PROGRAM INFORMATION DOCUMENT (PID)
APPRAISAL STAGE

October 10, 2017
Report No.: 120764

Operation Name	MG – Fiscal Sustainability and Investment 2 DPO
Region	AFRICA
Country	Madagascar
Sector	General public administration sector (50%); Central government administration (50%)
Operation ID	P164137
Lending Instrument	Development Policy Lending
Borrower(s)	Government of Madagascar
Implementing Agency	Ministry of Finance and Budget
Date PID Prepared	September 11, 2017
Estimated Date of Appraisal	September 27, 2017
Estimated Date of Board Approval	November 16, 2017
Corporate Review Decision	*The team was authorized to proceed to appraisal and negotiation.*
Other Decision *{Optional}*	

I. Key development issues and rationale for Bank involvement

1. **The Malagasy economy is characterized by persistent poverty.** The headcount poverty rate declined slightly over the 2001-2012 period, but it remains exceedingly high at 70.7 percent in 2012. In 2012[1], only 30 percent of Malagasy lived above the national poverty line and only 10 percent above the international poverty line. Inequality is defined not by an excessive concentration of wealth for a few but by deep poverty, where the average Malagasy consumes 46 percent less than a person living right at the national poverty line. Various factors have entrenched poverty in Madagascar. The latest Poverty Assessment of 2016 found that access to electricity is one of the most important predictors of higher consumption levels among the poor.[2]

2. **Constrained fiscal space limits the resources that are available for spending on national development priorities.** Subdued levels of economic activity, particularly during the most recent political crisis period (2009-2013), and poor tax administration procedures have resulted in low levels of domestic revenues. High levels of transfers to regressive areas of expenditures such as fuel subsidies and pensions have further constrained fiscal space.

3. **Improving the investment climate is fundamental for stimulating private sector led growth.** As discussed in the Country Partnership Framework (2017-2022), the potential for the private sector to thrive has been limited by poor access to electricity, high costs of credit and weaknesses in enforcing contracts.[3] As of the last enterprise survey (2013) firms reported electricity to be the biggest constraint to their business after political stability, reflecting unreliable and expensive electricity supply from

[1] Most recent data available drawn from the ENSOMD 2012 survey.
[2] Republic of Madagascar, Employment and Poverty Analysis, Imperfect Information, Shocks, and Policy Responses, World Bank, 2016
[3] As of the latest Doing Business Report, Madagascar ranks 185/190 on Getting Electricity, 170/190 on Getting Credit and 158/190 on Enforcing Contracts. The latest Financial System Stability Assessment (FSAP) highlights the vulnerability of the financial sector associated with the emergence of a lending expansion

JIRAMA, the state-owned utilities enterprise. An unreliable judicial system has compromised the fairness of resolving commercial disputes, and increased the cost of doing business.[4] And the stability of the financial sector has been compromised by a rapidly growing microfinance sector, which has led to the deterioration of portfolio quality.

4. **Madagascar's relative political stability provides an opportunity to continue the reform momentum.** Madagascar's return to constitutional order in 2014 has seen a much-anticipated pick-up in growth. Nevertheless, as discussed in the recently approved World Bank Country Partnership Framework (2017-2022), strengthening governance remains key to addressing the country's deep-rooted fragility, and is therefore central to the reforms being supported in this programmatic DPO series. The Government has implemented the DPO program and managed the macroeconomic shocks from the two natural disasters (keeping the IMF Extended Credit Facility (ECF) program on track).

II. Proposed Objective(s)

The program development objectives of this programmatic operation are to: (i) strengthen the fiscal framework by creating fiscal space to support priority expenditures; and (ii) improve the environment for investment. The first development objective has been tightly focused compared with DPO1 to emphasize that improvements to the fiscal framework are intended to increase priority expenditures.[5] The proposed operation is the second in a series of two programmatic operations aiming at supporting the government in its goal of accelerating growth and reducing poverty.

III. Preliminary Description

5. **The actions supported by this operation are arranged around two pillars:** (i) strengthening fiscal management; and (ii) improving the environment for investment. The reforms to the fiscal framework under the first operation are being deepened by: increasing transparency of tax expenditures and eliminating those that do not have an economic, social or environmental benefit; taking a risk-based approach to reducing fraud through auditing customs and tax data for large economic operators; updating the institutional framework to eliminate fuel price subsidies; completing the removal of ineligible pensions beneficiaries; and reforming the institutional framework for PIM to better use domestic resources and crowd-in private investments. Reforms to the investment climate are being strengthened through continued improvements to JIRAMA's procurement procedures; updating the legal framework to incorporate reforms on the management of commercial cases; and strengthening the stability of the microfinance sector, following previous microfinance institutional failures.

IV. Poverty and Social Impacts and Environment Aspects

Poverty and Social Impacts

6. **The operation is expected to have an overall positive poverty and social impact, but some mitigation measures are needed for certain households.** The policy reform with the largest expected effects on the distribution of income is the fuel subsidy removal, while the elimination of certain tax

[4] Risks related to the poor institutional environment for commercial justice have contributed to higher interest rates.

[5] Social priority spending refers to the sum of budget allocations to the Ministries of Health, Education, Population and Water excluding salaries and externally financed investment (consistent with the IMF's ECF).

expenditures and exemptions and the reduction of budget transfers to the Pension Fund may also have welfare effects. While the other policy reforms may have beneficial poverty and social effects in the longer-run if complementary conditions are present, assessing their potential distributional impacts at present is not possible in a credible way.

7. **Reforms to fuel subsidies, tax expenditures, and transfers to the Pension Fund are expected to reduce the extent to which public spending is regressive significantly.** As of 2012, when the household survey was conducted, the top quintile of the income distribution in Madagascar benefitted from an estimated 40 percent of total expenditures due to the untargeted nature of subsidies on fuel. Similarly, 73 percent of future pension beneficiaries (public sector employees who are entitled to social benefits-including SOEs) are currently in the top consumption quintile, with another 17 percent in the fourth quintile. Likewise, the list of tax expenditures to be cancelled under the reform proposal relates to goods that are not typically consumed by the poor, such as hand-made sports clothes and propane gas.[6]

8. **Any residual effects on the poor need to be mitigated through the scale-up of social safety systems.** Because of their dependence on kerosene for lighting, the bottom 40 percent of Madagascar's population accounted for 14 percent of total fuel consumption in 2012. However, the fuel subsidy reform has been more aggressive on non-kerosene fuel products resulting in only a marginal increase in the price of kerosene. As a result, the subsidy removal on kerosene has reduced the purchasing power of households in the bottom 40 percent by only [1] percent. The depth of poverty in Madagascar means, however, that even such a small loss of purchasing power can put poor households under stress.

9. **The Government, with support from the World Bank, is scaling up its social protection programs.** The WB's Social Safety Net program in Madagascar is composed of three programs: a conditional cash transfer, a productive safety net program, and an emergency cash transfer program in the drought-affected southern regions. In May 2017, the program consisted of more than 130,000 households (approx. 650,000 people), with more than 68 percent of cash transfers paid to the female head of the household. The Government is also making improvements to the institutional framework for social protection, with better coordination among key line ministries. This progress in developing and implementing social protection programs was reflected in a higher CPIA score.

10. **A new transport subsidy was introduced to mitigate the impact of rising fuel prices on urban households.** The removal of the fuel subsidy mainly affects the wealthier parts of society as their consumption patterns include cars and generators that heavily use fuel. However, the urban poor also benefitted from the fuel subsidy because of the reduced cost of urban transport. The Government has therefore put in place a subsidy for urban public transportation fares to mitigate the effect of the reform on the urban poor. The ability of this reform to deliver a compensation to the urban poor will depend on the effective implementation of the subsidy to transporters. However, this transport subsidy already presents a step in the right direction as it is 19 times lower than the fuel subsidy.[7]

Environment Aspects

11. **The reforms supported by this operation are not expected to have significant direct positive or negative effects on the environment, as the DPO is focused on policy reforms, and not physical investments.** The elimination of fuel subsidies might have positive environmental impact through price-induced reduction in demand. However, the effect of price increase on demand is forecast to be insignificant given the estimated inelasticity of the demand to price. The elimination of the exemption

[6] In Madagascar propane gas is only used by the top income quintile.

[7] This is based on the total value of the transport subsidy and the total savings from the removal of the fuel subsidy for the years 2016 and 2017 and assumes an all else equal scenario.

on propane gas may lead to higher use of charcoal, but the environmental impact is expected to be insignificant given that less than 1 percent of households declared using propane gas in the latest household survey.

12. **The scaling-up of investments and PPPs may have potential environmental impacts, which are regulated by the Environment Charter, [8]complemented by a wide range of sectoral regulatory framework.[9]** By the end of this programmatic DPO, total investments are projected to increase to 21.4 percent of GDP, supported by an improved investment climate. The main investment projects include port and road infrastructures, investment in agriculture and fishing, and in energy. Some of these investment projects may have an impact on the environment, positive or negative, which will be assessed through Malagasy legislative and institutional framework. The legislation requires that all investment projects private or public, that are likely to have an environmental impact and require administrative approval, prepare an Environmental and Social Impact Assessment (ESIA).[10] Each ESIA must be approved by the Ministry of Environment, and thereafter published in the project area and the National Environment Office (NEO). The environmental impact assessment might require the elaboration of a Project Environmental Management Plan, the execution of which is monitored by the NEO. The recently adopted PPP decrees states that a preliminary assessment of a project is undertaken to estimate the environmental and social feasibility (amongst others) and that this information is presented in a risk matrix.

13. **The reforms on JIRAMA and the PPP have the potential to increase the use of renewable energy**. The authorities are seeking to develop small solar and hydro projects to reduce the reliance on expensive fossil fuels. The environmental impact is expected to be positive. Moreover, the decentralized use of small solar and run-of-river hydro sites, closely located to demand, is further reducing any potential negative impacts on the environment compared to larger sites Most of these projects are however at an early stage, thus making it challenging to quantify the environmental effects.

14. **The World Bank energy project includes measures to strengthen the Government's implementation capacity of social and environmental assessment mechanisms** particularly in the areas of preparing, reviewing, implementing and monitoring social and environmental assessment, management documents and resettlement plans and linking these documents with bidding and contract documents. To address these needs, the project will undertake a quick diagnostic of the current legal regulatory framework for social and environmental safeguards as well as the Government's implementing capacity and prepare an action plan to identify gap-filling measures (to be funded by the project) that will further strengthen implementation capacity in the short and medium term.

V. Tentative financing

Source:	($m.)
BORROWER/RECIPIENT	0
International Development Association (IDA)	45
Borrower/Recipient	
IBRD	
Others (specify)	
Total	45

8 Law No. 90-033 of 21 December 1990 modified by Law No. 97-012 of 6 June 1997 and Law No. 2004-015 of 19 August 2004

9 Some of these regulatory frameworks are listed in the World Bank (2003) Country Environmental Analysis.

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

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