**PROGRAM INFORMATION DOCUMENT (PID)**

**APPRAISAL STAGE**

Report No.: 84260

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| **Operation Name** | Third Governance and Competitiveness Development Policy Operation (DPO3) |
| **Region** | AFRICA |
| **Sector** | Central government administration sector (100%).  |
| **Project ID** | P146953 |
| **Lending Instrument** | Development Policy Operation |
| **Borrower(s)** | DEMOCRATIC REPUBLIC OF SÃO TOMÉ AND PRÍNCIPE |
| **Implementing Agency** | MINISTRY OF FINANCE AND INTERNATIONAL COOPERATION |
| **Date PID Prepared** | January 24, 2014 |
| **Estimated Date of Appraisal**  | January, 27 2014 |
| **Estimated Date of Board Approval** | April 15, 2013 |
| **Concept Review Decision** |  |

1. **Key development issues and rationale for Bank involvement**

São Tomé and Príncipe (STP) faces structural vulnerabilities due to its small size as well as external vulnerabilities due to a narrow export base, aid dependence, and limited institutional capacity.STP isan archipelago of just over 1,000 square kilometers, with fewer than 200,000 inhabitants and a gross domestic product (GDP) per capita in PPP of about US$1, 852 (2012). As for other small states, STP cannot take advantage of economies of scale in economic production, or in the provision of public goods, while its small domestic labor pool and limited consumer market seriously constrain private sector growth and thus, trade competitiveness. Persistent risks steams from its extreme sensitivity to changes in global market conditions, particularly for strategic imports, and high aid dependence. The level of debt inherited from the past and the narrow export base further expose the country to high level of debt distress.

Poverty remains a serious and pressing concern. STP is among the countries with the most equal income distribution in Sub-Saharan Africa.[[1]](#footnote-1) Notable progress has been made in a range of education and health indicators. Yet more than half of the population lives in poverty. Between 2000 and 2010, poverty rate at declined from 66.8 to 61.7 percent and the decline was larger in rural area compared to urban area.

To help address these development challenges and promoting broad based growth, the government approved the Second Poverty Reduction Strategy (PRSP II). The strategy is designed around four strategic axes: (i) supporting good governance and public-sector reform; (ii) promoting sustainable and inclusive economic growth, (iii) enhancing human capital and extending basic social services, and (iv) reinforcing social cohesion and social protections, particularly for vulnerable groups. Given the inherent uncertainties regarding potential oil production, the PRSP-II has emphasized the crucial importance of accelerating structural reforms to diversify the economy and support inclusive growth.

STP’s government has built a solid reputation for prudent macroeconomic policy and has managed to sustain the momentum of the structural reform process over multiple administrations, paving the way for HIPC/MDRI debt relief and facilitating the strong economic growth rates observed during the past decade. The government has pursued responsible fiscal and monetary policies, enhanced the quality of governance in general and the efficiency of public spending in particular, promoted greater trade openness by reducing import tariffs, and progressively developed the capacity of its natural-resource management agencies in anticipation of the growth of the oil sector. In 2007 STP reached the Completion Point of the Enhanced HIPC Initiative and received a debt relief package equivalent to US$314 million, significantly improving its structural fiscal stance and reinforcing the long-term sustainability of its debt burden.

The Government is consolidating its fiscal position to build resilience and support the currency peg to the Euro. Fiscal performance has improved and the domestic primary deficit fell from 8 percent in 2009 to a projected 3 percent of GDP in 2013. The authorities remain committed to improving revenue collection through better enforcement of tax laws (including collection of tax arrears), improved customs administration, and by widening the tax base; and to contain spending if necessary. Furthermore, annual inflation has declined from a peak of 37 percent in June 2008 to a projected 8 percent by end-2013.

All in all, despite suffering a succession of shocks, STP has avoided major macroeconomic imbalances over recent years. Growth is projected to accelerate in 2014 and will rely on private sector investments in construction, agriculture, and tourism receipts. Donors will continue to finance capital investments. STP will remain structurally vulnerable to external shocks, which present serious downside risks to its macroeconomic outlook. The prospect of a prolonged economic downturn in key partners (particularly in Europe) could affect export growth in STP, including tourism receipts, and could also decrease private capital inflows and the availability of donor funds.

**II. Proposed Objectives**

The objective of the DPO series is to assist the Democratic Republic of São Tomé and Príncipe to: (i) strengthen economic governance, with a focus on improving the transparency, monitoring and accountability of public and natural resources, improving the management and reporting of statistics, promoting fiscal stability, and strengthening public debt management; and (ii) support broad-based growth by improving the business climate, with a focus on simplifying business regulations and reducing the cost of trading across borders, and by promoting economic diversification.

1. **Preliminary Description**

The proposed DPO is designed to support the implementation of STP's Government Program for 2010-14, whose objectives are aligned to the recently-adopted Second Poverty Reduction Strategy (PRSP II) for 2012-2016. Given the uncertainties surrounding the outlook for potential oil production, the Government Program for 2010-14 and the PRSP II underscore the importance of accelerating structural reforms to diversify the economy. In this regard, this DPO supports critical reforms aimed at strengthening the links between public expenditure, fiscal sustainability, and sector strategies.

The DPO contributes to the Bank’s Interim Strategy Note (ISN) for STP approved in May 2011. Specifically, it contributes to the ISN's pillar one (accelerate sustainable and broad-based economic growth) and pillar two (strengthen governance and public institutions). The proposed DPO is fully aligned with the Bank's Africa Region Strategy.

The reforms supported by the DPO series will contribute to macroeconomic stability and to a private sector-driven and sustainable growth. The reforms under the economic governance pillar will help the government’s efforts to tighten expenditure controls, broaden its revenue base, and increase the structural efficiency of public spending. Cross-cutting reforms to foster private sector growth will reduce transaction costs and promote business formalization. Finally, tourism sector reforms are crucial to the success of STP’s economic growth and diversification efforts.

The operation is the third in a series of three DPOs. The operation includes 9 prior actions, of which one targets improvements in the transparency and monitoring of public expenditures; two target the improvement in the management and reporting of statistics; one aims at promoting transparency in the management of natural resources (fisheries); two target the strengthening of public debt management; one targets the simplification of the process of business regulation; one targets the reduction of costs of international trade, and one targets the simplification of the visa process.

IV. **Poverty and Social Impacts and Environment Aspects**

The DPO series is expected to generate positive poverty and social impacts. The operation’s resources will provide the government with crucial fiscal space, allowing it to maintain expenditures on essential services while pursuing its longer-term poverty-reduction objectives. The government is committed to aligning its national budget with the agenda of the PRSP-II.

The PFM reforms supported by this operation are expected to significantly enhance the efficiency and effectiveness of public resources, improving the delivery of essential public goods and services on which the poor often rely most heavily. The DPO3 supports measures that promote transparency and efficiency in the budget process (including the management of natural resources), and increase accountability for the provision of public services. DPO3-supported reforms also strengthen internal and external expenditure controls, increasing the value-for-money of public spending. Improving the management of public resources will enhance the effectiveness of public spending, benefitting the entire population and especially the poor.

Concerning environmental impacts, the conclusion of an environmental screening of the DPO program indicates that the supported policy actions are not likely to have significant positive or negative effects on the environment, forests, or other natural resources. The policies supported under this grant address primarily institutional reforms. The focus of the reforms is on transparency and accountability or public resources, on the efficiency of public expenditures, and on promoting good governance. If environmental impacts arise, they are expected to be beneficial for STP.

1. **Tentative Financing**

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| Source: | ($m.) |
| BORROWER/RECIPIENT | 0 |
| International Development Association (IDA) | 2.2 |
|  Total | 2.2 |

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1. based on the latest available data in Povcalnet, The Gini index for STP in 2010 was 33.6, well below the median Gini index for Sub-Saharan Africa (42.7). [↑](#footnote-ref-1)