PROGRAM INFORMATION DOCUMENT (PID)
CONCEPT STAGE

July 21, 2017
Report No.: 120763

Operation Name	MG – Public Finance Sustainability and Investment II DPO
Region	AFRICA
Country	Madagascar
Sector	General public administration sector (50%); Central government administration (50%)
Operation ID	P164137
Lending Instrument	Development Policy Financing
Borrower(s)	Republic of Madagascar
Implementing Agency	Ministry of Finance and Budget
Date PID Prepared	July 21, 2017
Estimated Date of Appraisal	
Estimated Date of Board Approval	October 10, 2017
Concept Review Decision	Following the Concept Note Review Meeting, the team reverted to the chair and it was decided to keep this DPO series limited to two operations, merging when appropriate reforms in DPO3 into DPO2.

I. Key development issues and rationale for Bank involvement

1. **Madagascar is characterized by political fragility, although there have been notable signs of progress to build resilience.** Governance challenges are deep rooted as evidenced by a prolonged political crisis from 2009 to 2013. The return to constitutional order in 2014 was widely welcomed, and important signs of progress are evident. The Government has elaborated a National Development Plan 2015-2019 (NDP) that aims to improve economic management and promote private-sector led growth. With support from the international community, municipal and senatorial elections were peacefully held in July and December 2015, the Independent National Commission for Elections was established, and security reforms are ongoing. While the forthcoming elections are expected to be tense, it is widely hoped that this will be the first time since independence that a Presidential term starts and ends through democratic means.

2. **The costs of fragility have been high, where Madagascar is one of the poorest countries in the world.** [1] Since 2001, there have been two political crises, disruptions in access to markets for textiles and manufacturing exports, severe climatic shocks, and global food price fluctuations. Against this backdrop, the headcount poverty rate declined slightly over the 2001-2012 period, but it remains exceedingly high at 70.7 percent in 2012. The average Malagasy is 42 percent poorer today than she was in 1960[2], the

[1] World Bank (2016). "Recent Trends and Analytical Findings on the Causes of Madagascar's Persistent Poverty." It uses household survey data from EPM 2001, 2005, 2010, and ENSOMD 2012. Also see World Bank (2014). "Face of Poverty in Madagascar: Poverty, Gender, and Inequality Assessment." The next household survey is expected to take place in 2018, following the census.
[2] Measured in real GDP per capita. Only DRC and Liberia fared worse than Madagascar over the 1960-2010 period.

year of Madagascar's independence. In 2012[3], 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.

3. **Promoting broad-based growth is key to reducing poverty and enhancing resilience.** As noted in Madagascar's Systematic Country Diagnostic (SCD), low tax revenues have been a constraining force to spending on the country's priorities, where the country has one of the lowest tax to GDP ratios in the world. Fiscal space is further constrained by transfers and subsidies to non-priority areas such as State-Owned Enterprises (SoEs) and a Pension Fund, which are regressive and are not targeted to the poor. As the authorities seek to scale-up public investments, it is critical that resources are directed to well-planned and prioritized projects to address the country's deficiencies in human and physical capital. And while a modest growth momentum has started, there is significant scope to improve key sectors such as electricity and air transport, as well as enhance the business environment. These measures will be critical for stimulating productivity and creating jobs, which are key for realizing the objectives of the NDP and reducing poverty.

4. **At the request of the authorities, this DPO series aims to continue supporting the Government's reform efforts.**

II. Proposed Objective(s)

5. **The program development objectives of the proposed operation are (i) to strengthen Madagascar's fiscal framework to increase social spending and investment, and (ii) to enhance the environment for investment.** It supports the "macroeconomic stability" pillar of the government's national development plan 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.

III. Preliminary Description

6. **The actions supported by this operation are arranged around two pillars which reflect the two program development objectives.** The two objectives of the DPO are complementary by seeking to stimulate broad based growth. By strengthening Madagascar's fiscal framework and reducing non-targeted expenditures, the reforms under the first pillar seek to enhance fiscal space for spending on pro-poor policies and investment, which should contribute to reduced poverty (provided spending is well targeted) and further stimulate growth. Under the second pillar, the reforms seek to support the recovery of electricity and air transport sectors, which are critical for realizing Madagascar's economic potential, as well as enhancing the investment climate, thereby contributing to broad based growth.

IV. Poverty and Social Impacts and Environment Aspects

[3] Most recent data available drawn from the ENSOMD 2012 survey.

Poverty and Social Impacts

7. **The overall poverty and social impact of the policies supported by this DPO are positive**. The improvements to the fiscal framework are expected to contribute to poverty reduction as the Government spends additional resources on priority sectors and increases investment. However, these intended impacts will depend on how well the authorities target social expenditures and whether investments are well selected and implemented. Benefits are more likely to be felt over the medium-term.

8. **The tax administration reforms are not likely to have an adverse effect on poorer households.** The analysis for the first tax expenditures statement undertook an assessment of which households were likely to benefit from VAT exemptions. The study found that the very poorest households that are based in rural areas are likely to not benefit from exemptions since levels of subsistence consumption are high, at around 40 percent. Rather, VAT exemptions particularly for rice, are more of a benefit for urban households that are non-agricultural producers. Further, the customs reforms focus on large economic operators that present a higher risk for fraud.

9. **The reforms related to the fuel subsidy removal are expected to increase the cost of living, with the burden largely falling on richer households.** 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). The Bank is currently undertaking an incidence analysis of higher fuel prices to inform the dialogue with the authorities on mitigating policies.

10. **Some mitigating measures have been implemented by the government ahead of the transition to the automatic pricing adjustment.** The authorities have distributed school kits to pupils at primary school (school year 2014-2016) and subsidized urban public transport (January 2015 to June 2017). 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. The government is also providing a subsidy for urban transport companies to maintain the cost of a bus ticket. The impact of this policy is currently being assessed in the incidence analysis underway.

11. **Improvements to JIRAMA's procurement practices are expected to have progressive distributional indirect impacts 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. Improved financial soundness of the electricity provider could in the long run result in an expansion and improvement of services, which would help to stimulate the business environment. Electricity coverage is very low and excludes most of the poor.[4] Since electricity usage, and therefore explicit and implicit subsidies, are highly regressive, reduction of subsidies to JIRAMA would have progressive impacts. Improvements to JIRAMA would also improve the business environment.

[4] 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.

12. **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 enhance the operating environment for private operators while a stable financial sector would translate into a solid financial sector able to facilitate economic growth. A more dynamic private sector would increase productive employment opportunities which would benefit the general population, including the poor.

Environment Aspects

13. **The ongoing reforms to JIRAMA and the PPP framework may result in increased use of renewable energy.** The authorities are in the process of assessing possible small hydro projects as a source of energy supply for JIRAMA, potentially financed through PPP contracts. This use of renewable energy sources would reduce reliance on expensive thermal generation, which has comparatively larger detrimental effects for the environment. The use of smaller hydro sites would also have a reduced impact on the environment than larger sites, and it would be more feasible to mobilize financing. Further, the expansion of energy supply, particularly to rural areas, could in the long term reduce reliance on wood as a daily energy source, which contributes to deforestation and environmental degradation.

14. **Efforts to scale-up public investment may have an environmental impact, which will be assessed through the Government's Environmental and Social Impact Assessment (ESIA) mechanism.** Certain investment projects may have an impact on the environment. Since the Government is still at an early stage of scaling-up public investments it is not possible to determine the nature of these effects. However, the Government does have its own safeguards mechanism in place. The Malagasy Environment Code requires that all investment projects private or public, that are likely to have an impact, prepare an ESIA.[5] Each ESIA must be approved by the Ministry of Environment, and thereafter published in the project area and the National Environment Office (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.

V. Tentative financing

Source:		($m.)
BORROWER/RECIPIENT		0
International Development Association (IDA)		40
Borrower/Recipient		
IBRD		
Others (specify)		
	Total	40

VI. Contact point

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

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