Program Information Document (PID)

Appraisal Stage | Date Prepared/Updated: 30-Oct-2019 | Report No: PIDA27690

BASIC INFORMATION

A. Basic Project Data

Country	Project ID	Project Name	Parent Project ID (if any)
Sao Tome and Principe	P164321	THIRD STRENGTHENING GROWTH AND FISCAL POLICY DEVELOPMENT POLICY FINANCING (P164321)	P161707
Region	**Estimated Board Date**	**Practice Area (Lead)**	**Financing Instrument**
AFRICA	18-Dec-2019	Macroeconomics, Trade and Investment	Development Policy Financing
Borrower(s)	**Implementing Agency**		
Democratic Republic of São Tomé and Príncipe	Ministry of Planning, Finance, and Blue Economy		

Proposed Development Objective(s)

The objective of this operation is to help the government introduce growth-enabling reforms in the financial sector, business environment, and infrastructure; generate fiscal resources and savings; and improve quality of expenditures.

Financing (in US$, Millions)

SUMMARY

Total Financing	5.00

DETAILS

Total World Bank Group Financing	5.00
World Bank Lending	5.00

Decision

The review did authorize the team to appraise and negotiate

B. Introduction and Context

Country Context

STP is a low middle-income and small-island country that faces challenges typical of small states. It consists of two main islands in the Gulf of Guinea, has a surface area of 1,001 sq. km, and is administratively divided into six districts, in addition to the Autonomous Region of Príncipe *(Região Autonóma do Príncipe*, RAP). STP is a multiparty democracy and a unitary state, and its total population is approximately 200,000 people, with 42.6 percent of the population at or below the age of fourteen. In 2018, the country's per capita gross national income was estimated at US$3,430 in purchasing power parity (PPP), and its per capita gross domestic product (GDP) was US$1,890. As a small island country, STP is characterized by: (i) a small population, (ii) a small land area, (iii) remoteness; and (iv) a high fixed cost of public goods—all factors that affect the country's public capacity, trade, fiscal accounts, and human development.

Poverty reduction appears to have been rather stagnant in STP since 2010. Poverty numbers from the latest survey in 2017 are not yet available. But estimates based on growth and distribution assumptions indicate that around one-third of the country's population lives on less than US$1.9 (2011 PPP) per day in 2019, a decline of roughly 2 percentage points relative to 2010. The change in poverty has been mainly attributed to economic growth (increases in the mean value of household income) rather than the redistribution of income across the population, and inequality in STP remains high for international standards (Gini index of 56.3 in 2017). Additional welfare indicators such as the Human Development Index (HDI), at 0.59 for STP lags the average for peers (at 0.62). Moreover, STP's total fertility rate is 4.5 births per woman, and its adolescent fertility rate is 96.3 per 1,000 women aged 15-19. The unemployment rate in STP is 8.9 percent in 2017, with females having an unemployment rate 3 times higher than that among males (14.5 performance among females compared to 5 performance among males).

Economic growth, which has been overly reliant on public expenditure, has been declining due to reduced government funding (external loans, grants, and own-source revenues), and more recently due to the energy crisis. The country's GDP growth rate slowed from an average of 4.9 percent in 2010-15 to 2.7 percent in 2018. In the same period, public investments dropped from an average of 22.1 percent of GDP to 9.0 percent, while grants declined from an average of 15.2 percent of GDP to 8.2 percent. Tax revenues also declined by about three percentage points of GDP between 2010-15 and 2018. As a result, public debt increased significantly, reaching 118 percent of GDP as of June-2019. The rise in public debt was further propelled by a build-up of government and state-owned enterprises' (SOEs) arrears, which increased domestic debt. While the agriculture and tourism sectors—where most private-sector-led growth originates— grew in the last 10 years, they have not been able to replace the government as the economy's main growth driver. The combination of a weak private sector and strained public sector has reduced economic growth, and has brought about energy outages, a liquidity crunch, and high exposure of banks to the public sector.

The macroeconomic situation remains challenging, but recent government measures and the new IMF program have been addressing these imbalances. The government has acknowledged the severity of the country's current macroeconomic situation. The approved 2019 budget promotes fiscal consolidation of more than 1 percentage point of GDP. Moreover, a new IMF program has been negotiated with the GoSTP and is expected to be presented to the IMF's Board of Directors in October 2019. The new 3-year program is expected to be extended under the ECF modality and for a total of US$19 million. It will focus on fiscal consolidation, SOE reform, and monetary tightening to support the country's currency peg. Although the macroeconomic imbalances have deteriorated since the approval for the second operation, the government has taken measures to address these imbalances; the proposed DPO program, complementary Bank engagement, and the ECF will ensure that critical reforms such as the VAT implementation and SOE reform remain on track.

Relationship to CPF

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

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

C. Proposed Development Objective(s)

This proposed operation is the third in a programmatic series of three development policy operations (DPOs). The program development objective of the operation is to help the government introduce growth-enabling reforms in the financial sector, business environment, and infrastructure; generate fiscal resources and savings; and improve the quality of expenditures. The reforms of the proposed operation are aligned with the International Monetary Fund's (IMF) new Extended Credit Facility (ECF), which was presented to the IMF Executive Board in October 2019. The operation supports Maximizing Finance for Development-enabling reforms, including achieving macro-financial stability; improving the business climate; implementing SOE reforms; and regulating the energy sector. It is also aligned the Africa Regional Strategy, as it aims to create sustainable and inclusive growth (through increased domestic resource mobilization, improved public investment management, and higher financial inclusion) and strengthen human capital (by expanding social protection coverage).

Key Results

The expected key results of this operations are:

i. to have all banks comply with the minimum capital adequacy ratio;
ii. to increase in the quality and quantity of payment services provided by banks and the entry in the market of new payment service providers, increasing competition and offer of new digital financial services;
iii. to improve the effectiveness of property registration and to increase the recognition and protection of women´s property rights;
iv. to improve EMAE's operational results and the quality of energy services;
v. to broaden the tax base and generate a stable source of public revenue;
vi. to improve SOE management, oversight, and performance; and
vii. to increase transparency and control as well as more timeliness and predictability in the disbursement of social protection benefits.

D. Project Description

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

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

Prior Action #1: The Recipient, through BCSTP, has approved the Report for the São Tomé and Príncipe Banking System Asset Quality Review, as part of its efforts to improve financial soundness of commercial banks.

Prior Action #2: The Recipient through: (i) its National Assembly, has passed the legal framework for payment services providers and payment system operators, which outlines the oversight framework, and duties and powers of BCSTP; and (ii) BCSTP, has passed the key implementing regulations under the National Payments System Law, which provide for the legal protection of the electronic transfer of funds and the licensing and supervision of payment institutions and payment system operators.

Prior Action #3: The Recipient, through BCSTP, has passed key regulations, which establish the minimum entry, operation requirements, risk management minimum requirements, and supervisory and reporting procedures for microfinance institutions.

Prior Action #4: The Recipient, through its Council of Ministers, has approved the institutional structure for enabling interoperability between the land property register *(Registo de Propriedade*) and the cadaster *(Registo Cadastral*).

Prior Action #5: The Recipient, through the Presidency of the Republic, has instituted an energy demand management program, which includes the exchange of low efficient bulbs with higher efficient ones.

Prior Action #6: The Recipient, through its Council of Ministers, has approved: (a) a Least-Cost Power Sector Development Plan, which provides the basis for a competitive process for all power generation activities; and (b) a Management Improvement Plan for EMAE, which aims to improve EMAE's operational performance.

Prior Action #7: The Recipient, through AGER, has signed a concession contract with EMAE, which stipulates the obligations of the Recipient and the licensee, including rules on tariffs and sanctions.

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

Prior Action #8: The Recipient, through the National Assembly, has passed the Value Added Tax Code, which sets forth provisions aimed at broadening the tax base and generating more own-source revenues**.**

Prior Action #9: The Recipient, through the Ministry of Finance, has instituted a financial system-based (non-cash) payment mechanism to allow for the tracking and reconciliation of funds allocated to social protection payments.

E. Implementation

The Ministry of Planning, Finance, and Blue Economy will be the coordinating agency for monitoring and evaluation of the program implementation and progress towards the achievements of the results. The MPFBE has created a dedicated macro and fiscal unit that will coordinate the program implementation and will serve as the main point of contact with international financial organizations. The unit will develop a brief monitoring and evaluation manual with the sources and the methodology for calculating each result indicator. The MPFBE has coordinated several externally financed projects and is the main counterparts of the GoSTP in dealing with international financial organizations, therefore it has experience and adequate institutional capacity to monitor the DPO program implementation.

F. Poverty and Social Impacts and Environmental Aspects

Poverty and Social Impacts

Overall, the proposed DPO supports policy and institutional changes that are expected to have poverty-reducing effects in the medium - to long-term; however, there will be distributional effects in the short-run that should be addressed. The main poverty-reducing effects from this DPO come from the support to introduce cash transfer to poor and vulnerable families, the energy demand program that will distribute for free more efficient light bulbs for all households, and the reforms on the payment system and microfinance. The short-term negative effect on poverty comes from the introduction of VAT.[1] However, the introduction of the VAT will help improve the fiscal position of the government and to improve macro-stability and economic growth in the medium to long term. In turn, this could help prevent economic crisis-induced

[1] This DPO does not support energy tariff revision or increases of any sort.

increases in poverty.

While the introduction of the VAT will not affect income concentration, it is expected to increase the poverty headcount between 1.5 and 3.0 percentage points. The simulation of the impact of the VAT was done by taking into account direct and indirect effects using consumption data from the 2017 household survey. It reveals the VAT will not affect income concentration, as measured by the Gini coefficient, in a significative way, even when different sets of exemptions are introduced. However, the implementation of the VAT is expected to increase the poverty headcount by between 1.5 and 3.0 percentage points. Moreover, the poverty impacts of the VAT appear to be mitigated by exempting food, small producers, and health and education expenditures (exempting health and education spending will be more significant in urban areas). Taking into consideration the early stage of the social safety net system in the country, there are limited prospects at this stage, for using cash transfers to mitigate the negative impacts of VAT on the poor or any other sub-population group with precision.[2] Nonetheless, the deployment of cash transfers program as supported in prior action 9 will mitigate some of the effects of VAT, even though that is not the primary purpose of the program. Fortunately, as it is confirmed by the simulations of the impacts of a VAT exempting food, small producers, and health and education expenditures, the approved VAT law reducing the tax burden on food staple items by 50 percent, seems to be contributing significantly at mitigating the negative impacts of the VAT. It is also reassuring that the analysis reveals that 51 percent of the VAT collection will be paid by the richest decile of the population.

Improved financial inclusion and a more resilient financial system will benefit the poor. Modern development theory sees lack of access to finance as a cause of persistent income inequality and slower growth. Small enterprises and poor households face greater obstacles with access to finance, especially in developing countries. The 2017 household survey and the 2017 survey on financial inclusion show that poor people are excluded from banking, financial transactions, and credit. Poverty rates are higher (70 percent) among the group who declare not having a bank account compared to those who do (43.8 percent). Only 38.7 percent of the population has banks accounts, with a significant gender and rural gap; 58.7 percent of women and 60 percent of rural population do not have a bank account. The expansion of the payment system network and the use of other delivery channels such as mobile banking could have a relevant impact on poverty since near 70 percent of the population receives their income in cash or check. In addition, 75 percent of the population does not have any bank credit and 89 percent of the SMEs had credit requests denied.

Poorer households tend to use less electricity, yet electricity spending is more of a financial burden. The 2019 survey on energy access based on the Multi-Tier Framework found that while nearly 50 percent of the households in the first quintile of the income distribution use less than 100 kWh per month, 47.5 percent of these households spend more than 10 percent of their budget on electricity. In addition, the same survey reported that affordability was the main hindrance for households not being connected to grid with 42 percent pointing to the one-time cost of the connection and 15 percent pointing to the monthly fees. Therefore, the energy demand program, which will replace for free the low efficient light bulbs for higher-efficiency ones, will reduce the cost of energy for the population. This will be particularly beneficial to the poorer households, which spend a larger share of their income on electricity.

[2] For example, the recent Poverty Assessment for Sao Tome & Principe (2019) confirms that, holding all else equal, female-headed households have the same likelihood of being poor as male-headed households.

Environmental Aspects

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

The exchange of low efficient incandescent bulbs to higher efficient LED can bring environmental benefits (Prior Action #5). Positive environmental impacts on deployment of LED bulbs are related to its lifecycle environmental impacts, which are significantly less in comparison to the traditional incandescent bulbs. Moreover, the use of LED bulbs can contribute to significant energy savings, lower local pollution, and reduce greenhouse gas (GHG) emissions.

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

G. Risks and Mitigation

The overall risk of the proposed operation is high. The rating is attributed to: (i) political and governance; (ii) macroeconomic; and (iii) fiduciary risks; as well as (iv) risks related to the country's institutional capacity for implementation and sustainability. While the technical design of the program and related fiduciary risks are rated as substantial, all other categories are rated as moderate.

CONTACT POINT

World Bank

Rafael Chelles Barroso
Senior Economist

Borrower/Client/Recipient

Democratic Republic of São Tomé and Príncipe
Wagner Fernandes
Director of Budget
wag_fernandes@outlook.com

Implementing Agencies

Ministry of Planning, Finance, and Blue Economy
Ginésio da Mata
Head os Studies and Economic Policy Cabinet
gmata@minfin.gov.st

FOR MORE INFORMATION CONTACT

The World Bank
1818 H Street, NW
Washington, D.C. 20433
Telephone: (202) 473-1000
Web: http://www.worldbank.org/projects

APPROVAL

Task Team Leader(s):	Rafael Chelles Barroso

Approved By

Country Director:	Abdoulaye Seck	25-Sep-2019