resulted in the accumulation of arrears to suppliers. Favorable developments in international oil prices and the exchange rate facilitated the reduction of subsidies to 0.2 percent of GDP in 2015, and the elimination of pump price subsidies since November 2015. These developments paved the way for introducing the reform on setting pump prices starting in March 2016.

(ii) Pensions: Madagascar allocates significant resources to its two civil service pension schemes. The schemes[16] are financed on a pay-as-you go basis, where contributions from current employees and employers are used to pay benefits of existing pensioners, and deficits, if any, are covered by the state budget. The schemes have been in deficit for several years and have been topped up with an increasing budget allocation, reaching 0.9 percent of GDP in 2015 (or approximately 8 percent of current expenditure). Weak fiduciary controls in the management of the scheme are contributing to higher costs. The database of pension beneficiaries is outdated and initial works on a census of pensioners revealed that 10 percent of the register were fraudulent beneficiaries and 20 percent were missing vital information such as the date of birth of the individual. The first step in the cleaning-up of pensioners' registry allowed the government to detect 8534 irregular beneficiaries. Their removal from the list resulted in savings amounting to MGA12.8 billion (US$ 4 million, equivalent to 5 percent of the annual transfer to the pension schemes and 0.04 percent of GDP). Looking ahead, failure to adjust the design of the schemes[17], as their costs balloon, may place the funds in an unsustainable position.

(iii) SOEs: Transfers to SOEs are dominated by allocations that subsidize the loss making electricity utility, JIRAMA. Reforms to improve the performance of this company and to reduce the subsidies are underway and are supported by the second pillar of this DPF.

[16] The first one is the *Caisse de Retraite Civiles et Militaires* which covers career civil servants and the military, and the second one is the *Caisse de Prévoyance et de Retraite* which covers contractual government employees.
[17] Such as the retirement age, contribution rates, or the salary linked basis for setting pension levels.

Figure 5: Size of transfers and subsidies (% of GDP)



Source: Ministry of Finance and Budget (September 2016)

42. **Reforms**. The authorities recognize the urgency of downsizing transfers and subsidies as they seek to widen the space for social spending and investment. The government transitioned to a flexible fuel pricing mechanism, which allows fuel prices at the pump to follow market price movements, eliminating the need for budget subsidies (prior action). The authorities are also seeking to strengthen management of the public pension program to ensure its sustainability and limit its costs to the budget. A physical control of pension beneficiaries was launched to identify and remove "ghost pensioners" from the roster of beneficiaries, starting with the main urban centers (prior action). This step is a prerequisite for the deeper reform of the pension schemes[18] identified through World Bank analysis[19].

- **Prior action 3:** The Recipient has through its Ministry of Energy and Hydrocarbons, issued an *Arrêté relative au mécanisme d'ajustement automatique des prix maxima affichés à la pompe,* that establishes an automatic adjustment mechanism of fuel prices at retail locations, dated July 1, 2016 (N°14176/2016).
- **Prior action 4:** The Recipient has completed the verification of pension beneficiaries in the large urban centers to remove ineligible beneficiaries from the Pension Register.

43. **Trigger 2.** In order to further strengthen the pricing mechanism, the government will conduct a review of fuel pricing structures and strengthen the underlying legal framework. The existing legal framework stipulates a regime of liberalized pricing mechanism and a regulatory agency (*Office Malgache des Hydrocarbures)* is tasked with monitoring fair competition in the oil market. A desk study of the current price structure revealed that some components of the structure are on the high side, suggesting lack of competition.

44. **Trigger 3.** In order to complete the cleaning-up of pension beneficiaries' roster, the government will complete the verification of pension beneficiaries in the remaining territories.

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[18] The pension reform agenda includes the merging of the two pension schemes, the postponement of the retirement age, increase in contribution rates, and setting a salary-linked basis for pension levels. These are to be complemented in the longer term by reform of the private sector pension system which is managed by a state-owned entity.
[19] Madagascar: Long-term projections of the civil service pension scheme (2015).

45. **Results**. The fiscal management reforms supported by this DPF series are expected to contribute to the government's objective of reducing non-priority expenditures and increasing the share of priority spending[20] as more resources become available. This programmatic DPO will track spending on priority areas, an approach that is aligned with the quantitative performance criteria under the IMF's ECF program. The achievement of these results are supported by an ongoing World Bank technical assistance (TA) on fuel subsidies removal (P153084) which aims to advise the government on the definition of the pricing mechanism, an investment project financing (IPF) on Social Safety nets (P149323) helping the government in identifying reforms related to pension and increasing the access of extremely poor households to safety net services, and an IPF on the energy sector (P151785). The IMF has provided TA on fuel subsidies in 2014. Since the beginning of the cleaning up of the pensioners' register in November 2015 and the implementation of the mechanism of automatic adjustment of pump prices in March 2016, the government has managed to save up to 0.4 percent of GDP. This amount will accrue as the government pursues the reform which will contribute to achieve its objective of reducing the share of non-priority spending.

Strengthening priority spending for investment

46. **The second operation in this series will include reforms to strengthen public investment management with a focus on the framework for Public Private Partnership (PPP) and the mechanisms for appraising public investment projects.** The placement of these reforms in the latter part of this series partly reflects the nascent nature of this reform agenda which recognizes the need for impact and value for money in the public investment program and is complementary to the focus on expanding fiscal space through revenue mobilizations and efficiency gains in spending. The law on PPP[21], adopted in February 2016 lays out the legal framework of PPP in Madagascar and requires the adoption of implementing decrees to be fully effective. Although the legal framework is not yet complete, the government has already engaged in PPP contracts[22]. Hence, there is a need to reinforce the governance framework to manage the potential fiscal risks associated with these projects.

47. **Diagnostic work has already been undertaken to identify areas of support in public investment management, which the World Bank is already responding to through tailored technical assistance.** The first Public Investment Management (PIM) Assessment for Madagascar was completed in August 2016. The assessment stresses the weakness of public investment management institutions and highlights the importance of defining the institutional framework for PIM, including strengthening project appraisal methodology and procedures. Within this background, the World Bank has started providing assistance to the authorities by advising the government on the coordination of the institutions in charge of public investment management, on the consolidation the dispersed data on public investment, and on the preparation of an Excel-based tool which will allow the government to identify priority projects based on priorities identified under the NDP.

48. **Trigger 4.** The government will adopt the implementing decrees related to procedures and institutions for the PPP law.

49. **Trigger 5.** The Ministry of Finance will adopt procedures to strengthen the quality and objectivity of investment project appraisal and selection process for large projects.

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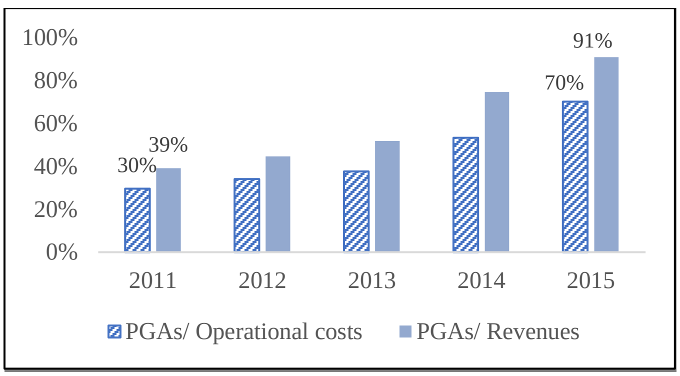
[20] Priority spending is defined as the sum of budget allocations to the Ministries of Health, Education, Population, and Water, excluding salaries and externally financed investment.
[21] The preparation was supported by technical assistance from the World Bank (P113971)
[22] The most important of which is the extension of the international airport in Ivato. The project budget is estimated at US$168 million which is equivalent to 1.7 percent of GDP.

Pillar B: Enhancing the environment for investment

Promoting the recovery of the electricity sector

50. **Rationale**. An underperforming electricity sector has long been one of main constraints to growth in Madagascar. The sector relies on costly diesel generated power and has suffered from years of mismanagement and underinvestment. Access to electricity supply is low, with frequent and unplanned load shedding and very low supply levels in rural areas. Recurrent blackouts and difficulties in accessing electricity are regularly cited amongst the top constraints by the private sector. Madagascar is ranked 188 out of 189 countries in the Doing Business indicator for access to electricity. It is hence one of the main obstacles to businesses, which suffer from low quality supply. In addition to this, JIRAMA (the electricity utility) continues to be a drain on the public treasury, with subsidies from the State budgeted at MGA 300 billion (US$93m or 5.8 percent of total spending) in 2016. A recent audit of existing power supply contracts revealed that one of the important sources of inefficiency in JIRAMA's expenditure in the past has been uncompetitive sourcing of power purchase agreements, generator rentals and fuel purchases (mostly diesel). Single-sourcing and non-transparent procurement procedures have committed the company to series of costly contracts that are contributing to its weak financial position. Expenditure on power purchase agreements and generator rentals alone amount to 70 percent of JIRAMA's operating costs and over 90 percent of revenues (Figure 6). The use of competitive procedures for such contracts is a legal requirement under the public procurement law. Additional scrutiny of JIRAMA contracting practices would increase value for money and contribute to improving its financial position.

Figure 6: Ratio of JIRAMA's Power Generation Agreements to Operational Costs and Revenue



Source: WB staff estimates

51. **Reforms**. JIRAMA's procurement contracts will be subject to ex ante controls by the *Commission Nationale des Marchés*[23], an entity of the procurement authority (prior action), which is tasked with overseeing all JIRAMA contract procurement. Previous regulation exempted State-Owned Enterprises from ex-ante control of competitive procurement. In light of a recent audit of JIRAMA's electricity supply contracts, the regulatory framework has been revised in order to cancel this "prerogative". In addition to this, JIRAMA has started to publish quarterly statistics on the cost of electricity per KWh for each existing power supply contract on its website[24] (prior action). The publication will reinforce transparency in the management of the company.

<u>Prior action 5:</u> The Recipient has, through its Ministiry of Finance and Budget, issued an *Arrêté précisant*

[23] Autorité de Régulation des Marchés Publics.
[24] There is a lag of three months between the end of each quarter and the date of publication.

le mode de computation des seuils des marchés publics et fixant leurs montants, that imposes *a priori* review of all JIRAMA procurement by the CNM in accordance with the provisions of the 2004 Public Procurement Code dated March 31, 2016 (N°7275 /2016/MFB).

Prior action 6: The Recipient has caused JIRAMA to begin publication of quarterly statistics on the cost of electricity per KWh for each existing power supply contract beginning with the first two quarters of 2016.

52. **Trigger 6:** To strengthen the fairness of its procurement, JIRAMA will adopt standard contracts for power generation agreements, starting next year. This would ensure equal treatment of all JIRAMA's suppliers, adequate protection of JIRAMA's interests, and an easy monitoring of unit cost of each contract. This is a necessary step to strengthen oversight over JIRAMA and manage the process for its recovery.

Results. The achievement of the result will be monitored by the share of power generation contracts awarded competitively. Transparent and well managed contracting and procurement processes will increase value for money and contribute to improving JIRAMA's financial position. The World Bank project on the energy sector supports JIRAMA and contributes to the achievement of this result by providing assistance in the drafting of the standard contracts. The IMF ECF program also monitors the procurement process applied by JIRAMA.

Strengthening commercial justice

53. **Rationale**. Madagascar ranks amongst the least performing countries in the region and worldwide on the Ease of Doing Business (164 out of 189 economies). Difficulties in accessing electricity, getting credit, and enforcing contracts are amongst the top contributors to this weak performance. More detailed diagnostics of the business environment in Madagascar have highlighted weaknesses in commercial justice, including significant delays in the treatment of commercial disputes and weak governance in the management of judicial affairs. In the recent past, commercial judges were often assigned based on their connections to the plaintiffs, a practice that has compromised the independence of the judiciary and led to significant delays for a number of major investment disputes. These practices have led to significant frustrations amongst existing investors, and has also sent a negative signal to prospective investors. Improving commercial justice is essential to regain the confidence of investors—whether small or large; domestic or foreign.

54. **Reforms**. To address these challenges, the authorities have set out a program to strengthen commercial justice which are supported by World Bank technical assistance. The reform includes the computerization[25] of the commercial chain to accelerate and increase the transparency of how commercial cases are treated, the establishment of dedicated clerks in order to reduce the period between a judge's decision and notification, the restriction in the number of allowed referrals, and the development of dashboards related to each stage of the commercial chain for easier monitoring. The authorities also imposed the random allocation of cases to magistrates presented before the Commercial Court of Antananarivo to enforce transparency and principles of equality before the law in implementing judicial proceedings (prior action).

Prior action 7: The Recipient has strengthened the judicial procedures for commercial cases by its Ministry of Justice issuing a *Circulaire pour l'Amélioration de la Justice commerciale et réduction des délais de traitement des dossiers commerciaux* that mandates the random allocation of commercial cases to magistrates dated May 25, 2016 (N°016-MJ/SG/DGAJER/DAJ/CIR/16).

[25] The final delivery of the computerization of the commercial chain is expected by end May 2017.

55. **Trigger 7.** In order to ensure the sustainability of the reforms, the *Code des Procédures Civiles* will be updated to integrate commercial justice reforms in the legal framework. The revision will include the random allocation of cases, the reduction and explicit limitation of processing delays, and the rationalization of the rules over the number of postponements

56. **Results**. The achievement of the reforms on commercial justice will be tracked through the effective implementation of the random allocation of cases and the number of days it takes to resolve a commercial dispute. It is expected that this process will be computerized from the end of May 2017. While the software is being developed, cases will be tracked manually by the commercial court. The manual system of randomization will be tracked via the monitoring and evaluation component of the Integrated Growth Poles and Corridor Project 2 (P113971). Specifically, a technical committee will establish, whether the principles of random allocation were respected and audit how cases were evaluated. These reforms are designed to reduce the discretionary powers of the magistrates and to combat corruption in Madagascar.

Promoting a stable financial sector

57. **Rationale.** Access to credit remains one of the most stringent constraints to business in Madagascar. The country is ranked 167 out of 189 countries on getting credit in the Doing Business indicators and the ratio of credit to the private sector to GDP at 11.8 percent of GDP is among the lowest in the Sub-Saharan Africa region. As the country strives to continue its economic recovery, the financial sector is expected to accompany the recovery process through increased access to credit while preserving financial stability. While the financial sector remains resilient, even during the political crisis, financial supervision is deemed very weak and is not able to proactively detect and address emerging risks. In fact, commercial bank supervision is too compliance oriented and onsite supervision activities are not as frequent as needed and are not prioritized based on risks. Financial institutions have considerably increased their business in recent years but have not been inspected for several years, some of them for more than 10 years and this situation poses a systemic risk. The recently completed Financial Sector Assessment Program highlighted the need to consider as the highest priority the launch of risk-based on-site supervision of banks as a pre-requisite for the development of the banking sector. It also recommended reforming the microfinance law to strengthen the stability of the sector and promote financial inclusion, since the population's low levels of access to banking services is partially compensated by access to microfinance.

58. **Reforms.** The CBM has conducted on-site inspections of the two largest banks (prior action) focusing on the quality of their large loan portfolios and on the soundness of the internal control procedures. The supervision is to be extended to the other largest banks and a third on-site supervision has been launched. This helps the CBM to strengthen its responsibilities with respect to financial sector soundness and to guarantee the adequate oversight on the stability of the sector.

Prior action 8: The Recipient has caused the Central Bank, through the *Commission de Supervision Bancaire et Financière (CSBF),* to complete on-site supervision of the two largest banks in its territory**.**

59. **Trigger 8.** This action is to be followed by measures aiming at reducing the risks to the financial sector from microfinance institutions. To this end, the government will submit the draft revised law on microfinance institutions to parliament. This will be accompanied by the adoption of related regulatory framework by the CBM that would establish, among others, adequate asset classification and provisioning practices.

60. **Results.** This reform will be monitored through risk based supervision. The ultimate result expected is enhanced operator confidence through a well-preserved stability of the financial sector.

Table 4: DPF Prior Actions and Analytical Underpinnings

Prior actions	Status	Analytical Underpinnings
Pillar A: Strengthening the fiscal framework		
PA#1. The Recipient has, through its Ministry of Finance and Budget, issued an *Arrêté portant exonération des droits et taxes à l'importation* that restricts the scope of the customs exemption regime in the Customs Code dated May 4, 2016 (N° 10416/2016/MFB/SG/DGD). PA#2. The Recipient has, through two decisions of its General Directorate of Customs dated November 6, 2015 and September 19, 2016 respectively: (a) adopted an expedited custom clearance process based on objective measures for large importers, and (b) established a practice of performance contracts for customs inspectors at the port of *Toamasina*.	Completed Completed	The World Bank policy note on custom data mirror analysis and the Tax Policy Diagnostic report by the IMF (2015) identified sizeable leakages through the abuse of some exemption regime and weaknesses on customs administration.
PA#3.The Recipient has through its Ministry of Energy and Hydrocarbons, issued an *Arrêté relative au mécanisme d'ajustement automatique des prix maxima affichés à la pompe*, that establishes an automatic adjustment mechanism of fuel prices at retail locations , dated July 1, 2016 (N°14176/2016).	Completed	Analysis of pump price subsidies (World Bank, 2014) and the IMF TA on pump price subsidies confirm that subsidies are regressive while being a heavy fiscal burden for the government.
PA# 4. The Recipient has completed the verification of pension beneficiaries in the large urban centers to remove ineligible beneficiaries from the Pension Register.	Completed	World Bank analysis of pension funds (2016) recommended updating the administrative database to permit evidence-based policy decisions.
Pillar B: Enhancing the environment for investment		

Prior actions	Status	Analytical Underpinnings
PA#5. The Recipient has, through its Ministiry of Finance and Budget, issued an *Arrêté précisant le mode de computation des seuils des marchés publics et fixant leurs montants*, that imposes *a priori* review of all JIRAMA procurement by the CNM in accordance with the provisions of the 2004 Public Procurement Code dated March 31, 2016 (N°7275 /2016/MFB).	Completed	Reengagement policy notes (2014), Doing Business Survey and Entrepreneurs Survey have found access to electricity to be one of the most significant constraints to private sector activities.
PA#6. The Recipient has caused JIRAMA to begin publication of quarterly statistics on the cost of electricity per KWh for each existing power supply contract beginning with the first two quarters of 2016.	Completed	The Doing Business report on Getting Electricity: measuring reliability, prices and transparency (2016) advocates that making tariffs readily available and providing advance notice of changes in tariffs can help businesses manage their costs.
PA#7. The Recipient has strengthened the judicial procedures for commercial cases by its Ministry of Justice issuing a *Circulaire pour l'Amélioration de la Justice commerciale et réduction des délais de traitement des dossiers commerciaux* that mandates the random allocation of commercial cases to magistrates dated May 25, 2016 (N°016-MJ/SG/DGAJER/DAJ/CIR/16). .	Completed	The Madagascar Doing Business assessments and the World Bank study of the commercial justice system both highlighted the difficulties in enforcing contracts and the importance of effective commercial justice for attracting private investment to Madagascar.
PA#8. The Recipient has caused the Central Bank, through the *Commission de Supervision Bancaire et Financière (CSBF),* to complete on-site supervision of the two largest banks in its territory**.**	Completed	The Reengagement policy notes (2014) and the Madagascar FSAP (2015) underline the deficiency in financial sector supervision in recent years and identify among the main priorities the adoption of a more proactive and risk-based supervision.

4.3 LINK TO CPF, OTHER BANK OPERATIONS AND THE WBG STRATEGY

61. **The SCD presented to the Board in August 2015 emphasized the need to be cognizant of the country's fragility, and working towards improved efficiency and transparency of public service delivery as a way of helping the country to turn around**. As almost 80 percent of the Malagasy population lives in extreme poverty, the SCD recommended concentrating on the first of the World Bank Group's twin goals of fighting extreme poverty (based on 2012 estimates), and consistent with the Africa Strategy, to work selectively and flexibly. The SCD underscored the importance of enlarging the fiscal space as a prerequisite, so that the government has the means of implementing policies and making public

investments. The efforts to enlarge fiscal space are underway, but they will take a few years to bear significant results. They are also likely to encounter strong resistance from vested interests, who have become accustomed to not complying with the tax obligations during the long political crisis. Thus, governance and transparency were identified as priorities in the SCD. The SCD also recognized the importance of tackling the problem of access to electricity, challenges related to increasing investments through PPP and effective public investments as a way of promoting private sector-led growth.

62. **The proposed DPF is an integral part of the World Bank's new Country Partnership Framework (CPF) for Madagascar**, which will operationalize the SCD's findings and recommendations. The CPF will be presented to the Executive Board of Directors in FY17 Q3, taking into account the increased financing package under the exceptional allocation regime for countries facing "Turn-around" situations.[26] The Turn-around facility enhances IDA financing to qualifying countries where fragility and conflict impose severe constraints on development, are confronted with a turn-around situation and are committed to reform.

63. **The proposed operation is designed to complement the investment and technical assistance projects that are ongoing or under preparation.** Its principal goal of strengthening the fiscal framework is complemented by the Public Sector Performance project (P150116), approved in 2016, which focuses on strengthening revenue mobilization by establishing a tax information management system and introducing performance contracts at the Tax and Customs Departments, public service delivery, and governance in general. In addition, the technical assistance provided through the Madagascar Pump Price Subsidy Removal TA (P154083) supports the government in the reforms of the fuel pricing mechanism; the Social Safety Net Project (P149323) assists the government in identifying the reforms related to pension schemes and the Support to strengthen Public Investment, Risk and Debt Management project (P156508) will accompany the government's effort in strengthening public investment management. The Energy Sector Operations and Governance Improvement project (P151785), approved in March 2016, seeks to improve the operational performance JIRAMA, and improve the reliability of electricity supply in the project area. It hence complements this operation. The Integrated Growth Pole project (P113971) and the Madagascar – Microfinance supervision project (P153761), which support the improvement of the investment climate, contribute to the objective of enhanced environment for growth.

64. **This operation will be complemented by a second programmatic DPO to be initiated this FY Q3.** The Inclusive Growth DPO will support longer term structural reforms with increased focus on rural development including agricultural productivity improvement, land titling reforms and access to financial services.

4.4 CONSULTATIONS AND COLLABORATION WITH DEVELOPMENT PARTNERS

65. **This operation supports the implementation of the NDP, which was prepared through an extensive consultative processes.** The Ministry of Economy and Plan led the work of a multidisciplinary team from 18 ministries in the formulation of the NDP under the supervision of the Steering Committee composed by the general secretaries from these ministries. During the preparation of the NDP, the authorities organized consultations in the capital and the regions with the participation of relevant stakeholders coming from sector ministries, civil society, academia, private sector representatives as well as development partners. Other reforms areas supported by this DPF also benefited from consultations. The diagnosis and identification of the commercial justice reforms involved working groups including representatives from different ministries, private sector professional groupings, and academics. The customs administration maintains exchanges with private operators on the implementation and evaluation

[26] See "Implementation Arrangements for Allocating IDA Resources to Countries Facing "Turn-Around" Situations. IDA, October 2013.

of expedited clearance process. In addition, some of the reforms are explicitly identified in the NDP, such as the strengthening of the PPP legal framework or the rejuvenation of state-owned companies such as JIRAMA.

66. **The proposed operation is part of a program of coordinated reform dialogue with other providers of budget support operation.** The *Cadre de Partenariat*, co-chaired by the MFB and the World Bank, provides a forum for collaboration among potential providers of budget support. The members are the African Development Bank (AfDB), France, the European Union, and the World Bank. The program is closely aligned with the IMF's recently approved ECF program. The AfDB's budget support for 2016 is focused on the energy sector and supplements the reform on JIRAMA supported by this operation. The complementarity of the different programs of the donors reflects the convergence of views on what are the priorities and feasible reforms for the country at this juncture.

5. OTHER DESIGN AND APPRAISAL ISSUES

5.1 POVERTY AND SOCIAL IMPACT

67. **The overall poverty and social impact of the policies supported by this DPO are positive**. The fiscal space that would result from the actions designed to improve fiscal revenue and improve expenditure composition are estimated to contribute to poverty reduction and enhance growth in the future by increasing the public resources that the government can reallocate toward pro-poor spending and investments. But given that 78 percent of the Malagasy population counts as extremely poor, some of the policies such as the removal of regressive subsidy will inevitably affect the "upper" poor. However, as more resources become available, the government will have the means to implement its social program to compensate for the loss including those laid out in the Social Protection National Policy and/or to increase the level of investment. In recent years, the government has already started to increase the budget allocation for investments in social sectors and complied with its commitment on the floor on social priority spending[27], which will continue to be tracked under the ECF program and this DPF series.

68. **The revenue measures pursued under the first DPO in the series are designed to narrow revenue leakages by focusing on improvements in tax administration.** The pension reforms will not affect legitimate beneficiaries and will contribute to promoting the financial sustainability of the schemes. Similarly, customs reforms are expected to generate further revenue through addressing exemptions, which are not expected to have a direct impact on the poor. A second DPO will complement the fiscal and governance measures supported by this operation, and will be more focused on structural long term measures toward inclusive growth such as agricultural development, land reform and financial inclusion.

69. **The measures related to the removal of the fuel subsidy is expected to increase the cost of living, with the burden largely falling on the wealthier.** On average, the elimination of fuel price subsidies is estimated to increase the cost of living by 0.3 percent. However, the estimated share of the total direct burden of fuel price increases is much higher for the top quintile, at 42 percent compared with 10 percent for the bottom quintile. Estimation of the indirect effects of a fuel price increase through higher food and public transportation costs mirror the data for direct effects, with the burden largely falling on the wealthier decile. It is estimated that the bottom quintile bears 7 percent of the indirect burden compared with 46 percent burden for the top quintile (IMF, 2014). Therefore, while the removal of generalized fuel subsidies will have an impact on the living conditions of all households, the subsidies are regressive.

[27]Under the staff-monitored program (SMP) program with the IMF, the government met the performance criteria related to the floor on social spending, defined as the primary budget allocation to the ministries of education, health, population and water.

70. **Some mitigating measures have been implemented by the government ahead of the transition to the automatic pricing adjustment.** In order to minimize the impact on the poor, the government distributed school kits to pupils at primary school (school year 2014-2015) and subsidized urban public transport (January 2015 to March 2016). An evaluation of these mitigating measures revealed that the distribution of school kits seems to have been effective in encouraging school enrolment by reducing the financial burden on the poorest parents although the government did not clearly communicate about the link between the removal of fuel subsidies and the operation. In 2016, the Government is expanding the distribution of school kits to pupils at primary schools and launched a monthly grant covering 11,000 pupils at first year of college. The government is also considering the introduction of a subsidy to urban and suburban public transporters, which could potentially benefit the poor disproportionately.[28] An assessment remains to be made to establish whether this subsidy will really benefit the poor or just bolster the profit margins of transportation companies.

71. **More broadly, as part of the NDP, the government is developing social programs targeting the poorest population.** The government, through the Ministry of Population, Social Protection and Promotion of Women and the "Intervention Fund for Development (FID)" and with support from the World Bank, has developed a program of safety nets for the poorest population. To date, about 50,000 people are covered by two programs: A Human Development (conditional) Cash Transfer Program, and a Productive Safety Net Program, both providing selected households with regular cash transfers over a three-year period against co-responsibilities related to children's regular school attendance of work requirements. In addition, due to the severe drought situation in the South of the country, the Government is setting up an emergency cash transfer program in the south. By December 2016, these three safety net programs are expected to reach 450,000 people in nine regions of the country. A further scale up to 650,000 people is planned for 2017.

72. **The prior action targeting the improvement of the procurement process of JIRAMA will not have any direct poverty and social impact, but progressive distributional indirect impacts is expected in the long run**. The intended impact is that JIRAMA secures advantageous contracts in power supply, which in turn should improve its finances and allow the State to reduce subsidies to the company. International evidence shows that improved financial soundness of the electricity provider would in the long run result in expansion of service and greater reliability of existing service. This could result in a more stable power provision for the private sector. In addition, electricity coverage is very low and excludes most of the poor[29]. Since electricity usage, and therefore explicit and implicit subsidies, are highly regressive, reduction of subsidies to JIRAMA would have progressive impacts.

73. **The prior actions on commercial justice and banking supervision complement the improvement in JIRAMA's electricity supply in enhancing the attractiveness of the business environment.** These measures address some of the most pressing constraints to operations and growth identified by formal entrepreneurs. Improving commercial justice would provide an equal playing field for private operators while a stable financial sector would translate into a solid financial sector able to accompany the economic growth. A more dynamic private sector would increase productive employment opportunities which would benefit the general population, including the poor.

[28] The announcement was made by the Ministry of Transport on Friday, October 7, 2016.
[29] Only 14 percent of the population had access to electricity in 2010, and new connections have been expanding at approximately 1 percentage point per year.

5.2 ENVIRONMENTAL ASPECTS

74. **The policy actions supported by the first DPF of this series are not likely to have significant positive or negative effects on the environment, forests, and natural resources.** The policies addressed by this operation focus on reforms aiming at improving the efficiency of the administration mostly in sectors unrelated to the environment, forests and natural resources and thus without any expected short-term direct or indirect environmental impact. Over the medium to long term, ongoing reforms in the electricity sector may contribute to JIRAMA changing its source of energy. This could have positive, neutral or negative effects depending on the source of energy selected. The World Bank will continue to work closely with JIRAMA to assess the environmental impact of the preferred sources of energy.

75. **The second DPO of this series is anticipated to include measures that strengthen public investment management, which may have an environmental impact.** Following a request from the government, the World Bank is supporting public investment management reforms to improve the appraisal and selection of large investment projects, including those financed through PPP arrangements and through the expected increased fiscal space. These measures will help to address years of under-investment in infrastructure. Some of these infrastructure projects could have an environmental impact. While it is hard to assess the nature of the environmental aspects of these projects at this time, it is worth noting that the Malagasy Environment Code requires that all investment projects private or public, that are likely to have an impact, prepare an Environmental and Social Impact Assessment (ESIA)[30]. Each ESIA must be approved by the Ministry of Environment, and thereafter published in the project area and the National Environment Office (NEO).

5.3 PFM, DISBURSEMENT AND AUDITING ASPECTS

76. **Addressing the fiduciary concerns and strengthening the government's public financial management have been the subjects of an ongoing dialogue and technical assistance** over the last decades. A series of reforms have been implemented in the areas of taxation, budgeting, treasury and cash management. Progress has been made in the area of budget management. The 2014 PEFA (Public Expenditure and Financial Accountability) self-assessment showed that the country has improved budget credibility regarding revenue forecasting. The General Government budget are published on the Ministry of Finance and Budget (MFB) website in a timely manner. In addition, the MFB initiated in 2015 the publication of a citizen budget, including in Malagasy language. The Resilience DPO (P153084) supported the improvement in budget transparency with the regular publication of Quarterly Budget Execution Reports on the MFB's website within a month of the end of the period, and in catching up with the production of annual consolidated account. Non-governmental organizations (NGO) are closely scrutinizing these publications and regularly shares their findings to the public. To improve the control of budget execution, the *Cour des Comptes* published its first report covering the year 2014 in May 2016. Moreover, the audited final accounts of the State Budget for the fiscal years from 2009 to 2012 were validated by the Parliament in 2015 and 2016, allowing the government to catch up over 5 years of delay.

77. **Challenges remain, however, in some areas**. The 2014 PEFA self-assessment indicates there has been no progress on budget credibility on expenditure execution side since the 2008 assessment. The gap between budgeted and executed expenditure exceeded on average 15 percent during the three years covered by the assessment (2010-2012). This finding has yet to be substantiated for the recent state of budget execution as the assessment covers years of crisis when the authorities voluntarily restricted expenditure for the sake of austerity in response to declining revenues. The situations have likely improved as more public resources became available. A new PEFA exercise is planned for 2016. Budget information is not

[30] See decree No. 2004-167 of 3 February 2004 on Development of Investment Compatibility with the Environment (MECIE).

exhaustive and includes only central government operations. The inventory of arrears incurred during the political transition has been challenging as some expenditures were executed out of normal budget procedures. The PFM reform strategy under preparation for the 2016-2019 period aims at addressing these challenges.

78. **Progress has been made in strengthening the safeguards framework at the CBM since the 2015 IMF safeguards assessment**. Governance arrangements and central bank autonomy are expected to be strengthened through the new Central Bank Act. The CBM has also reinforced its audit oversight and control environment, and is committed to undertake the necessary steps to implement International Financial Reporting Standards. However, the timeliness of audit completion and publication of audited financial statements needs further improvement. The functioning of the foreign exchange market has improved since the CBM discontinued buy-back operation in September 2016. The next IMF safeguards assessment is planned before the end of 2016, but the report is not expected to become available until 2017. The implementation of the recommendations of the 2015 IMF safeguards assessment is closely monitored by the IMF.

79. **The proposed grant will be disbursed following the standard IDA procedures for development policy operation**. A grant in the amount of SDR 46.6 million (US$65.0 million equivalent) will be made available upon effectiveness and, provided IDA is satisfied with the implementation of the development policy financing program and the appropriateness of the Recipient's macroeconomic policy framework, disbursed as a single tranche following the submission of an acceptable withdrawal application by the government. IDA will disburse the proceeds into a dedicated US dollar-denominated account designated by the Recipient that is part of the country's foreign exchange reserves account at the Central Bank of Madagascar. The dedicated account will be used exclusively for the proceeds of the DPF grant. The Recipient shall ensure that upon the deposit of the grant proceeds into said account, an equivalent amount is credited in the Recipient's budget management system, in a manner acceptable to IDA. The Recipient will report to IDA on the amounts deposited in the foreign-currency account and credited to the budget-management system within 30 days of the disbursement.

80. **The financial support provided under this operation is not intended to finance goods or services in the standard negative list**. If the proceeds of the grant are used for ineligible purposes as defined in the Financing Agreement, IDA will require the Recipient, promptly upon notice from IDA, to refund an amount equal to the amount of said payment to IDA. Amounts refunded to IDA upon such request shall be cancelled. At the request of the Association, an audit of the dedicated account will be carried out by the Recipient and the result of such audit will be furnished to the Association within four months of the request. A legally registered, private and independent audit company meeting appropriate international standards will be contracted to perform the audit, and in accordance with the Terms of Reference agreed upon with the Government of Madagascar. All audit costs will be borne by the Government of Madagascar.

5.4 MONITORING, EVALUATION AND ACCOUNTABILITY

81. **Progress on the results indicators will be monitored and evaluated jointly by the Recipient and the World Bank**. The project is coordinated by the Economic Council team of the Presidency which has an adequate capacity. As the main implementing agency, the MFB will coordinate with the Economic Council in the collection of the data needed for monitoring the progress of the indicators in close collaboration with the other interested ministries, the entity in charge of the regulation of public procurements (*Autorité de Régulation des Marchés Publics)* and CBM. The monitoring and evaluation will be conducted jointly by all members of the *Cadre de Partenariat* providing budget support this year.

82. **Grievance Redress**. Communities and individuals who believe that they are adversely affected by specific country policies supported as prior actions or tranche release conditions under a World Bank

Development Policy Operation may submit complaints to the responsible country authorities, appropriate local/national grievance redress mechanisms, or the World Bank's Grievance Redress Service (GRS). The GRS ensures that complaints received are promptly reviewed in order to address pertinent concerns. Affected communities and individuals may submit their complaint to the World Bank's independent Inspection Panel which determines whether harm occurred, or could occur, as a result of WB non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the World Bank's attention, and Bank Management has been given an opportunity to respond. For information on how to submit complaints to the World Bank's corporate GRS, please visit http://www.worldbank.org/GRS. For information on how to submit complaints to the World Bank Inspection Panel, please visit www.inspectionpanel.org.

6. SUMMARY OF RISKS AND MITIGATION

83. **The overall risk rating for the operation is 'substantial,' with four main sources of risk that are inter-connected and that could potentially jeopardize the expected outcomes and benefits of this operation**. The risks are (i) political and governance; (ii) macroeconomic; (iii) institutional capacity; and (iv) fiduciary. Measures to mitigate these risks are outlined below. The potential benefits of the proposed operation outweigh the residual risks and warrant IDA's assistance.

Risk categories	
1. Political and governance	High
2. Macroeconomic	Substantial
3. Sector strategies and policies	Moderate
4. Technical design of program	Moderate
5. Institutional capacity for implementation and sustainability	Substantial
6. Fiduciary	Substantial
7. Environment and social	Moderate
8. Stakeholders	Moderate
9. Others (i.e. vulnerability to weather-related shocks and natural disasters)	Moderate
Overall	Substantial

84. **Political tensions and weak governance present high risks to maintaining reform momentum**. The country has a deep rooted governance problem that had been exacerbated during the last crisis. There are a few reformers who are striving to improve governance to put the country on a stable growth path, and there are vested interests who prefer status quo. The proposed operation supports actions which could help the reformers, but it is possible that the vested interests find ways of subverting the longer term reform agenda. Some of the reforms needed, such as steps to contain losses at JIRAMA and discontinuing fuel subsidies, are predominantly pro-poor, but politically sensitive. The government may find it tempting to reverse them, if political tensions mount especially as the Presidential election approaches. If the reform efforts stall, unable to overcome the resistance or overwhelmed by political events, the development objectives would not be achieved. These risks are high and cannot be controlled completely. The operation seeks to mitigate them by being cognizant of recent political economy analysis and weaving measures to strengthen governance and transparency through the program. Through the DPF, the World Bank will coordinate with the IMF and other partners to maintain the reforms on the top of ongoing policy agenda. In addition, the World Bank Public Sector Performance project (P150116) will contribute to strengthening governance in Madagascar.

85. **Macroeconomic risk is also substantial, particularly in relation to fiscal management.** Insufficient tax revenues, large transfers to the SOEs, and unaffordable schedule for arrears clearance

constitute a macroeconomic risk, and a delay in economic recovery and aid disbursements will compound it. Increasing the fiscal space is one of the main goals of the proposed operation and of the public sector project approved in June 2016; it is also supported by technical assistance from the IMF. Reducing inefficiencies at JIRAMA, supported by this operation, would mitigate this risk. In addition, the government has entered into agreement with most of his creditors in order to stretch the arrears clearance schedule to match its ability to pay. The financial contribution provided by this operation will also reduce this risk directly.

86. **Fiduciary risks remain substantial despite the ongoing implementation of PFM reforms.** While there has been progress in implementing PFM reforms, the remaining fiduciary weaknesses are significant. They are partially mitigated by continued donor assistance in public financial management and public administration reforms, including the World Bank Public Sector Performance project.

87. **Institutional capacity is weak and represents a significant risk.** Weak capacity, particularly at the technical level, poses the risk that the actions supported by this program might not be implemented as successfully as expected or in the agreed timeframe, or that the capacity constraints prevent the attainment of the expected results. This operation mitigates these risks it in two ways. First, it seeks to attain the strongest possible actions needed to build the reform momentum without overwhelming the capacity of the post-crisis government. Second, it is complementary to other projects and technical assistance provided by IDA and development partners, which together constitute a more holistic support environment than one operation can offer.

88. **In addition, Madagascar's vulnerability to natural disasters and weather-related shocks represents a moderate and indirect risk to this operation.** Madagascar ranks among the countries most exposed to droughts, floods and cyclones. Severe natural hazards present threats to public health, food security, and the government's poverty reduction goals. The immediate necessity of responding to environmental shocks could draw scarce administrative resources away from the reform program and threaten its long-term continuity. This risk is mitigated by the ongoing dialogue on enhancing resilience to natural disasters, and support provided by the World Bank and other development partners to the government. For example, the World Bank is currently supporting the rehabilitation of cyclone and flood early warning systems and hydro meteorological station nationwide.

ANNEX 1: POLICY AND RESULTS MATRIX

Prior Actions and Triggers		Results (2019)
Prior Actions (2016)	**Triggers (2017)**	
Pillar A: Strengthening the fiscal framework		
1.1 Increasing tax revenues		
PA#1. The Recipient has, through its Ministry of Finance and Budget, issued an *Arrêté portant exonération des droits et taxes à l'importation* that restricts the scope of the customs exemption regime in the Customs Code dated May 4, 2016 (N° 10416/2016/MFB/SG/DGD). PA#2. The Recipient has, through two decisions of its General Directorate of Customs dated November 6, 2015 and September 19, 2016 respectively: (a) adopted an expedited custom clearance process based on objective measures for large importers, and (b) established a practice of performance contracts for customs inspectors at the port of *Toamasina*.	Trigger# 1: The Recipient, through its Ministry of Finance, has published the first annual tax expenditure statement.	Revenue effort increased Baseline: 10.4 percent of GDP (2015) Target: 12 percent of GDP (2019)
1.2 Reducing cost of non-targeted expenditures		
PA#3. The Recipient has through its Ministry of Energy and Hydrocarbons, issued an *Arrêté relative au mécanisme d'ajustement automatique des prix maxima affichés à la pompe*, that establishes an automatic adjustment mechanism of fuel prices at retail locations , dated July 1, 2016 (N°14176/2016). PA#4. The Recipient has completed the verification of pension beneficiaries in the large urban centers to remove ineligible beneficiaries from the Pension Register.	Trigger #2: The Recipient has conducted a review of fuel pricing structures and strengthened the underlying legal framework. Trigger #3: The Recipient has completed the verification of pension beneficiaries in the remaining territories.	Share of transfers in total expenditure Baseline: 22.5 percent (2015) Target: 15 percent (2019) Share of priority spending Baseline: 0.7 percent of GDP (2015) Target: 1.3 percent of GDP (2019)
1.3 Strengthening priority spending for investment		

Prior Actions and Triggers		Results (2019)
Prior Actions (2016)	**Triggers (2017)**	
	Trigger #4: The Recipient has adopted the implementing decrees related to procedures and institutions for the PPP law. Trigger #5: The Recipient has adopted procedures to strengthen the investment project appraisal and selection process for large projects.	Share of large investment projects subject to appraisal Baseline: 0 (2015) Target: 30 percent (2019)
Pillar B--- Enhancing the environment for investment		
2.1 Promoting the recovery of the electricity sector		
PA#5. The Recipient has, through its Ministry of Finance and Budget, issued an *Arrêté précisant le mode de computation des seuils des marchés publics et fixant leurs montants*, that imposes *a priori* review of all JIRAMA procurement by the CNM in accordance with the provisions of the 2004 Public Procurement Code dated March 31, 2016 (N°7275 /2016/MFB). PA#6. The Recipient has caused JIRAMA to begin publication of quarterly statistics on the cost of electricity per KWh for each existing power supply contract beginning with the first two quarters of 2016.	Trigger #6: JIRAMA has adopted standard contracts for power generation agreements.	Share of power generation contracts awarded competitively and published Baseline: 0 (2015) Target: 70 (2019)
2.2 Strengthening commercial justice		
PA#7. The Recipient has strengthened the judicial procedures for commercial cases by its Ministry of Justice issuing a *Circulaire pour l'Amélioration de la Justice commerciale et réduction des délais de traitement des dossiers commerciaux* that mandates the random allocation of commercial cases to magistrates dated May 25, 2016 (N°016-MJ/SG/DGAJER/DAJ/CIR/16).	Trigger #7: The *code des procedures civiles* has been updated to integrate commercial justice reforms in the legal framework.	Percentage of cases randomly allocated Baseline: 0 (2015); Target: 100 (2019) Number of days to resolve a commercial dispute Baseline: 871 (2015); Target: below 365 (2019)
2.3 Promoting a stable financial sector		

Prior Actions and Triggers		Results (2019)
Prior Actions (2016)	**Triggers (2017)**	
PA#8. The Recipient has caused the Central Bank, through the *Commission de Supervision Bancaire et Financière (CSBF)*, to complete on-site supervision of the two largest banks in its territory.	Trigger #8: The government has submitted the draft revised law on microfinance institutions to parliament.	Extent of risk based supervision Baseline: no risk based supervision (2015) Target: risk based supervision in place (2019)

ANNEX 2: LETTER OF DEVELOPMENT POLICY

Translated from the original French

MINISTRY OF FINANCE AND BUDGET

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Minister

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Antananarivo, September 29, 2016

Dr Jim Yong Kim

World Bank

1818 H Street NW, Washington DC

Mr. President,

Madagascar continues the implementation of the National Development Plan (NDP) and its Implementation Plan (*Plan de Mise en Oeuvre*) to reduce poverty and to establish an inclusive and sustainable development. The outline of the program of the Government, presented to the National Assembly and the Senate, set the objectives around three priorities, namely: (i) the strengthening of governance, the rule of law and the establishment of fair justice; (ii) the economic recovery through the establishment of a stable social and political environment, the preservation of macroeconomic stability and the restoration of an attractive business environment; and (iii) the expansion of the access to quality basic social services.

This letter reflects the Government's willingness to meet the challenges of our mid-term economic development by strengthening the performance of tax and customs revenue and by optimizing the allocation of resources toward the sectors with tangible impacts on the population (education, health, and infrastructure).

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During the past two years, social indicators have not improved despite the willingness of the Government to promote the mechanisms and systems of human capital valorization and social protection. With a Human Development Index as low as 0,510, Madagascar is ranked at 154 out of 188 countries in the 2015 Report on Human Development of the United Nations and missed the Millennium Development Goals at the end of 2015.

The economic recovery remains fragile in 2015 and the performances by sector are mitigated. It reflects cautious investments in economic activities by the operators as well as low supply. In addition, the volatility of the price of nickel and the cyclone-related damages in the first quarter of 2015 exacerbated the situation. Economic growth barely reached 3.1 percent compared to the targeted 5 percent in the National Development Plan. The inflation rate is estimated at 7.6 percent at the end of 2015.

The main economic and strategic directions of the State were aligned to the National Development Plan. The Government is decided to face the urgent economic and social challenges of the country with the support from technical and financial partners. The new agreement for Madagascar under the Extended Credit Facility (ECF), approved in July 2016 by the Board of Directors of the International Monetary Fund (IMF), confirms the determination to further support the investments in infrastructure, the expansion of access to education and health care, the implementation of reforms aimed at strengthening economic and financial governance.

Regarding public finances, the ratio of tax to GDP stood at 10.1 percent in 2015. It has decreased compared to the target set in the initial Finance Law, essentially as a result of the decline in the international price of oil and the volume of imports. The lack of dynamism of sectoral activities, the lack of measures to limit fraud and tax evasion and the limited capacity of the current information technology operating system are the main obstacles to the recovery of domestic resources.

Public expenditures are estimated at 15.1 percent of GDP in 2015. The social sectors (health, education, social protection) remain priorities despite the limited available resources to meet the needs of the State. The current expenditures and investment of the four social ministries (Ministry of Water, Ministry of National Education, Ministry of Public Health and Ministry of Population) will be increased to reach 1.3 percent of GDP in 2019. These expenditures are estimated at 0.7 and 0.8 percent of GDP in 2015 and 2016.

Economic growth is expected to accelerate to 4.1 percent by 2016 and 4.5 percent in 2017. This growth should contribute to the reduction of poverty and vulnerability, over the combined effects of improved governance and investment efforts. Economic growth will be primarily driven by sectoral activities related to infrastructures construction and public works, the activities in the primary sector and Free Processing industries.

The end of period inflation rate for 2016 is estimated at 7.1 percent. The change in the consumer price index (CPI) will be further moderated as a result of the downward trend in oil price on the international market. Moreover, effective monetary policy will support the achievement of this goal.

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Public finances strategies aim to preserve macroeconomic stability, and will be based on the support to socio-economic development as well as the practice of good governance. Fiscal policy aims to increase the fiscal space through the broadening of the tax base and the intensification of the efforts focused on the efficiency of public spending. Thus, the net tax ratio will stand at 10.8 percent by 2016 and 11percent in 2017.

Public expenditures are estimated at 16.2 percent of GDP in 2016 and 18.3 percent in 2017. They will focus on activities which contribute to both economic growth and the improvement of the standard of living of the population while aligning to the development priorities identified in the NDP.

A recovery of total investment is expected. Capital expenditures represent 5.3 percent of GDP in 2016, against an estimated 3.5 percent in 2015.

The Government is committed to avoid the accumulation of domestic arrears and to clear the existing stock of arrears within a timetable compatible with the Treasury’s repayment capacity. A time-bound action plan has already been established for the repayment (VAT, liabilities) that will be extended until 2019. Negotiations with creditors have also begun for the securitization of some liabilities to reduce State expenditures.

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Public finances management reforms will enhance the efficiency of public spending. The reforms action plan will take into account in one hand the recommendations of the PEFA self-assessment in 2013 and on the other hand the reforms planned in the Extended Credit Facility (ECF) program approved in July 2016.

An increase by 0.5-point per year in the tax ratio to GDP will be set to achieve a tax ratio to GDP equivalent to 12 percent in 2019. The Government will continue reforms to strengthen the performance of the

Tax and Customs administrations in order to implement an efficient and fair tax system while aiming at improving and securing tax revenues.

The Customs Code has been revised to restrict the scope of exemption regime. This will limit the decline in Customs revenue generated by the implementation of commercial and regional treaties in the coming years.

A modern Customs system has been implemented for the facilitation at the borders and the strengthening of ex-post controls. Thus, the dematerialization of procedures will be reinforced. The Customs administration has set up a risk-based control mechanism for large importers. For this purpose, new conditions have been adopted to benefit from the expedited Customs clearance (*Procédure Accélérée de Dédouanement).* A performance contract has been established for Customs agents at the port of *Toamasina* and is planned to be extended to the other sites. The contracts for the Department of fight against fraud (*Service de Lutte contre la Fraude)* is scheduled at the beginning of 2017.

Furthermore, to ensure a better budget transparency in tax derogations, an inventory of tax expenditures will be regularly carried out and will be accompanied by regular publication of an annual report.

In order to strengthen the sound management of public expenditure, the Government proceeded to a cleaning-up of the management of the pension accounts (*Caisse de Prévoyance et de Retraite – Caisse de Retraite Civiles et Militaires*) through the replacement of pensioners' identification cards and the physical verification of the beneficiaries in the major urban centers. To this end, the pensioners were required to go themselves to the pension desks to get new cards.

The decline in the price of petroleum products on the international market helped to reduce public expenditures through the reduction in fuel subsidies. The gap between the price at the pump and the reference price has been eliminated since October 2015. In March 2016, the Government has introduced a monthly automatic adjustment mechanism to pump prices based on international prices and the fluctuations of exchange rates.

Proactive measures have been taken by the Government to limit the expenditures on transfer to JIRAMA. This last was requested to adjust electricity prices, to proceed to the replacement of diesel generators to fuel generators which are more cost-effective, and to prepare a new law punishing the theft of water and electricity. An ex-ante review by the *Commission Nationale des Marchés* of all contracts to be negotiated by JIRAMA above pre-defined thresholds (Ariary 80 million for supplies) is recommended. A ministerial *Arrêté* was established for this purpose on March 31, 2016 targeting State-owned companies and public corporations benefitting from financial aids from the State.

With respect to the policy on transparency, JIRAMA will publish quarterly statistics on the cost of electricity per KWh on each existing contract for electricity supply.

The Government has strengthened commercial justice by improving the judicial procedures for commercial cases. A *Circulaire* has been established and published to this end. In order to sustain these reforms and to place them into legal framework, the code of civil procedures (*Code des Procédures Civiles)* will be revised to incorporate the content of the *Circulaire*.

To accelerate the economic recovery, the Government committed to prioritize public investment in pro-economic growth sectors, including infrastructure, agriculture, tourism, and industrial and mining sectors. Recourse to the support from technical and financial partners as well as the promotion of the Public Private Partnership (PPP) are necessary in view of the limited public resources.

The State has already confirmed its willingness to develop PPP by establishing a PPP law, approved and promulgated in February 2016. However, the implementation of this law is not yet effective. To this end, two decrees on procedures and on institutions are currently being prepared for submission to the Council of Government.

To improve the efficiency and the impact of investments, the Government will proceed to the prioritization of investment projects by strengthening the mechanisms of appraisal and projects selection.

Regarding microfinance, the Government's policy is deliberate and is related to both its development and its regulation. A regulatory framework has been implemented to ensure the development of microfinance initiatives. A law on the activity and the control of microfinance institutions was adopted in September 2005 and is currently under review. Relevant regulations will be adopted by the commission for banking and finance supervision (*Commission de Supervision Bancaire et Financière*).

The implementation of all the actions envisaged under the National Development Plan will allow the Government to achieve its objectives, including the attainment of a high economic growth and poverty reduction. However, the scarcity of resources led the Government to solicit the financial support from the World Bank through a budget support.

The Minister of Finance and Budget

REPOBLIKAN'I MADAGASIKARA
Fitiavana - Tanindrazana - Fandrosoana

**MINISTERE DES FINANCES
ET DU BUDGET**

Le Ministre

Antananarivo, le 29 SEPT 2016

LE MINISTRE DES FINANCES ET DU BUDGET

à

Dr JIM YONG KIM

BANQUE MONDIALE

1818 H Street NW, Washington DC

Monsieur le Président,

Madagascar poursuit la mise en œuvre du Plan National de Développement (PND) et de son Plan de Mise en Œuvre (PMO) dans le but de réduire la pauvreté et d'asseoir un développement inclusif et durable. Les grandes lignes du programme du Gouvernement, présenté devant l'Assemblée Nationale et devant le Senat, fixent les objectifs autour de trois axes prioritaires, à savoir: (i) le renforcement de la Gouvernance, de l'Etat de droit et l'instauration d'une justice équitable ; (ii) la reprise économique à travers l'instauration d'un environnement social et politique stable, le maintien de la stabilité macroéconomique et le rétablissement d'un climat des affaires attrayant et (iii) l'élargissement de l'accès aux services sociaux de base de qualité.

La présente lettre témoigne de la volonté du gouvernement de relever les défis pour le développement économique à moyen terme en raffermissant la performance des recettes fiscales et douanières et en optimisant l'allocation des ressources en faveur des secteurs ayant des impacts tangibles sur la population (éducation, santé, infrastructures).

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Au cours des deux dernières années, les indicateurs sociaux ne se sont pas améliorés malgré la volonté du gouvernement de promouvoir les mécanismes et les systèmes de valorisation du capital humain et de protection sociale. Avec un Indice de Développement Humain faible de 0,510, Madagascar occupe la 154ème place sur 188 pays du Rapport sur le Développement Humain 2015 des Nations Unies et n'a pas atteint les Objectifs du Millénaire pour le Développement à l'échéance de 2015.

La reprise des activités économiques reste encore fragile en 2015 et les performances par branches d'activités demeurent mitigées. Elles traduisent une prudence d'investissement des opérateurs dans les activités économiques ainsi qu'une faiblesse de l'offre. En outre, la volatilité du cours de nickel, les dégâts cycloniques au cours du premier trimestre 2015 ont aggravé la situation. La croissance économique n'a atteint que 3,1% par rapport à l'objectif de 5% prévu par le PND. Le taux d'inflation est évalué à 7,6% à fin 2015.

Les grandes orientations économiques et stratégiques de l'Etat ont été alignées sur le Plan national de Développement. Le Gouvernement est déterminé à affronter les défis économiques et sociaux urgents du pays avec l'appui des Partenaires Techniques et Financiers. Le nouvel accord en faveur de Madagascar au titre de la Facilité Elargie de Crédit (FEC), approuvé en juillet 2016 par le Conseil d'Administration du Fonds Monétaire International (FMI), confirme la volonté de soutenir davantage les investissements dans l'infrastructure, l'élargissement de l'accès à l'éducation et aux soins de santé, la mise en œuvre des réformes destinées au renforcement de la gouvernance économique et financière.

Concernant les Finances Publiques, le taux de pression fiscale était de 10.1% pour l'année 2015. Une baisse a été constatée par rapport à l'objectif fixé dans la Loi de Finances Initiale, provenant principalement de la baisse des prix internationaux du pétrole et du volume des importations. Le manque de dynamisme des secteurs d'activités, l'insuffisance des moyens pour limiter les fraudes et évasions fiscales ainsi que la limite de la capacité du système d'exploitation informatique actuel sont les principaux obstacles au recouvrement des ressources internes.

Les dépenses publiques sont évaluées à 15,1% du PIB en 2015. Les secteurs sociaux (santé, éducation, protection sociale) demeurent prioritaires malgré la limitation des ressources disponibles pour subvenir aux besoins de l'Etat. Les dépenses des 04 ministères sociaux (Ministère de l'Eau, Ministère de l'Education Nationale, Ministère de la Santé Publique, Ministère de la Population) en fonctionnement et en investissement seront augmentées pour atteindre 1,3% du PIB en 2019. Ces dépenses sont estimées à 0,7% et 0,8% du PIB en 2015 et 2016.

La croissance économique devrait s'accélérer pour atteindre 4,1 % en 2016 et 4,5 % en 2017. Cet essor devrait contribuer à la réduction de la pauvreté et de la vulnérabilité, sous l'effet conjugué d'une meilleure gouvernance et des efforts d'investissements. La croissance économique sera principalement tirée par les branches d'activités rattachées à la construction d'infrastructures et Travaux Publics (BTP), les activités du secteur primaire et les industries franches.

Le taux d'inflation pour 2016 est estimé à 7,1% en fin de période. La variation de l'Indice des Prix à la Consommation (IPC) sera plus modérée à cause de la tendance baissière du prix du pétrole sur le marché international. Par ailleurs, la politique monétaire en vigueur soutiendra l'atteinte de cet objectif.

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Les stratégies des Finances Publiques visent à préserver la stabilité macroéconomique, et se baseront sur l'appui au développement socio-économique ainsi que la pratique de la bonne gouvernance. La politique budgétaire a pour objectif d'accroître l'espace budgétaire à travers l'élargissement de l'assiette fiscale et l'intensification des efforts axés sur l'efficacité des dépenses publiques. C'est ainsi que le taux de pression fiscale net s'établira à 10,8% en 2016 et 11% en 2017.

Les dépenses publiques sont estimées à 16,2% du PIB en 2016 et 18,3 % en 2017. Elles seront axées sur les activités contribuant à la fois à la croissance économique et à l'amélioration du niveau de vie de la population tout en s'alignant aux priorités de développement définies dans le PND.

Un redressement des investissements totaux est escompté. Les dépenses en capital représenteront 5,3% du PIB en 2016, si estimées à 3,5% en 2015.

Le Gouvernement s'est engagé à éviter l'accumulation des arriérés intérieurs et à apurer le stock existant d'arriérés dans un délai compatible avec les capacités de remboursement du Trésor. Un plan d'action assorti d'un calendrier a déjà été établi pour le remboursement (TVA, créances fournisseurs) qui s'étalera jusqu'en 2019. Des négociations avec les créanciers ont également été entamées pour la titrisation de certaines créances afin d'alléger les dépenses de l'Etat.

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Les réformes de la Gestion des Finances Publiques rehausseront l'efficience des dépenses publiques. Le plan d'actions de réforme prendra en compte d'une part des recommandations de l'autoévaluation PEFA 2013 et d'autre part des reformes prévues dans le programme de la Facilité Elargie de Crédit (FEC) approuvé en juillet 2016.

Une augmentation de 0,5 point par an du taux de pression fiscale sera fixée pour atteindre un taux de pression fiscale de 12% en 2019. Le Gouvernement continuera les réformes pour renforcer la performance des administrations fiscales et douanières en vue de mettre en place un système fiscal efficace et équitable tout en tablant sur l'amélioration et la sécurisation des recettes fiscales.

Le code des douanes a été révisé afin de restreindre le champ d'application du régime d'exonération. Ceci permettra de limiter les effets de la diminution des recettes douanières dans les prochaines années, générée par l'application des traités commerciaux et régionaux.

Un système douanier moderne a été mis en place pour la facilitation au niveau des frontières et le renforcement du contrôle à posteriori. La dématérialisation des procédures sera ainsi renforcée. L'administration des douanes a mis en place un mécanisme de contrôle basé sur le risque pour les grands importateurs. A cet effet, des nouvelles conditions sont adoptées pour le bénéfice de la Procédure Accélérée de Dédouanement. Un contrat de performance a été instauré pour les agents douaniers du Port de Toamasina, qui sera étendu aux agents des autres sites. Celui du Service de la Lutte contre la Fraude sera prévu au début de l'année 2017.

Par ailleurs, pour assurer une meilleure transparence budgétaire des mesures fiscales dérogatoires, un inventaire des dépenses fiscales sera régulièrement effectué avec publication systématique d'un rapport annuel correspondant.

Afin de renforcer la gestion rationnelle des dépenses publiques, le gouvernement a procédé à un assainissement de la gestion des comptes des pensions (CPR-CRCM) par un remplacement des cartes des pensionnés et la vérification physique des bénéficiaires dans les grands centres urbains. A cet effet, les pensionnés ont dû se présenter eux-mêmes aux guichets pour se procurer des nouvelles cartes.

La baisse du prix des produits pétroliers sur le marché international a permis d'alléger les dépenses publiques en réduisant les subventions aux carburants. L'écart entre le prix à la pompe et le prix de référence a été éliminé depuis octobre 2015. En mars 2016, le gouvernement a introduit un mécanisme d'ajustement automatique mensuel pour les prix à la pompe basé sur les cours internationaux et les fluctuations des taux de change.

Des mesures volontaristes ont été prises par le Gouvernement pour limiter les dépenses de transfert à la JIRAMA. Cette dernière a été appelée à ajuster les tarifs d'électricité, à procéder au passage des générateurs diesels en générateurs fioul étant plus économiques, et à préparer une nouvelle loi sanctionnant le vol d'électricité et d'eau.

Une revue à priori par la Commission Nationale des Marchés (CNM) de tous les contrats à conclure par la Jirama excédant des seuils prédéfinis (80 millions d'Ariary pour les fournitures) est préconisée. Un arrêté ministériel a été établi à cet effet le 31 mars 2016 à l'endroit des Sociétés d'Etat et des Etablissements Publics bénéficiant de concours financiers de l'Etat.

Dans le cadre de la politique de transparence, la JIRAMA publiera des statistiques trimestrielles relatives au coût de l'électricité par KWh sur chaque contrat de fourniture d'électricité en vigueur.

Le gouvernement a renforcé la justice commerciale en améliorant les procédures judiciaires relatives aux affaires commerciales. Une circulaire a été établie et publiée à cet effet. Afin de pérenniser ces réformes et de leur donner un cadre légal, le code de procédure civile sera révisé pour incorporer le contenu de la circulaire.

Pour accélérer la relance économique, le Gouvernement s'est engagé à prioriser les investissements publics dans les secteurs stimulant la croissance économique, notamment l'infrastructure, l'agriculture, le tourisme, les secteurs industriels et miniers. Le recours à l'appui des Partenaires Techniques et Financiers ainsi que la promotion du PPP (Partenariat Public Privé) sont nécessaires compte tenu des ressources publiques limitées.

L'Etat a déjà confirmé sa volonté de développer le Partenariat Public Privé en établissant une Loi sur le PPP, adoptée et promulguée en février 2016. Toutefois, la mise en application de cette Loi n'est pas encore effective. A cet égard deux décrets sur les procédures et sur les institutions sont actuellement en cours de préparation pour être soumis au Conseil du Gouvernement.

Pour une amélioration de l'efficience et de l'impact des investissements, le Gouvernement procédera à la priorisation des projets d'investissement en renforçant le mécanisme d'évaluation et de sélection des grands projets.

Au niveau de la microfinance, la politique du Gouvernement est volontaire et concerne à la fois son développement et sa régulation. Un cadre réglementaire a été mis en place pour assurer le développement des initiatives en microfinance. Une Loi relative à l'activité et au contrôle des Institutions de Microfinance a été adoptée en septembre 2005 et est actuellement en cours de révision. Les réglementations y afférentes seront adoptées par la Commission de Supervision Bancaire et Financière (CSBF).

La mise en œuvre de toutes les actions envisagées dans le cadre du Plan National de Développement permettra au Gouvernement d'atteindre ses objectifs, notamment la réalisation d'une croissance économique élevée et la réduction de la pauvreté. Toutefois, la limitation des ressources conduit le Gouvernement à solliciter l'appui financier de la Banque Mondiale dans le cadre d'un appui budgétaire.

MINISTERE DES FINANCES ET DU BUDGET

RAKOTOARIMANANA François M.M. Gervais

ANNEX 3: FUND RELATIONS ANNEX

IMF Executive Board Approves US$304.7 million Extended Credit Facility Arrangement for Madagascar

July 28, 2016

On July 27, 2016 the Executive Board of the International Monetary Fund (IMF) approved the equivalent of SDR 220 million (about US$304.7 million, or 180 percent of current quota) under a 40-month Extended Credit Facility (ECF) arrangement for Madagascar, to help reinforce macroeconomic stability and boost sustainable and inclusive growth.

Following the Board's decision, SDR 31.428 million (about US$43.5 million) is available for immediate disbursement; the remaining amount will be available in phases over the duration of the program, subject to semi-annual reviews.

The Executive Board was also informed about the Managing Director's approval of the first and final review under the six-month Staff-Monitored Program (SMP) covering the period from September 2015 up to the end of March 2016. During this time, the country built a satisfactory track record of sustained reforms, with progress in most areas.

Following the Board discussion, Mr. Mitsuhiro Furusawa, Deputy Managing Director and Acting Chair, made the following statement:

"The new arrangement for Madagascar under the Extended Credit Facility aims to reinforce macroeconomic stability and promote sustainable and inclusive growth. Weak revenue collections, substantial low-priority spending, and the need for strengthened economic governance all pose challenges to medium-term economic development. Against this background, rigorous and sustained reform implementation will be crucial.

"Rapid growth and sustained poverty reduction will require more investment in infrastructure and broader access to education and health care, in addition to structural reforms. It will be essential to increase tax revenue and to contain and then reduce lower-priority spending, including transfers to state-owned enterprises, such as the utility company JIRAMA. While substantial external borrowing is appropriate to finance development, debt sustainability must be preserved and the authorities should rely as much as possible on external grants and concessional financing.

"Reforms to strengthen governance are also central to the success of the economic program. Key actions include strengthening public financial management and procurement practices, increasing budget transparency, carefully managing the fiscal implications of Public Private Partnerships, and reinforcing the institutions and legal framework for combatting corruption.

"Creating a solid foundation for further financial deepening will be crucial for reinforcing economic growth and stability. This will require more frequent and deeper supervision of banks and nonbanks, establishment of a legal and operational framework for institutions in difficulty, and promotion of modern payment methods.

"The central bank has been strengthened by increased legal independence and growing international reserves. The authorities should remain vigilant about maintaining price stability, and continue to improve the operational framework for monetary policy implementation, including by establishing a well-functioning money market."

Recent Economic Developments

Hampered by fragile institutions, Madagascar is striving to recover from an extended political crisis and international isolation from 2009 to 2013. During this period, key social and developmental indicators deteriorated.

The recovery that began in 2014 has so far failed to gain much momentum due to key commodity prices falling, weather-related shocks, and deep-rooted structural weaknesses. GDP growth is now estimated at 3.1 percent in 2015, which is slightly lower than in 2014 and barely higher than population growth. Inflation fell back to 6.3 percent at end-May 2016 from 7.6 percent at end-December 2015, led by lower food and fuel prices.

Budget execution was challenging in 2015. Priority spending was squeezed by underperforming revenue collections, financing difficulties, and unexpected needs for transfers to state-owned enterprises and pensions. The fiscal deficit increased to 3.3 percent of GDP. Despite international headwinds, economic conditions are expected to improve in 2016 supported by country specific factors.

Performance Under the Staff-Monitored Program (SMP)

Macroeconomic performance was broadly satisfactory under the SMP, which ran from September 2015 to end-March 2016. Macroeconomic targets were met through end-March 2016, with the exception of the ceilings on net credit to government and new external payment arrears, due to technical difficulties in making payments. Tax revenue began to improve gradually, thanks to additional measures under the program, and priority social spending targets were met. A robust accumulation of foreign exchange reserves boosted external buffers.

Progress was also achieved on the structural front, including strengthened audits and controls for revenue collections; an automatic fuel pricing mechanism to avoid any fuel subsidies; the submission to Cabinet of a revised Central Bank Act, advancing a key institutional objective for macroeconomic stability; the Cabinet approval of a National Social Protection Policy; better transparency and functioning of the foreign exchange market; and a new database to enhance debt management capacity and transparency.

Program Summary

The government program, supported by the ECF, aims at reinforcing macroeconomic stability and promoting sustainable and inclusive growth. The program focuses on:

- **boosting prospects for inclusive growth** through improved access to education, health care, and social protection combined with enhanced infrastructure and private sector development;
- **creating fiscal space** through improved revenue generation and spending prioritization
- **reinforcing economic governance by strengthening public financial management** and intensifying anti-corruption measures; and
- **strengthening macroeconomic stability by bolstering central bank operations** and financial supervision. Reform implementation will benefit from a targeted program of capacity building and technical assistance.

Madagascar: Selected Economic and Financial Indicators, 2013-19							
	2013	2014	2015	2016	2017	2018	2019
	Actuals		Prel. Est.	Projections			
	(Percent change; unless otherwise indicated)						
National account and prices							
GDP at constant prices	2.3	3.3	3.1	4.1	4.5	4.8	5.0
GDP deflator	5.1	6.6	7.6	6.7	6.9	6.4	6.1
Consumer prices (end of period)	6.3	6.0	7.6	7.1	7.1	6.3	5.9
Money and credit							
Reserve money	-6.1	14.1	9.6	16.0	12.7	11.9	11.9
Broad money (M3)	5.3	11.1	14.6	17.9	12.7	12.5	12.3
	(Growth in percent of beginning of period money stock (M3))						
Net foreign assets	-13.5	5.4	6.9	7.5	3.3	2.6	2.5
Net domestic assets	18.7	5.7	7.7	10.4	9.4	9.9	9.8
of which: Credit to the private sector	6.9	8.6	8.2	4.6	6.6	7.8	7.7
	(Percent of GDP)						
Public finance							
Total revenue (excluding grants)	9.6	10.1	10.4	11.0	11.2	11.7	12.2
of which: Tax revenue	9.3	9.9	10.1	10.8	11.0	11.5	12.0
Grants	1.3	2.3	1.5	2.0	2.7	1.5	1.3
Total expenditures	14.9	14.7	15.1	16.2	18.3	17.6	18.0
Current expenditure	11.8	10.8	11.7	11.0	10.3	10.0	9.9
Capital expenditure	3.1	3.9	3.5	5.3	8.0	7.6	8.1
Overall balance (commitment basis)	-4.0	-2.3	-3.3	-3.2	-4.4	-4.4	-4.4
Float (variation of accounts payable, + = increase)	-0.2	0.6	0.1	0.0	0.0	0.0	0.0
Variation of domestic arrears (+ = increase)	2.2	-0.7	-0.5	-1.2	-0.7	-0.5	-0.3
Overall balance (cash basis)	-2.0	-2.4	-3.7	-4.5	-5.1	-5.0	-4.7
Primary balance excl. foreign-financed investment[2]	...	...	-1.3	-0.6	0.1	0.2	0.3
Savings and investment							
Investment	15.9	15.6	13.1	15.3	18.2	18.2	18.6
Gross national savings	10.0	15.3	11.1	13.0	14.5	14.0	14.4
External sector							
Exports of goods, f.o.b.	18.1	20.6	21.0	21.5	20.8	20.7	20.9
Imports of goods, c.i.f.	30.7	30.2	28.7	30.2	31.2	31.5	31.6
Current account balance (exc. grants)	-6.5	-1.5	-3.4	-4.3	-6.4	-5.6	-5.5
Current account balance (inc. grants)	-5.9	-0.3	-1.9	-2.3	-3.7	-4.2	-4.2
Public debt	33.9	35.8	41.0	41.7	42.8	43.6	44.5
External	22.8	24.4	28.4	30.4	32.6	34.5	35.8
Domestic	11.1	11.4	12.6	11.3	10.2	9.1	8.6
	(Units as indicated)						
Gross official reserves (millions of SDRs)	502	535	600	701	782	859	945
Months of imports of goods and services	2.2	2.5	2.9	3.3	3.4	3.5	3.6
Terms of trade (percent change, deterioration -)	0.0	0.8	6.6	6.6	-4.6	-2.1	-1.9
GDP per capita (U.S. dollars)	462	453	402	391	405	419	437
Nominal GDP at market prices (billions of ariary)	23,397	25,775	28,585	31,773	35,507	39,609	44,103

Source: Malagasy authorities; and IMF staff estimates and projections.

ANNEX 4: Environment and Poverty/Social Analysis Table

Prior actions	Significant positive or negative environment effects (yes/no/to be determined)	Significant poverty, social or distributional effects positive or negative (yes/no/to be determined)
Pillar A: Strengthening the fiscal framework		
The Recipient has, through its Ministry of Finance and Budget, issued an *Arrêté portant exonération des droits et taxes à l'importation* that restricts the scope of the customs exemption regime in the Customs Code dated May 4, 2016 (N° 10416/2016/MFB/SG/DGD).	No. Renewable sources of energy will continue to benefit from the customs exemption regime as efforts to reduce dependence on charcoal and deforestation are pursued over the long-term.	Yes, positive. The reforms are expected to generate increased fiscal space, which can be directed to increased social spending.
The Recipient has, through two decisions of its General Directorate of Customs dated November 6, 2015 and September 19, 2016 respectively: (a) adopted an expedited custom clearance process based on objective measures for large importers, and (b) established a practice of performance contracts for customs inspectors at the port of *Toamasina*.	No, this is a reform aiming at improving the efficiency of the customs administration, which has been assessed as not having an impact on the environment.	Yes, positive. The improved tax administration reforms are expected to contribute to increase fiscal revenues. As a result, resources available for pro-poor spending are expected to increase.
The Recipient has through its Ministry of Energy and Hydrocarbons, issued an *Arrêté relative au mécanisme d'ajustement automatique des prix maxima affichés à la pompe*, that establishes an automatic adjustment mechanism of fuel prices at retail locations , dated July 1, 2016 (N°14176/2016).	No, this institutional reform is not anticipated as having an environmental impact.	Yes, positive. The increase in fuel prices is expected to affect all households positively through direct and indirect effects. The burden of the subsidy removal will largely be felt by the wealthier, as subsidies were regressive. To mitigate adverse consequences for the poor of the subsidy removal, other policies should be considered such as well-designed social protection programs. This will be explored in the DPO series on inclusive growth.
The Recipient has completed the verification of pension beneficiaries in the large urban centers to remove ineligible beneficiaries from the Pension Register.	No, this institutional reform is unrelated to the environment, natural resources and forests, and is not assessed as having an environmental impact.	Yes, positive, as the reform is expected to increase resources for pro-poor spending.

Prior actions	Significant positive or negative environment effects (yes/no/to be determined)	Significant poverty, social or distributional effects positive or negative (yes/no/to be determined)
Pillar B: Enhancing the environment for investment		
The Recipient has, through its Ministry of Finance and Budget, issued an *Arrêté précisant le mode de computation des seuils des marchés publics et fixant leurs montants*, that imposes *a priori* review of all JIRAMA procurement by the CNM in accordance with the provisions of the 2004 Public Procurement Code dated March 31, 2016 (N°7275 /2016/MFB).	No, in the short term. In the medium to long term reforms to the electricity sector may lead to JIRAMA revising its choices on the preferred sources of energy. Such measures may have an environmental impact that is not possible to assess at this time.	Yes, positive. Improved operational performance of JIRMA would reduce the need for subsidies, thereby increasing fiscal space for pro-poor spending. Further, as reforms to the electricity sector progress it is anticipated that supply will become more affordable and accessible for all types of consumers, including small and medium enterprises.
The Recipient has caused JIRAMA to begin publication of quarterly statistics on the cost of electricity per KWh for each existing power supply contract beginning with the first two quarters of 2016.	No, this institutional reform is not expected to have an environmental impact.	Yes, positive. Increasing transparency of JIRAMA's operations is likely to improve investor confidence and promote the importance of obtaining value for money.
The Recipient has strengthened the judicial procedures for commercial cases by its Ministry of Justice issuing a *Circulaire pour l'Amélioration de la Justice commerciale et réduction des délais de traitement des dossiers commerciaux* that mandates the random allocation of commercial cases to magistrates dated May 25, 2016 (N°016-MJ/SG/DGAJER/DAJ/CIR/16).	No, this institutional reform is not expected to have an environmental impact.	Yes, positive. This reform is likely to improve business confidence and facilitate the environment for growth.
The Recipient has caused the Central Bank, through the *Commission de Supervision Bancaire et Financière (CSBF)*, to complete on-site supervision of the two largest banks in its territory**.**	No, this institutional reform is unrelated to the environment, natural resources and forests, and is not expected to have an environmental impact.	Yes, positive, by facilitating the environment for growth over the medium to long term.