

***SÃO TOMÉ e
PRÍNCIPE***

Diagnostic Trade Integration Study

March 1, 2006

**SÃO TOMÉ AND PRÍNCIPE
DIAGNOSTIC TRADE INTEGRATION STUDY**

TABLE OF CONTENTS

PREFACE.....	I
EXECUTIVE SUMMARY AND ACTION MATRIX	II
1. THE ECONOMY OF SÃO TOMÉ E PRÍNCIPE.....	1
Introduction.....	1
Political Background and Recent Developments.....	2
The Poverty Reduction Strategy Paper (PRSP) and the Need for a National Consensus on Development Priorities	2
Recent Economic Developments and the Macroeconomic Framework	5
The Coming Oil Era.....	8
2. THE FOREIGN TRADE OF SÃO TOMÉ E PRÍNCIPE	13
Introduction.....	13
The Structure of Foreign Trade.....	13
Services.....	15
The Trade Regime.....	16
International Trade Relations and Access to Markets	17
<i>Accession to the World Trade Organization (WTO)</i>	17
<i>The Economic Partnership Agreement with the European Union</i>	21
<i>Other Trade Relations</i>	28
<i>Negotiating Capacity</i>	29
Customs Administration and Procedures.....	30
3. EXPORT AND POVERTY REDUCTION POTENTIAL FROM RENEWABLE NATURAL RESOURCES AND TOURISM	33
Introduction.....	33
The Rural Sector in STP	33
Agricultural Production	35
<i>Cocoa</i>	35
<i>Non-traditional Food Exports</i>	37
Fisheries	40
Tourism.....	43
Forests and the Environment	45
An Action Program	47
<i>Public Sector</i>	47

<i>Private Sector</i>	50
4. IMPEDIMENTS TO TRADE EXPANSION AND DIVERSIFICATION.....	53
Introduction.....	53
Infrastructure and Finance Services.....	53
<i>Electricity and Water</i>	54
<i>Telecommunications</i>	57
<i>Internal Transport</i>	59
<i>Port and Airport Facilities</i>	60
<i>Finance</i>	65
The Public-Private Interface.....	66
Special Regimes.....	68
Governance.....	71
Conflict Resolution.....	75
The Land Issue.....	76
Human Capital.....	78
Summary of Recommended Measures.....	80
5. THE IMPACT OF TRADE ON POVERTY.....	82
Introduction.....	82
Poverty in STP.....	84
Simulations of the impact of trade shocks on poverty.....	87
<i>Impact of worsening terms of trade</i>	87
<i>Impact of the construction of a deep-water port</i>	91
<i>Impact of oil money inflows</i>	93

List of Tables

Table 1. 1: São Tomé and Príncipe: Key Macroeconomic Indicators, 1998-2004.....	6
Table 1. 2: São Tomé and Príncipe: Key Macroeconomic Indicators, 2003-2007.....	8
Table 2. 1: Composition and Direction of STP's Foreign Trade	14
Table 2. 2: Share of Main export commodities in total export.....	15
Table 2. 3: STP'S Terms of Trade and the Price of Cocoa.....	15
Table 2. 4: STP Government Revenues.....	16
Table 3. 1: Summary Farm Budget Smallholder (dobros of 1997/month).....	38
Table 3. 2: Number of Foreigners Visiting STP between 1998 and June 2003.....	43
Table 3. 3: Sao Tome and Principe: Production of Main Agricultural Products.....	52
Table 3. 4: Sao Tome and Principe: Agricultural Exports.....	52
Table 3. 5: Sao Tome and Principe: Crop Mix, 1996.....	52
Table 4. 1: Comparative Data for Factor Costs in Selected African Countries.....	54
Table 4. 2: São Tomé International Airport Selected Indicators	64
Table 4. 3: Nominal Bank Deposit and Lending Rates in Selected African Countries	66
Table 5. 1: Share of Various Income Sources by Income Quintile	85
Table 5. 2: Descriptive Statistics by Strata	86
Table 5. 3: Share of Various Expenditures by Consumption Quintile, 2000-01	86
Table 5. 4: Change of commodity prices and exchange rate from 2001 to 2011	88
Table 5. 5: Effect on poverty of adverse terms of trade – all exports and cocoa only.....	89
Table 5. 6: Effect on poverty of adverse terms of trade decomposed into wage effect and export earnings.....	90
Table 5. 7: Effect of a fall in import prices and an increase in export earnings of 5, 10 and 15 %	92
Table 5. 8: Evolution of the exchange rate and consumer prices	94
Table 5. 9: Price effect of appreciation on poverty decomposed into wage effect and goods price effect.....	94

List of Boxes

Box 1. 1: São Tomé and Príncipe's Oil Sector.....	9
Box 1. 2: The December 2004 Oil Revenue Management Law (ORML).....	11
Box 2. 1: The process of accession to the WTO.....	18
Box 2. 2: STP and the European Union: Generalized System of Preferences, Everything But Arms, and the Cotonou Agreement.....	22
Box 2. 3: African Growth and Opportunity (AGOA).....	29
Box 4. 1: Electricity Supply in STP.....	55
Box 4. 2: Current Conditions in the Port of São Tomé.....	62
Box 4. 3: São Tomé e Príncipe's Current Tax Regime.....	68

Box 4. 4: The 1992 Investment Code	69
Box 4. 5: STP's Free Zone Regime	69
Box 4. 6: Capacity Building in the Justice Sector	75
Box 4. 7: The Land Question and Foreign Investment in STP.....	77
APPENDIX 1: ACTUAL AND PREDICTED EVOLUTION OF EXPORT PRICES.....	97

CURRENCY EQUIVALENTS

Currency unit = São Toméan dobras (Db)
US\$1.00 = Db 9,699.40 (period average 2005)

ABBREVIATIONS AND ACRONYMS

ACP	African, Caribbean and Pacific Countries
AGOA	African Growth and Opportunity Act
APHIS	Animal Plant Health Inspection Service
BISTP	Banco Internacional de São Tomé et Príncipe
CEMAC	Central African Economic and Monetary Community
CIAT	Centro de Investigação Agronómica e Tecnológica
CNP	Conto Nacional de Petróleo
CST	Companhia Sãotomense de Telecomunicações
DTIS	Diagnostic Trade Integration Study
EBA	Everything But Arms
ECCAS	Economic Community of Central African States
EMAE	Empresa de Agua e Electricidad
EPA	Economic Partnership Agreement
EU	European Union
FIAS	Foreign Investment Advisory Service
FPA	Fisheries Partnership Agreement
FZA	Free Zone Authority
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
GSD	Generalized System of Preferences
HIPC	Highly Indebted Poor Countries
IDA	International Development Association
IFAD	International Fund for Agricultural Development
IFC	International Finance Corporation
IMF	International Monetary Fund
ISP	Instituto Superior Politécnico
LDC	Least Developed Countries
NGO	Non-Governmental Organization
OECD	Organisation for Economic Cooperation and Development
ORML	Oil Revenue Management Law
PRGF	Poverty Reduction and Growth Facility
PRSP	Poverty Reduction Strategy Paper
SPS	Sanitary and Phytosanitary Measures
TBT	Technical Barriers to Trade
TEU	Twenty Foot Equivalent Unit
TRIPS	Trade Related Intellectual Property Rights
UNDP	United Nations Development Program
WADCO	West African Development Company
WAEMU	West Africa Economic and Monetary Union
WTO	World Trade Organization

PREFACE

This report was drafted following a visit by a team of foreign and local consultants who worked in São Tomé e Príncipe (STP) during a three week visit in October, 2004. Updates were provided during a subsequent visit by the mission chief in May, 2005. The team was guided by the Ministry of Commerce, Industry and Tourism. The focal person in the Government was Mr. Idalino Lopes Dos Ramos Rita, Director of Commerce.

The study team consisted of Nelson Antonio Abreu de Asunção, Enrique Aldaz-Carroll, Acacio Elba Bomfim, Paulo Brigido do Macedo, Jean-Marie Burgaud, Robert Lacey (chief of mission) and Richard Lacroix. Dorsati Madani (Country Economist for STP, World Bank), and Philip English (Trade Coordinator, West Africa, World Bank) provided inputs to later versions of the report and guided the process. The report draws on background papers and other work of the World Bank, UNDP, the IMF, other United Nations Organizations, and the Earth Institute, University of Columbia.

Thanks are due to the Government officials and the many individuals interviewed by the team in STP as well as in Europe and North America. The UNDP Resident Mission in STP provided welcome logistical support during the main mission as well as helpful comments on a first draft of the report. A subsequent draft benefited from comments from the Integrated Framework partner agencies, a review meeting at the World Bank, a public workshop in Sao Tome and Principe, and from various Government Ministries. Josette Percival provided valuable administrative support throughout the entire exercise, and editorial assistance in documentation preparation.

EXECUTIVE SUMMARY AND ACTION MATRIX

1. The Integrated Framework (IF) was established under the auspices of the World Trade Organization (WTO) in October 1997, to facilitate the coordination of trade-related technical assistance to least developed countries (LDC), and to promote an integrated approach to assist these countries in enhancing their trade opportunities. In accordance with the requirements of the IF process, this Diagnostic Trade Integration Study (DTIS) for São Tomé e Príncipe (STP) is intended to be a vehicle to analyze constraints to the country's integration into the global economy, identify the trade-related technical assistance needs to enhance prospects for increased integration, and to incorporate trade issues into the country's national development strategies including its poverty reduction strategy.
2. After this Executive Summary, the DTIS contains an Action Matrix indicating the policy measures, technical assistance and investment projects required to enhance trade. The Matrix is subdivided according to time periods and priorities. The body of the study consists of five chapters. Chapter One introduces STP's economy against the background of the approaching oil era; Chapter Two discusses STP's trade relations; Chapter Three examines export potential in the light of the country's natural resource endowments; Chapter Four analyses the main impediments to investment and export growth and diversification in STP; and Chapter Five reviews the state of poverty in STP, and simulates the impact that falling long term cocoa prices, enhanced trade facilitation, and oil revenues could have on the poor.
3. For a small, open economy, export trade is remarkably underdeveloped in STP. While imports are equivalent to 84 percent of GDP, exports equal just over one third of GDP. The gap is financed by foreign grants and loans, mostly on concessionary terms. Low exports reflect STP's restricted production base. Goods exports are dominated by cocoa, which has been in long term decline for nearly a century. Tourism, although small scale, now earns more foreign exchange than all goods exports put together.
4. STP is a poor, least developed country. Over half the population of about 150,000 lives below the poverty line and 15 percent is extremely poor. The majority of the poor, and nearly all the extremely poor, live in rural areas. Since the redistribution of much of the large, formerly Portuguese - and subsequently state-owned - cocoa estates, most agricultural production is carried out by smallholders. Under current production conditions, cocoa does not provide most smallholders with enough income to meet basic needs. Many of them, therefore, also work as wage earning laborers and/or supplement cocoa with other crops or livestock.
5. Increasing the very low productivity of existing smallholder production and promoting diversification to higher income yielding crops are, therefore, essential to alleviate poverty in STP. There is convincing evidence that both would be technically

feasible for smallholders. Given the very low level of effective local demand, most increased output would need to be exported.

6. The priority of smallholder agriculture is fully recognized in STP's Poverty Reduction Strategy Paper (PRSP), which proposes a comprehensive private sector-led development strategy. It aims at broad based growth founded on product diversification for export. This approach is also supported by the economic analysis carried out in this study which assesses the impact of falling long term cocoa prices, enhanced trade facilitation (through, for example, better trade-related infrastructure), and -- eventually -- oil revenues on the poor.

7. In addition to enhanced and diversified agricultural production, STP also has the potential for significant increased earnings from service activities. Of these, the most immediately promising is high value tourism (especially eco-tourism attracted by the Islands' unique flora and fauna). Later, there could be scope for the provision of goods and services to the oil industry and the development of international transshipment and entrepôt services.

8. In the short term, priority should be given to increasing smallholder income from cocoa – which currently employs the overwhelming majority of the working poor -- through improved varieties, production techniques and marketing. There is convincing evidence from both STP and elsewhere that this would be technically feasible. Improved varieties have already been successfully introduced into STP by a few investors, and can be spread to smallholders, together with enhanced production techniques, both through investors relying on out-growers, and through greatly strengthened local extension and research services.

9. However, perhaps the largest potential pay-off, at least in the short term, is through better post harvest techniques and marketing. Most smallholders sell raw cocoa beans to traders for a low price and with no value added. The trader carries out the grading, cleaning, fermentation and, most importantly, drying. There is already a major price incentive¹ for transferring the fermentation and drying operations to the village level as is common in cocoa growing areas on the African continent and elsewhere. That this nevertheless hardly ever happens suggests the presence of technical and institutional constraints. These could be addressed by (i) increasing the availability of small scale solar powered cocoa driers²; (ii) having the major buyers, in collaboration with the extension services, conduct rural workshops on collection, drying and other post harvest technologies; and (iii) equipping extension workers with simple hand-held scales which would enable the small farmer to verify the veracity of the weights measured by the buyers³. Efforts could equally focus on strengthening the marketing power of small

¹ The price of dry beans (8,000 dobras/kilo) was four times that of wet beans (2,000 dobras/kilo) at the time of the main DTIS mission in October 2004.

² The roça “Diogo Vaz” has a number of well-thought-out solar driers that could be scaled down for village use. Moreover, the banking system or the donor community could finance the import of materials (notably plastic cover sheets) needed for the construction of solar driers.

³ These are cheap and widely available. See, for example, <http://store.yahoo.com/auspexcorps/sprinscal30.html> for a scale costing less than US\$10.

producers through grouping of farmers into cooperatives or similar organizations, and through enhancing farmers' knowledge of the market through regular broadcasting of international and local buying prices and of quantities exported on a rural radio service.

10. There are already indications of the potential for diversification to higher-income yielding crops. Despite the limitations of the current infrastructure, a few small operations are able to cultivate high quality coffee, palm oil, tropical flowers, and fruits and vegetables, mostly for the export market. Experience both in these operations and in cocoa shows that a model involving a partnership between private investors and smallholders can be successful. Investors provide smallholders with credit, technical assistance, and – above all – guaranteed access to market. Their own farming operations, except in the initial stages, supply only a portion of the produce exported. As time goes on, they rely increasingly on out-growers. Other models may also be suitable to STP's environment. Palm oil and cassava meal, all produced by smallholders, have been successfully exported by local traders to the Portuguese ethnic market. Local farmers could form an association to produce for export. While successful elsewhere, this latter kind of operation has not yet developed to any significant extent in STP.

11. After agriculture, the activity which provides the greatest potential for poverty reduction in the short to medium term is fishing. The artisan fishing industry is, after cocoa, the most important income source for the poor. It provides principal or supplementary employment to about 18,000 people, including (mostly women) traders, whose annual per capita income was estimated in 2001 to be just over US\$160. About 70 percent of the protein consumption of STP's population comes from fish. However, the sector is underdeveloped and characterized by extremely rudimentary production and marketing techniques. Donor projects, of which there have been several, have had little or no impact.

12. In addition to artisan activity, industrial fishing is carried out by foreign (mostly European) fleets in STP's territorial waters. STP receives an annual compensation for this which is theoretically set at 750,000 euros, but is almost always considerably less than this. There would appear to be scope for negotiating a substantial increase in STP's revenue from this activity. These receipts could, in turn, be partly earmarked for the development of the local, artisan fishing industry. Funds could also be invested in enhancement of the Navy to enable it to patrol STP's fishing waters more effectively and to provide a search and rescue service for local fishing vessels.

13. Although substantially less than in agriculture and fisheries, the potential contribution of tourism to economic growth and poverty reduction in STP is nevertheless significant. The sector's current small size, the low occupation rates of existing facilities, and the archipelago's natural assets, all indicate considerable scope for expansion. This would not, however, take the form of mass "beach" tourism, which would be inconsistent both with STP's comparative advantage and with sustainable development goals. Rather, the Government's strategy is to focus primarily on adventure/cultural/eco-tourism, combining this with modest growth in beach resorts.

14. No reliable statistics exist of the number of tourists visiting STP. The number of foreign visitors – currently about 10,000 per year -- has almost doubled since 1998. It is informally estimated that about half of these may be holiday tourists. Except for the main hotel in São Tomé city, existing tourist facilities throughout the archipelago are distinctly under-occupied. The Government aims to increase the number of foreign visitors to 25,000 by 2010. The additional 15,000 visitors are expected to create some 1,500 direct and indirect jobs and to double the share of tourism in GDP to about 4.5 percent. Construction would also benefit from the provision of about 350 additional hotel rooms.

15. If this, or even a more modest, target is to be achieved, improvements would need to be made in: (a) health conditions and services, especially in reducing the incidence of malaria and of water-borne intestinal infections and establishing adequate emergency care, including evacuation facilities; (b) the quality and cost of air transport to and from STP; (c) training of tourist industry personnel; (d) tourist infrastructure, facilities and sites; and (e) sector regulatory and supervisory capacity especially with regard to environmental protection.

16. STP stands on the threshold of the oil era. Oil may increase the country's per capita income by more than ten fold by the beginning of the third decade of this century. The prospect of this wealth increases rather than diminishes the importance of focusing on enhanced efficiency and diversification in agriculture, fisheries and tourism. This is for at least four reasons. First, oil riches will be temporary, and it is essential that the country be provided with a more solid production base for the long term future. Second, export diversification will make the country less vulnerable to oil price volatility. Third, while developing agriculture, fishing and tourism would build upon STP's long term comparative advantage, probable upward pressures on the real exchange rate will need to be offset by increased productivity. Fourth, higher agricultural output from smallholders, with concomitant increases in rural living standards, together with modernization of the artisan fishing industry are crucial for reducing poverty in the short-term. They will continue to be important, even after the advent of oil revenues, if the population is to be gainfully employed and not over-dependent on oil-related transfer payments.

17. After the advent of oil, new opportunities for further diversification may present themselves. These could include supplying the oil industry with basic goods and services, and creating an international container transshipment and entrepôt center in STP. Provided international quality and hygienic standards can be met, oil industry personnel, both land-based and those working on extraction platforms, could represent an important new market for local food production. Equally, these personnel will require the services of cleaners, gardeners, plumbers, auto-mechanics, carpenters and the like. Currently many of these and similar skills are in short supply in STP. State-and-donor-sponsored vocational training schemes are not well-suited to enhancing them. Appropriate efforts in this direction could significantly increase the contribution of the oil industry to the growth and development of the local economy.

18. With regard to international shipping services, the Government has retained consultants to examine the feasibility of constructing a new deep water port on São Tomé Island. Their preliminary conclusions indicate that such a port, which would cost in the

order of US\$200 million, would only be financially feasible if STP were able to develop a significant (i.e. at least 200,000 TEUs per annum) trans-shipment service for containers to and from African continental ports. Consultations with the European shipping industry indicate that the necessary potential for this traffic may exist. There could, however, be difficulties in mobilizing the necessary finance for the construction of the facility, over three-quarters of the cost of which would be for basic infrastructure. Given these high costs as well as the uncertainties inherent in such a venture, it is unlikely that the facility would be constructed until some time after the beginning of the oil era⁴.

19. In order to realize its short and longer term potential, STP needs to attract large amounts of investment, especially from the foreign private sector. As the PRSP and other recent strategy documents acknowledge, the challenge of achieving this is formidable. The most important constraint faced by investors is the poor state of the country's infrastructure. The port, originally constructed in colonial times for coastal traffic to and from Angola, is antiquated, poorly equipped and maintained, and totally unsuitable for the requirements of modern maritime transport. Depth at the single quay is so restricted that vessels must anchor out in the sea roads, and goods must be transported to and from the quay in barges. This imposes very high economic costs on STP, not the least of which is the requirement to use small and uneconomic vessels. This has the attendant disadvantage of restricting the direction of trade to traditional origins and destinations – notably Portugal and the Netherlands – which are willing and able to operate the services concerned.

20. Given that a new deep water port is unlikely to be operational before the middle of the next decade at the earliest, a solution needs to be found urgently to the economic costs associated with the existing facilities. Various possibilities have been suggested, including improvements to the operation of the existing port (the solution preferred by most current users), or the construction of a cheap, pre-fabricated jetty which would provide sufficient draft for ocean-going vessels to berth. These alternatives require further in-depth study.

21. Other infrastructure services are also in need of major improvement. The international airport is small, technically restricted, costly to use, and lacks adequate accommodation for passengers and cargo; security is also deficient. Consultants are examining options for improving the airport. Electricity and water services are of very poor quality and coverage is low. Any business requiring a regular and dependable supply of either of these utilities must invest in its own facilities. Telecommunications are reasonably efficient technically (although below current international standards in some services), but are uncompetitive and costly; coverage is also low. Strong regulation must accompany the proposed opening of the market if services are to be improved and prices reduced. The road infrastructure is so inadequate that a considerable number of rural communities are without road access of any kind; many others are poorly served by earth roads which become impassible during the frequent rains. The main road network is

⁴ There is apparently a possibility that a donor may consider financing the port construction in exchange for the right to use part of the facility as a naval base. However, little or no "hard" information is available about such a possibility at this time.

narrow, poorly maintained, and without the capacity to sustain a rapidly growing, trade-oriented economy. Road sector management is shared among a number of agencies in a way which is not conducive to clearly defined roles and responsibilities.

22. With the exception of the port and the airport (which are already being extensively studied), and partially of telecommunications, it is necessary that STP elaborate strategies for improving infrastructure services. The strategies should take full account of the needs of trade and tourism, of the approaching oil era, and – above all – of increasing affordable access by the poor. They are all the more urgent given an unfortunate tendency to react to crises by seeking short term emergency solutions which may be less than optimal. There have been two recent examples of this in the electricity and telecommunications sectors. In both cases, contracts have been awarded not only in the absence of a strategy, but also without competitive bidding or due diligence.

23. Investment is also discouraged by the poor business climate in the country. STP's assets – its peace and tranquility, its functioning democracy, and its strategic location – are currently outweighed by problems and difficulties which lie within the competence of the Authorities to correct. Macroeconomic management, although improved since the mid-1990s, is still weak; the organization of both public revenue collection and expenditure management require further strengthening. Partly thanks to STP's historical legacy, an institutionally weak state takes too much upon itself and misdirects its efforts away from core functions which should accrue to government. There is a notable reluctance to trust the private sector. Information sharing is inadequate; although the society is small, there is little participation in policy making by civil society and the business community. Establishing and running a business in STP involves confronting a myriad of complex, and largely unnecessary, regulations and procedures.

24. Governance is an issue of increasing importance. Unless it is addressed, it will not only discourage needed investment, but also threaten the coherence of the country once the oil era begins. Already, there are signs that political stability is being undermined by poor governance. There have been six changes of government and five Prime Ministers since the elections of July 2001, as well as an attempted coup d'état in July, 2003. In most of these crises, governance issues have played a leading role. It is strongly recommended that all STP stakeholders – government, civil society and the private sector – collaborate in the preparation and implementation of a good governance strategy. This would build upon ongoing efforts and strengths, and would need to be comprehensive, embracing a range of parallel policies and actions in a number of areas. These would include capacity building in the judicial sector (also important for reinforcing conflict resolution mechanisms), reform of the career structure and salary scales of the public service, improved public financial management, reformed public procurement rules and procedures (including enhanced enforcement), strengthening of civil society, greater political accountability, and substantial simplification of regulations to reduce the discretionary power of individual civil servants.

25. The issue of land ownership – a complex and longstanding problem in STP – contributes to the poor business environment in a number of ways. Farmers currently have no clear title to the land they work and hence no certainty that their efforts will be

for their benefit and for that of their families. The lack of clear land titles impedes the development of a land market, which in turn restricts the availability of credit due to the absence of collateral. Moreover, the manner in which provisional land titles are allocated is non-transparent and can give rise to corruption. The Government is to initiate a study to identify solutions to this issue. A full cadastral survey of the entire national territory should also be undertaken as soon as possible.

26. Partly because of the land issue, credit is both difficult to obtain and expensive. Real interest rates on loans and bank spreads are high even by the standards of Sub-Saharan Africa. The banking sector, which until 2002 consisted of the Central Bank and one private institution, has become more competitive as four new banks have established themselves in anticipation of oil-related money. This has not so far led to any significant increase in credit expansion outside the traditional activity of short term lending at high rates of interest to trading companies. There may be scope for establishing a new private banking institution focusing on credit for agricultural production, though a more promising opening for credit for smallholders would probably be through the link with investors and traders described above.

27. The main impediments to greater international trade and investment in STP are, therefore, not directly related to the country's formal trade regime or trade agreements. Trade barriers were, moreover, substantially reduced in 2000, and STP's economy is now relatively open. There is also a great deal of informal trading, notably with Nigeria, though the extent is unknown. This is not to say that the trade regime, and related services, are not in need of improvement. The Customs Administration needs modernization. The official provision of quality, sanitary and phytosanitary certificates is not dependable, and most exporters must rely on other means to obtain the necessary documentation for access to, say, the European market. Bureaucratic procedures in the port are unnecessarily burdensome and inefficient. There is an almost complete absence of adequate initial processing or storage facilities, cold or otherwise, which exporters could use to at least partly combat the uncertainties and delays associated with the poor state of trade-related infrastructure. Imported goods needed by exporters, notably packaging materials and containers, are in short supply and are expensive. Many traders complain that the duty drawback system from which they should benefit is inadequate and often not applied in practice. However, the primary obstacles to trade facilitation are the state of the country's infrastructure and the level of investor confidence in public institutions.

28. With regard to STP's international trade relations, the two most important current concerns are accession to the World Trade Organization (WTO) and the negotiation of an Economic Partnership Agreement (EPA) with the European Union (EU). The Government decided in 2004 to apply formally for full membership of the WTO, at which STP currently has observer status. WTO membership would undoubtedly bring important advantages to STP, as indeed to any other country. It would, however, be important to ensure that adequate support is available to help this small and institutionally weak nation to meet the costs or challenges that membership would inevitably imply. The process of negotiation, although beneficial in a number of respects, would exact heavy demands on an already overstretched administration. Compliance with WTO rules and

regulations, even if introduced gradually, would impose the need for substantial additional institutional changes and procedures on the country's weak institutions. The process of acquiring full membership status will likely stretch over several years. Technical and financial assistance should help to ensure that it does not reduce STP's capacity to deal with more immediate and pressing priorities.

29. STP's negotiation of an EPA with the EU has positive and negative aspects. On the positive side, it would deepen STP's relationship with the EU, its major trading partner, and would – since the EPA is to be negotiated not with individual countries but with trading blocs (CEMAC in STP's case) – facilitate closer cooperation and commercial integration with continental African countries. On the other hand, there are features of an EPA which may not be to the advantage of STP. The need for eventual reciprocity would have a negative impact on government revenues which rely heavily on trade-related taxes. Certain vulnerable sectors, notably horticulture, may suffer from the impact of unrestricted European competition. There is a danger that an EPA would further consolidate STP's reliance on existing trade patterns rather than encouraging diversification to potentially cheaper sources such as Brazil and South Africa. Although an EPA would have the potential to improve the efficiency and range of services, it may also strengthen the position of incumbent or potential EU suppliers of services, even though they may be costlier and less efficient than competitors from elsewhere. The EU would like to include in the EPAs a wide range of issues – such as competition policy, government procurement, labor market regulations, and the environment -- which may not be appropriate for STP at this time or indeed in the context of a trade agreement per se at all.

30. STP should bear in mind that it has an alternative to signing an EPA. As a least developed country (LDC), it already benefits from duty free access to the European market through the Everything But Arms (EBA) initiative. Although EBA remains at the discretion of the EU, whereas an EPA would be enshrined in a treaty, it is unlikely that the EU would abolish it or exclude STP from its benefits. True, after oil begins to flow, STP would eventually lose its LDC status, but this is unlikely to happen for some considerable time, as the classification depends on social indicators and not merely on per capita income. It is also improbable that the EU would cut off STP from development assistance in the absence of an EPA. In any event, once oil revenues arrive, the country will be able to purchase high quality technical services on the international market.

31. The issue of an EPA, therefore, merits careful debate and consideration in STP involving all stakeholders in the discussion. This does not preclude parallel discussions with the EU. Entering into negotiations, in partnership with the CEMAC countries or otherwise, does not constitute a commitment to sign an EPA.

32. An Action Matrix summarizing the policy actions required to enhance trade follows. This is divided into three sections: the first contains the most urgent measures which need to be taken as soon as possible, and in any event within the next 12 months; the second contains actions which should be taken within two years, and the third those within three to five years. Each section subdivides the measures according to the following interlinked areas:

- ❖ Facilitating expanded and export-oriented production by the poor.
- ❖ Improving the business environment.
- ❖ Improving infrastructure services.
- ❖ Reducing trade costs.
- ❖ Protecting the future of Príncipe.
- ❖ Human resource development.

MEASURES TO BE TAKEN WITHIN 12 MONTHS	
Objectives	Action recommended
FACILITATE EXPANDED AND EXPORT ORIENTED PRODUCTION BY THE POOR	Rehabilitate access roads to at least 10 rural farming communities using weather-proof material.
	Sell the processing and marketing assets pertaining to at least three previous cocoa plantations (“roças”) to agri-businesses willing to rely increasingly on out-grower smallholders.
IMPROVE THE BUSINESS ENVIRONMENT	Rigorously apply the existing law and regulations conducive to the transparent allocation of provisional land titles.
	Publish a register of existing holders of provisional land titles.
	Initiate a cadastre.
	Approve the new tax code.
	Establish a system of regular working level meetings with truly representative groups from the private sector and civil society.
IMPROVE INFRASTRUCTURE SERVICES	Determine, and begin to implement, an interim solution to the port problem.
	Rigorously apply the existing law regarding public procurement and contracts with strategic partners in the infrastructure sectors.
REDUCE TRADE COSTS	Approve the new customs code and abolish unnecessary requirements.

MEASURES TO BE TAKEN WITHIN TWO YEARS	
Objectives	Action recommended
FACILITATE EXPANDED AND EXPORT ORIENTED PRODUCTION BY THE POOR	Rehabilitate access roads to at least 10 more rural farming communities using weather-proof material.
	Create a legal and regulatory environment encouraging the creation of warehousing facilities for smallholders.
	Promote investment by experienced entrepreneurs in agriculture and agri-business who would rely increasingly on production by out-grower smallholders.
	Strengthen CIAT so that it can (i) carry out internationally acceptable tests and analyses before issuing certificates, and (ii) provide research and extension services useful to smallholders.
	Establish a weekly rural radio program with market price information.
	Provide financing for expanded village level processing of cocoa to increase local value added.
	Elaborate a strategy for the fishing industry which would include consideration of at least the following policy options: <ul style="list-style-type: none"> ➤ Renegotiation of fees from international industrial fishing in STP's waters. ➤ Promotion of STP nationals in crews of industrial fishing vessels. ➤ Earmarking of part of revenues from the above to develop the artisan fishing industry. ➤ Establishment of a naval/coastguard fleet for the patrolling of STP's fishing grounds and for a search and rescue service for the local fishing industry.
	Implement the strategy for tourism development agreed at May 2004 round table.
IMPROVE THE BUSINESS ENVIRONMENT	Drastically reduce the procedures for establishing and operating a business and set up a "guichet unique."
	Abolish the 1992 investment code.
	Abolish the free zone regime.
	Prepare and begin implementation of a National Good Governance Strategy.

IMPROVE INFRASTRUCTURE SERVICES	<i>International Transport</i>
	❖ Create a legal and regulatory framework to permit and encourage private sector participation in the ownership and management of port facilities.
	❖ Remove the port operations monopoly enjoyed by ENAPORT.
	❖ Implement interim solution to the port problem.
	❖ Expedite the award of a contract, through international competitive bidding, for the construction of a new deep water port capable of providing international container trans-shipment services.
	❖ Expedite the award of a contract, through international competitive bidding, for the expansion and improvement of the international airport.
	<i>Internal Transport</i>
	❖ Elaborate a strategy for the future development of road transport infrastructure in STP.
	❖ Create a legal and regulatory framework which provides for the properly funded maintenance, rehabilitation and construction of rural access roads by local communities.
	<i>Other Infrastructure Services</i>
	❖ Prepare a strategy for the electricity sector.
❖ Prepare a strategy for the water and sanitation sectors.	
❖ Define clearly the obligations and responsibilities of CST under its license.	
❖ Strengthen the telecommunications regulatory agency.	
REDUCE TRADE COSTS	Permit door-to-door delivery of stuffed containers.
	Eliminate the trade license ("alvara").
	Establish effective duty drawback scheme for exporters.
	Lower or remove tariff duties on all capital goods imports and treat public and private importers equally.
	Reduce surtax on used cars and diesel fuel.

MEASURES TO BE TAKEN WITHIN THREE TO FIVE YEARS	
Objectives	Action recommended
FACILITATE EXPANDED AND EXPORT ORIENTED PRODUCTION BY THE POOR	Complete the program of rehabilitation and construction of rural access roads using weather-proof material.
	Convert provisional land titles into clear and unambiguous titles of ownership. Allow titles to be rented and sold transparently.
	Develop a strategy to allow and expand the sustainable extraction of renewable resources, such as honey.
	Create incentives for traders to buy selected forest products.
	Implement fishing industry strategy.
IMPROVE THE BUSINESS ENVIRONMENT	Carry out and publish independent audits of all companies in which the Government has a shareholding.
	Strengthen the judiciary system and the offices of the Attorney General and Auditor General both financially and through training.
	Complete the cadastre for the entire country.
	Pass legislation dividing land into different zones, each one with predetermined uses, e.g. agricultural land, national parks, urban areas, public lands etc.
IMPROVE INFRASTRUCTURE SERVICES REDUCE TRADE COSTS	<i>International Transport</i>
	❖ Adapt legal and regulatory framework as necessary to permit and encourage private sector participation in the construction and operation of major infrastructure facilities (BOT, BOO etc.).
	❖ Facilitate the construction and operation, by the private sector, of storage facilities for perishable and non-perishable cargo at or near the international airport.
	<i>Internal Transport</i>
	❖ Strengthen the management of the road sector through consolidation of clearly demarcated responsibilities among government agencies.

	<p>Eliminate the obligation to channel all customs declarations through licensed brokers.</p> <p>Improve efficiency in Customs:</p> <ul style="list-style-type: none"> ➤ Acquire weighing scales to enable more adequate control of volumes ➤ Adopt new techniques for detecting infractions ➤ Involve the private sector in Customs reform through a Customs sub-Commission of the Multi-sectoral Commission of international trade negotiations. ➤ Join the World Customs Organization ➤ Strengthen the career structure, compensation and technical skills of Customs officials. ➤ Computerize collection and analysis of statistical information in customs; provide systematic automated link between port and customs statistics.
	<p>Enter into negotiations with shipping lines to include STP in more shipping routes.</p>
PROTECT THE FUTURE OF PRÍNCIPE	<p>Divide Príncipe into appropriate land use zones demarcating areas for tourism development and food production for export and/or for oil platforms.</p>
HUMAN RESOURCE DEVELOPMENT	<p>Rationalize foreign scholarship program:</p> <ul style="list-style-type: none"> ➤ Broaden range of destination countries to include more market-oriented economies. ➤ Establish transparent, merit-based selection process. ➤ Negotiate with destination countries application of laws and regulations obliging students to return to work for at least a minimum period in STP. ➤ Broaden contacts with foreign education institutions that could provide courses in STP or transfer knowledge.
STRATEGIC APPROACH TO INFORMAL SECTOR	<p>Research concerning the extent and nature of informal sector activities</p> <p>Census of commercial operators by sector</p> <p>Development of support services for informal sector</p> <p>Creation of an association of traders with no fixed address</p> <p>Creation of the necessary infrastructure to provide traders with a permanent location.</p>

1. THE ECONOMY OF SÃO TOMÉ E PRÍNCIPE

INTRODUCTION

1.1 The Democratic Republic of São Tomé e Príncipe (STP) is a small island country located in the Gulf of Guinea, some 400 kilometers to the west of Gabon (see maps at the end of this Chapter). It has a population of about 150,000 and a land area of just over 1,000 square kilometers. While the archipelago includes several islands, most of them very small, the population is concentrated only on the two largest – São Tomé itself and Príncipe. Only about 7,000 people are permanent residents of Príncipe. The population is increasing at about two percent per year. STP is one of the poorest countries in the Sub-Saharan African region with a per capita income of about US\$320 in 2003;⁵ it is designated as a Least Developed Country (LDC). Nearly half the population lives in the countryside, although urbanization is accelerating. The economy is dominated by – mostly public sector -- services (68 percent of GDP) and agriculture (18 percent). Manufacturing industry is very small, accounting for less than five percent of national output. There are no major foreign investments outside the tourist sector, though these may appear once petroleum-related activities start. The location of the islands presents its people with significant potential opportunities which remain largely unexploited.

1.2 This small community has known major vicissitudes during its turbulent history; inevitably, these have left their mark. Colonized by Portugal from the 16th century onwards (with a brief period of interruption by the Dutch during the 17th century), the islands were found empty. The Portuguese, therefore, brought slaves from the African continent who worked on sugar plantations. Cane sugar production was so successful that the islands became for a while the world's most important source of the product. Later there was a switch to tree crops, notably cocoa. A number of large plantations (*roças*) were established by the Portuguese on the islands, and in the 19th and early 20th centuries they became a major supplier of cocoa on the world market, as well as a source of high quality coffee. After the abolition of slavery, the plantations used indentured labor with low wages and very difficult working conditions. Gradually this gave way to normal wage labor, though this signified little if anything in the way of an improved life for the workers themselves. Independence in 1975 followed a peaceful socialist revolution in Portugal; like practically all ex-Portuguese colonies liberated at the time, STP opted for a Marxist, one party state and socialized the economy. The Portuguese abandoned most of the *roças* and the country *en masse*, and the plantations were taken over by the State. The islands' infrastructure, some of it over a hundred years old, was already decayed, and it deteriorated further after Independence. After a period of some 17 years of economic stagnation and deepening poverty, the country converted to a multi-party system in the early 1990s (following the collapse of the USSR and its satellites), and began gradually to abandon state socialism. A major land reform was initiated to transfer the state-owned cocoa plantations to the former estate workers (as

⁵ World Bank: "World Development Indicators," 2004

shown in the section on *The Public-Private Interface* in Chapter 4). After 1998, the Government has been attempting to follow more of a private sector oriented, free market development strategy.

POLITICAL BACKGROUND AND RECENT DEVELOPMENTS

1.3 Since 1991, STP has been transformed from a Marxist one party state into a pluralist democracy. Mr. Fradique de Menezes, a cocoa exporter, was elected President for a five year term in STP's third multi-party presidential election in July, 2001. In March 2002, National Assembly elections were held in which no party secured an overall majority. The elections were fair and have been held in a peaceful atmosphere. New presidential and parliamentary polls are due in 2006.

1.4 There are a number of political parties, and the situation is complex and unstable. Since the elections of 2001, there have been several political crises involving government reshuffles, most of them resulting in a change in Prime Minister. The instability is due in part to the delineation of power in the Constitution. Executive power is, in principle, the prerogative of the Government, but when the President is also an active participator in policy making, then conflicts can easily arise. This is all the more so when the political party which the President represents⁶ is in opposition to the Government, which has been the case since March, 2004. The Government is led by the Liberation Movement of São Tomé and Príncipe/Social Democratic Party (MLSTP/PSD)⁷.

1.5 If the period up to the next presidential and legislative elections in March and July 2006 were to be characterized by further political turbulence and increasing instability this could add to the difficulties inevitably involved in forging a national consensus on STP's future development, and in the implementation of international economic agreements.

THE POVERTY REDUCTION STRATEGY PAPER (PRSP)⁸ AND THE NEED FOR A NATIONAL CONSENSUS ON DEVELOPMENT PRIORITIES

1.6 With the approaching oil era, STP finds itself at a true crossroads. Future oil production will provide the country with an unprecedented opportunity to obtain the resources it needs to escape from its current poverty trap. Oil will not only generate substantially greater income in and of itself, but would encourage foreign investors, provided they are appropriately oriented, to finance much needed infrastructure development which would otherwise have to rely on public resources. This would, in

⁶ The Democratic Movement Force of Change (MDFM)

⁷ This is the successor to the former Marxist party which ruled STP from Independence in a one party system until the introduction of a multi-party state in 1991. Until March 2004, it was in coalition with the MDFM. Since this coalition broke up, the party has ruled in partnership with two other smaller parties.

⁸ The PRSP is prepared by the Authorities of the country, after widespread consultation with stakeholders, to support STP's application for debt relief under the Enhanced HIPC Initiative. STP reached the Decision Point of the enhanced HIPC Initiative in early 2001. Towards the end of 2004, the Government submitted the full PRSP, which was promulgated by the President of the Republic in January 2003, to the IMF and World Bank, together with an update of the strategy.

turn, release public funds, enhanced by oil income, to focus on areas in which it would be more difficult to interest the private sector – human development and basic infrastructure such as improved access to remote rural areas.

1.7 Unfortunately, it is far from inevitable that oil riches will play such a facilitating role. Quite the contrary. The experience of other oil producing states in Sub-Saharan Africa and elsewhere show that oil wealth, far from improving the climate for investment, economic development and poverty reduction, pose a significant danger to a country's cohesion. Substantially, but temporarily, increased per capita income can easily become concentrated in a few hands; the non-oil economy can be neglected to the point that the already limited productive base is further eroded; much needed social and infrastructure investments need not take place or can be misdirected; governance can sharply deteriorate; and the majority of the population can emerge from the oil era worse off than before it started. Under this scenario, one of STP's great assets – its reputation for peace and stability in a turbulent region – would swiftly be lost.

1.8 The critical choice between these two paths -- that which uses oil wealth to tackle the roots of poverty and spur development, or that which follows more closely the path of STP's neighbors -- has to be a conscious and deliberate one. It must be informed by an articulate vision of the Islands' future, shared by all stakeholders, and a strategy to realize that vision. This would be a catalyst for mobilizing the substantial investor interest in STP that will be required for the growth of trade, the creation of employment and the alleviation of poverty. It would be of great encouragement to potential investors to have access to a national strategy, knowing that this was the product of a consensual exercise in which their peers as well as civil society had participated. It would also be a comforting demonstration that the political will exists to tackle issues – such as property rights -- which are sensitive and have a long and difficult history.

1.9 This is why STP's PRSP is of such central importance. Although there have been a number of attempts in recent years to design a consensus action plan⁹, most of them, while containing a great deal of useful information and analysis, suffer from the weakness of being externally conceived and prepared. The PRSP escapes this drawback. It is a local product, based upon an extensive consultative process involving domestic and foreign stakeholders. Its preparation was managed by a steering committee chaired by the Prime Minister and consisting of representatives of Government, civil society and the private sector. Numerous workshops were organized on the islands of São Tomé and Príncipe. A special PRSP Directorate was set up in the Ministry of Planning and Finance to ensure the implementation and monitoring of the PRSP.

⁹ For instance, in 2003, Taiwan, at the request of the STP Government, prepared a "Master Plan" which went beyond the areas in which Taiwan was providing economic assistance to consider development priorities for the economy as a whole. The Center on Globalization and Sustainable Development (CGSD) of Columbia University is currently providing an economic advisory service to STP. Within this, their team has prepared a comprehensive "Consensus Plan of Action" for STP. The Plan covers the period 2005-2010, and includes a range of investments and policy actions deemed necessary for poverty reduction.

1.10 The PRSP's other main strengths are that it provides a poverty diagnosis¹⁰; it proposes a comprehensive private sector led development strategy for STP; it aims at broad based growth based on product diversification for export; it recognizes the importance of maintaining macroeconomic stability; it pays special attention to cross-cutting issues such as governance; it rightly considers that combating social exclusion is fundamental for reducing poverty, and emphasizes accordingly the need to improve the access of vulnerable groups – women, the elderly and the young (especially street children) – to health, education and other basic services; it analyzes the non-monetary aspects of poverty, and identifies the foreign and domestic factors that impede poverty alleviation; and it includes detailed indicators to monitor progress in poverty reduction.

1.11 Despite these strengths, a number of issues, both analytical and – more importantly – procedural, need to be addressed to reinforce the PRSP process as STP enters the implementation phase of its poverty reduction strategy. Analytically, the PRSP sets a highly ambitious policy agenda, which will cost some US\$210 million to implement during the first seven years¹¹. There is a not inconsiderable danger that STP will fail to reach these targets. Preliminary analysis conducted by the Authorities indicates that the country would need to grow at an annual average rate of over eight percent during the next decade to meet the poverty alleviation targets¹². To attain such a growth rate, STP would need to attract substantial volumes of private investment as well as mobilizing additional donor support.

1.12 The PRSP contains a very long list of needs and policy actions to address them. Future refinements should focus on narrowing them down into priorities. This would advantageously be backed by sound technical analysis, especially in sectors requiring heavy investments such as transport infrastructure. Sharper prioritization would also help to ensure that related public expenditures are within the available budgetary envelope.

1.13 Procedurally, a concerted effort needs to be made to move the PRSP back to the center stage of policy making. Although the Government has declared to the Bretton Woods Institutions that the PRSP is its development strategy and its key reference document, it does not, at present, occupy the place in the national discourse that this would justify¹³. If there is to be any chance of meeting the PRSP targets then its

¹⁰ The PRSP paints a stark picture of poverty in STP: 54 percent of the population live below the poverty line, of whom 15 percent are extremely poor. Improved macroeconomic and growth performance since 1998 has so far had little or no impact on the alleviation of poverty, which has, if anything, worsened as a result of external shocks (especially falling cocoa prices), lack of access to land and capital, low domestic savings and low overall productivity.

¹¹ The principal objectives are: (i) to reduce the 54% of the population living in poverty to 27% by 2010, and to less than 20% by 2015; (ii) to provide access to basic social services for the entire population; and (iii) to reduce social indicator gaps across urban and rural populations, geographical areas, and gender.

¹² About twice the average growth rate of recent years and also about double the rate projected by the IMF and World Bank for the period through 2007.

¹³ In this context, it is noteworthy that in the report of the proceedings of the National Forum of Reconciliation held in July 2004, there is no reference to the PRSP. The Forum was organized with the assistance of the São Tomé e Príncipe Advisory Project of the Center for Globalization and Sustainable Development at the University of Columbia, and was financed by UNDP. It was attended by the President of the Republic and other senior figures. Many groups expressed their views publicly on STP's future development, and there was widespread participation from all geographical areas of the Republic.

implementation must involve a strong joint effort by all stakeholders in STP's society. The PRSP Directorate in the Ministry of Planning and Finance needs to be strengthened in order to enhance its role as a coordinating body both within and outside Government. The process of intense consultation and feedback with the private sector, civil society, and the international community, which characterized the preparation stage, must be rekindled for the implementation phase, where it is even more important.

1.14 Given that STP is a small, open, island economy heavily dependent on imports and external financial assistance, it is self-evident that trade must play a central role in the attainment of PRSP objectives. Trade policy to expand and diversify exports, especially those in the production of which the poor are heavily involved¹⁴, would be a crucial component in the implementation of the PRSP. This DTIS, therefore, indicates not only the opportunities for growth and diversification of exports, but also the macroeconomic and poverty alleviation impact of enhanced trade. In Chapter 5 of this study, a simple model is developed which will allow policy makers to measure the effect of increased trade and external shocks on the sectors where the poor derive their income and the key products they consume.

RECENT ECONOMIC DEVELOPMENTS AND THE MACROECONOMIC FRAMEWORK

1.15 The World Bank and the IMF have been supporting STP's stabilization and structural adjustment programs for some years. Following a decade of very large macroeconomic imbalances, the Authorities have, since 1998, pursued more successful economic and financial policies. At the same time, the relative importance of cocoa has been reduced as tourism and construction have increased their contribution to economic growth. After a three-year Poverty Reduction and Growth Facility (PRGF) went off track in early 2001, macroeconomic policy implementation was supported by an IMF Staff Monitored Program in 2002,¹⁵. The IMF considers performance under this Program and in 2003 to have been broadly satisfactory.¹⁶

1.16 Better economic management has helped to raise real GDP growth and reduce inflation during the 1998-2003 period, although the fiscal situation has remained unsettled. As Table 1.1 shows, real GDP growth increased from 2.5 percent to 4 percent,

The occasion was also used to disseminate information accessible to the population on the development of the oil sector in an effort to combat the battery of rumors and misunderstandings surrounding this subject.

¹⁴ In Chapter 3 of this study, it is shown that STP's agriculture has become increasingly based on smallholders, among whom the rural poor are strongly represented. There are indications that smallholders could, with appropriate technical and financial support from both private and public agents, be at the origin of expanded agricultural output aimed at the export market.

¹⁵ Spending overruns were triggered by petroleum contract bonuses, election-related expenditures, a 25 percent public sector salary increase and a loan to the public electricity company.

¹⁶ IMF Article Four consultation, 2004.

Table 1. 1: São Tomé and Príncipe: Key Macroeconomic Indicators, 1998-2004

	1998	1999	2000	2001	2002	2003	2004 Est.
Real GDP (annual percentage change)	2.5	3.3	3.0	4.0	4.1	4.0	3.8
Consumer Price Index (end-of-period; annual percentage change)	20.9	12.6	9.6	9.4	8.9	10.2	15.2
Domestic primary fiscal balance (percent of GDP) 1/	0.7	1.3	2.1	-12.9	-4.3	-11.7	-20.6
External current account balance (percent of GDP)							
Including official transfers	-53.9	-62.0	-52.3	-25.3	-24.5	-20.1	-27.3
Excluding official transfers	...	-58.0	-52.3	-63.1	-53.9	-54.4	-61.5
NPV of external debt (in percent of exports of GNFS)	1634.6	1394.6	920.8	1200.9	1142.5	1024.5	899.7
Gross international reserves 2/	3.0	3.1	3.5	4.0	3.9	4.5	3.3

Source: IMF.

1/ Including HIPC Initiative spending.

2/ In months of following year's non-oil imports of goods and nonfactor services.

while inflation declined from 21 percent to 10 percent¹⁷. As well as improved policy performance, large inflows of foreign aid and initiatives to foster a nascent tourism industry¹⁸ played a part in these results. The external current account remained heavily dependent on concessional financing by donors throughout this period, while the external debt burden continued to be very heavy.

1.17 Preliminary figures for 2004 suggest continued robust growth, at just below four percent in real terms. Some reported expansion in fisheries and tourism was offset in part by a decline in the value of traditional exports, notably cocoa. Initial expectations that 2004 would see the start of an economic take-off fuelled by oil-driven foreign investment were disappointed. Fiscal imbalances widened significantly because the Authorities increased expenditures substantially in expectation of very large oil signature bonuses that in the event failed to materialize¹⁹. The main expenditures were a substantial rise in the government wage bill, heavy spending on goods and services and higher transfers to finance the state's overseas technical scholarship program. Domestically financed capital expenditure also increased significantly.

1.18 As a result, the overall fiscal deficit (commitment basis) rose to 26.1 percent of GDP from 17 percent in 2003. Part of this was financed by net credit from the Central Bank, leading to an increase in end year inflation to just over 15 percent from 10 percent the previous year (the average during the year was 12.8 percent). There was also sizeable net foreign borrowing, especially from Nigeria and Angola which both provided interest-free loans. Nigeria's loans amounted to \$15 million which have been partly paid back upon receipt of the Block One oil signature bonus. STP was also had arrears of about

¹⁷ The improvement is even more noteworthy when compared to the more distant past – between 1985 and 1997, the economy grew at an annual average rate of only one percent, while yearly inflation averaged over 80 percent.

¹⁸ As shown in the section on *Services* of Chapter 2 of this study for a discussion of recent developments in the tourist industry.

¹⁹ The revised budget of January 2004 anticipated that signature bonus payments would total some US\$150 million and would arrive during the first quarter. In fact, the bonus turned out to be less than one third of this, and was only cashed in the second quarter of 2005 (as shown in the section on *The Coming Oil Era* in Chapter 1 below)

US\$12 million to the Joint Development Authority. Domestic payments arrears rose, including outstanding debts to the public utility companies and the port enterprise, and deferment of payments due to the Joint Development Authority²⁰. Gross international reserves declined from US\$23 million (4.5 months of goods and services) at the end of 2003 to US\$17 million (3.2 months of imports) at the end of 2004.

1.19 On the basis of the medium term strategy set out in the PRSP, and in particular the recognition contained therein that attainment of STP's growth and poverty reduction goals will depend critically on the maintenance of macroeconomic stability, the Government has committed itself to a major adjustment program starting in 2005. The IMF is supporting this with a three year Poverty Reduction and Growth Facility which was approved in early August, 2005. In addition to fiscal and monetary targets, the program addresses a number of important structural issues including:

- ❖ Addressing the constraints impeding a diversified and expanded trade performance by STP.
- ❖ Submitting to the National Assembly legislation criminalizing money laundering and the financing of terrorism.
- ❖ Implementing a strategy to address the financial weaknesses of the electricity and water utility EMAE, including measurable targets for the reduction of arrears.
- ❖ Launching feasibility studies for the privatization of the port authority, ENAPORT, and the air security company ENASA.
- ❖ Submitting to the National Assembly a new investment code eliminating preferential tax regimes.
- ❖ Launching a study to analyze the factors that may be obstructing the development and diversification of the agricultural sector, including the current lack of full property rights for land-holders.

1.20 The macroeconomic projections for the period 2003-2007, which assume the program is successfully carried out, are shown in Table 1.2.

²⁰ These deferments until the oil signature bonus materialized, were foreseen under the financial arrangement with Nigeria.

Table 1. 2: São Tomé and Príncipe: Key Macroeconomic Indicators, 2003-2007

	2003	2004	2005	2006	2007
		Est.		Proj.	
Real GDP (annual percentage change)	4.0	3.8	3.20	4.5	5.5
Consumer Price Index (end-of-period; annual percentage change)	10.2	15.2	15.0	12.0	9.4
Domestic primary fiscal balance (percent of GDP) 1/	-11.7	-20.6	-14.8	-8.6	-4.8
External current account balance (percent of GDP)					
Including official transfers	-20.1	-27.3	-28.26	-23.5	-28.7
Excluding official transfers	-54.4	-61.5	-60.3	-60.3	-63.1
NPV of external debt (in percent of exports of GNFS) 2/	1024.5	899.7	862.3	384.5	402.9
Gross international reserves 3/	4.5	3.3.	3.4	3.5	3.5

Source: IMF

1/ Including HIPC Initiative spending.

2/ Assumes completion point under the Enhanced HIPC Initiative in 2006.

3/ In months of following year's non-oil imports of goods and nonfactor services.

1.21 The PRGF will enable STP to obtain much needed external debt relief, both from Paris Club rescheduling, and under the enhanced HIPC initiative once Completion Point is reached. However, even with this relief, STP's public debt burden will remain very high during the medium term. The net present value of the debt to export ratio is projected to fall from the estimated 900 percent at the end of 2004, but will still be over 400 percent by 2010. These projections are, moreover, highly vulnerable to external shocks, especially stemming from a decline in foreign transfers and/or an exchange rate depreciation. The debt indicators also worsen significantly under the assumption of incomplete fiscal adjustment. On the other hand, the program assumes that STP will receive no more oil signature bonuses through 2007. This assumption, while conservative, is prudent given the delays and difficulties associated with the first bonus payment.

1.22 Other than external shocks, the main risk to the program is political. Not only is STP entering a pre-electoral period, but there is inherent instability built into the system through the likelihood that the party of the Head of State will remain in opposition to the Government until the elections take place. There will be strong pressures on the fiscal front; resisting these will require a more than usual degree of strong political will, especially following the inflow of the first petroleum signature bonus in the second quarter of 2005. The program's success will also depend on urgently addressing governance issues (as shown in the section on *Governance* in Chapter 4) These undermine not only fiscal policy, but also important sector dimensions of the program, especially in infrastructure, utilities and the social sectors.

THE COMING OIL ERA

1.23 After decades of relative decline and stagnation, followed by a few years of improved economic performance but still deepening poverty, STP now stands at the threshold of the oil era. The onset of regular oil production from offshore fields,

anticipated in some seven or eight years from now, is certainly the most significant economic event facing the country in the foreseeable future, with far-reaching social and political implications.

Box 1. 1: São Tomé and Príncipe's Oil Sector

Geological analysis in the early 1990s identified large oil and natural gas deposits off-shore from the islands of São Tomé and Príncipe. In 1997, the government submitted São Tomé and Príncipe's maritime boundaries for approval by the UN and the Gulf of Guinea Commission. The proposed territorial boundaries were contested by neighboring countries, particularly Nigeria, and it was only in 2001 that the dispute was settled.

The territorial agreement with Nigeria resulted in the creation of a Joint Development Zone (JDZ) to be administered by the Joint Development Authority (JDA) headquartered in Abuja. It was agreed that São Tomé and Príncipe would receive 40 percent of all oil revenue from the JDZ. São Tomé and Príncipe also marked out an Exclusive Development Zone (EDZ) from which it would not have to share proceeds from oil production.

During 2003, the JDA conducted the first bidding round for licensing nine blocks located in the JDZ, but the auctions resulted

in the sale of a license on only block (Block One). A bidding round for five additional blocks in the JDZ was launched in late-2004, but the results have not yet been made public. Geological analysis of the EDZ has not yet been conducted.

On February 1 2005, Nigeria, STP and a Consortium consisting of Chevron-Texaco (51 percent), Exxon-Mobil (40 percent) and the Nigerian oil company, Energy Equity Resources (9 percent) signed the Production Sharing Contract for Block One. This triggered the release of the contract signature bonus, of which STP receives US\$49.2 million and Nigeria US\$78.3 million

1.24 Revenues from the offshore deposits are still extremely uncertain, but they could be very high indeed in *per capita* terms. Even with the most modest of current predictions of oil output – 70,000 barrels per day on average between 2012 and 2015, with no growth thereafter – STP will have some 140 barrels per year per person, higher by some considerable margin than any other African oil producer except Equatorial Guinea²¹. At current prices, and assuming that 60 percent of the revenue would accrue to Nigeria under the Joint Development agreement, even this conservative forecast implies the equivalent of an additional annual income for each Sãotomense of about US\$2,800.

1.25 The impact of oil will be felt long before the start of production itself. A contract signature bonus of about US\$49 million was received the second quarter of 2005, and further bonuses and other advance payments may well follow during the ensuing years. The Authorities face the challenge of administering these – for STP -- vast, but temporary, resources against the background of significant institutional weaknesses, especially in public financial management, and accountability for the use of public resources. There are also popular expectations that have been built up regarding the arrival of petroleum money and its expenditure on high poverty alleviation priorities.

1.26 One of the most important ways in which the advent of oil will affect STP is that it will lead to a drastic reduction in the amount of foreign external financial assistance on concessionary terms, and on which the country is currently so dependent. STP will cease to be a beneficiary of IDA, and -- depending on the progress of social and other indicators -- may also lose its LDC status. This is fully recognized in the PRSP, as is the transitory nature of the oil wealth. This is why diversification of production and exports to generate alternative sources of income in ways which will most effectively benefit the poor (and especially the rural poor) is at the heart of STP's poverty alleviation strategy.

²¹ In 2002, output of barrels per year per inhabitant were: Angola 25.5; Cameroon 2.2; Congo-Brazzaville 26.1; Equatorial Guinea 167.4; and Gabon 76.3.

1.27 The advent of oil presents STP with five further challenges if it is to avoid the pitfalls of other oil-producing countries in Sub-Saharan Africa and elsewhere. First, the use of oil revenues must be prudent and consistent with macroeconomic stability. Second, measures need to be taken to neutralize what has come to be called the “Dutch disease,” whereby the development of a large-scale natural resource has damaging side effects on the rest of the economy through upward pressure on the exchange rate and domestic prices as the growing natural resource center competes for goods and services. In the absence of compensating measures, these factors would lead to a serious erosion of STP’s competitiveness in non-oil tradables. Third, it will be critically important to ensure that a significant part of the revenues are used for key social and infrastructure expenditures which have a maximum impact on poverty reduction. Fourth, there is a probability that the oil sector would form an “enclave” with minimal links to the rest of the economy. This would stem from the capital intensive nature of the sector, the use of expatriate staffing and a large reliance on imports, not only for relatively sophisticated inputs, but even for basic supplies of goods and services, given the limited ability of the local economy to respond to the demand. This would severely limit the direct impact of oil exploitation on employment, incomes, and hence poverty reduction. Finally, oil presents a major challenge to good governance and transparency. Unless governance issues are adequately addressed, there is a considerable danger that STP would follow in the tracks of other low income oil exporting countries in Sub-Saharan Africa and elsewhere, which have seen an exacerbation of corruption, inequality, poverty and ultimately civil conflict in a context of deteriorating environmental conditions.

1.28 The appropriate policy response to the challenges posed by the coming oil era would therefore be a judicious mixture of (a) adequate macroeconomic management of oil revenues; (b) putting in place a practical system for revenue allocation aimed at ensuring that the bulk of them are geared towards poverty-reducing expenditures; (c) strengthened public sector financial management and better governance; (d) encouraging the growth and development of non-oil sources of income through improved efficiency, market access and flexible factor prices, and through the creation of a more favorable environment for business and investment; and (e) strengthening core skills and capacity to enable a wider proportion of STP’s population (especially the poor) to benefit from enhanced trade and from future oil-related opportunities, such as the provision of basic services to the oil industry and its personnel²².

1.29 STP has made a good start in addressing these issues with two important actions. First, in June 2004, President Menezes and President Obasanjo of Nigeria signed a nine-point agreement called the “Abuja Joint Declaration.” This committed the two countries to transparency in all payments and expenditures related to the exploitation of the JDZ. The guidelines adopted are those in the United Kingdom’s Extractive Industries Transparency Initiative. There is a website (www.nigeriasaotomejda.com) on which all

²² Because oil revenues are not expected to flow for at least another seven or eight years, some of these capacity-building investments would be for the medium term. Nevertheless, a strategy aimed at maximizing “local content” of oil company expenditures, needs to be developed as soon as possible so as to ensure that STP is ready in time. This is of particular importance given the fact that the offshore oil blocks are to be shared with Nigeria, which will therefore be a competing source for many services.

information which the two leaders have committed themselves to make public will appear.

1.30 Second, by the end of 2004, STP's the President had promulgated the Oil Revenue Management Law (ORML), which establishes a sound legal framework for the appropriate management of revenues in a transparent manner. The Authorities were assisted in the drafting of the ORML by two teams of experts, one from Alaska, financed by the World Bank and the UNDP, and the other from the Earth Institute of Columbia University, New York. The foreign expertise was requested by the Government and by the Presidency, both of which were concerned about the potential impact of unchecked inflows of oil-related money. The drafts of the Law were discussed extensively with a special committee of the National Assembly, and three national conferences were organized by UNDP and the World Bank to consider the content of the proposed legislation. The IMF, the World Bank, and the Earth Institute also provided extensive advice in the drafting of the final version of the law. The main features of the Law are shown in Box 1.2.

Box 1. 2: The December 2004 Oil Revenue Management Law (ORML)

The ORML seeks to ensure transparency and accountability in the management of oil and accountability in the management of oil revenues stemming from operations in STP's exclusive development zone (EDZ) and the joint development zone with Nigeria (JDZ). The Law also establishes rules for the use of oil revenues.

Transparency and Accountability. The ORML calls for (i) the establishment of a single national oil account (Conto Nacional de Petroleo or CNP) with a custodian foreign bank to collect all oil revenue; (ii) regular auditing of oil revenue accounts by a reputable international accounting firm; and (iii) the dissemination of information related to oil production operations and revenues through the internet. It also establishes an investment committee that would decide on the allocation of the resources accumulated in the CNP. The Law prohibits the investment of funds in the CNP in São Tomé e Príncipe assets, and any borrowing by the Sãotomean State or the Joint Zone Development Authority (JDA) using actual or prospective oil revenues as collateral.

Use of Oil Revenue. The ORML sets limits on the annual transfer of resources from the CNP to the national budget. For the period before production starts, the limits aim at ensuring a gradual – but complete – use of revenue from signature bonuses. For the subsequent period, the limits allow for a gradual build-up of a Permanent Fund. In broad terms, the annual drawings from the CNP are limited to the sum of: (i) the “long term real rate of return” multiplied by the level of the Permanent Fund; and (ii) the “long term real rate of return multiplied by the present value of estimated future oil revenues from the fields actually under production. To stress that these limits should not be considered as targets, the Law establishes that the transfers from the CNP should not be higher than the amounts determined by the Ministry of Planning and Finance in consultation with the Central Bank, taking into account the economy's absorptive capacity and the Government's inflation objectives. Transfers to the budget should be used to finance programs defines in STP's PRSP

1.31 While the ORML is undoubtedly a major step forward, and while STP deserves the congratulations that have been given to the country because of it, its significance should not be exaggerated. As shown in section on *Governance* in Chapter 4 of this study, governance remains a major and growing concern in STP, and mere legislation, sound as it may be, will not suffice to protect the oil sector from the ills of society as a whole. Evidence of poor governance from other sectors of the economy indicates that rules and regulations cannot, alone and of themselves, impede corruption. The key to a soundly and transparently managed oil sector will be in the application of the Law, which will require strong capacity and political will.

SÃO TOMÉ E PRÍNCIPE
MAPS



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2. THE FOREIGN TRADE OF SÃO TOMÉ E PRÍNCIPE

INTRODUCTION

2.1 This Chapter discusses STP's foreign trade in goods and services, and the country's multilateral and bilateral trade relations. It starts with a description of the structure, composition and direction of trade and considers trends in recent years. There is then a discussion of services, notably tourism. The Chapter then goes on to analyze the two major upcoming issues for STP in the trade domain – accession to the World Trade Organization (WTO), and negotiation of an Economic Partnership Agreement (EPA) with the European Union. These are highly complex questions, with both positive and negative dimensions for STP; they merit a wide ranging and participative discussion involving all stakeholders before irrevocable decisions are made. The Chapter then discusses other bilateral and regional trade relationships, and concludes with a section on trade facilitation which focuses on the Customs Administration and services responsible for issuing sanitary and phyto-sanitary certificates. The other, broader aspects of trade facilitation – the quality and cost of infrastructure and other factor services, regulations, the business climate etc. – are covered in detail in Chapter 4.

THE STRUCTURE OF FOREIGN TRADE

2.2 São Tomé e Príncipe (STP) has a large structural trade deficit related to the economy's low productive base and the availability of foreign aid. The very high ratio of imports to GDP (84 percent, on average, between 1998 and 2003) indicates the extreme openness and vulnerability of STP's economy. The ratio is well in excess of the average for small, open economies on the Sub-Saharan African mainland, though comparable with that of other small island economies. By contrast, exports represent an average of only just over one third (34 percent) of GDP. The deficit is financed almost entirely by overseas aid in the form of grants and concessional credits.

2.3 The composition and direction of STP's trade since 1997 is shown in Table 2.1. There have been little significant changes in either composition or direction of trade since 1998. The largest import item is, as might be expected, capital goods. Close behind, however, comes foodstuffs, with an average value of over US\$6 million over the six year period, around US\$42 worth of food per person per year. 80 percent of recorded imports come from Europe, where Portugal, accounting for nearly two thirds of the total, is by far the most important partner. This continued trade domination of the former colonial power reflects the failure to establish the means – notably shipping and air transport services -- through which STP could diversify its sources of imports. The reliance on Portugal has its price. Informal estimates suggest that STP may be paying an average premium of as much as 15 percent over what imports would cost if the country were capable of tapping other sources.

Table 2. 1: Composition and Direction of STP's Foreign Trade
(US\$ million)

	1998	1999	2000	2001	2002	2003
Composition						
<i>Exports f.o.b.</i>						
Cocoa	4.6	2.9	2.9	3.3	4.6	5.5
Other	1.6	1.0	0.3	0.4	0.4	0.9
Total	6.2	3.9	3.2	3.7	5.0	6.4
<i>Imports f.o.b.</i>						
Foodstuffs	4.3	4.8	4.5	7.7	6.0	9.7
Petroleum products	1.9	3.7	5.0	4.1	3.8	4.6
Investment goods	8.2	10.8	12.3	11.3	12.8	11.6
Other	2.5	2.6	1.0	1.2	2.0	1.6
Total	16.9	21.9	22.8	24.3	24.6	27.5
Direction						
<i>Exports f.o.b.</i>						
Angola	0.2	0.1	0.4	0.1	0.1	0.2
Belgium	0.3	0.1	0.2	0.5	0.7	1.6
Netherlands	2.9	3.4	2.0	1.7	2.0	2.7
Portugal	1.3	0.3	0.2	0.6	1.0	1.2
Other	1.5	0.0	0.4	0.8	1.2	0.7
Total	6.2	3.9	3.2	3.7	5.0	6.4
<i>Imports c.i.f.</i>						
Angola	2.8	2.0	2.5	4.2	3.4	3.0
Belgium	1.8	1.9	2.0	3.1	4.5	4.4
France	0.0	0.9	2.2	3.5	0.2	1.3
Gabon	0.6	0.5	0.9	1.2	0.9	1.2
Japan	2.2	12.8	2.8	1.9	2.1	1.1
Netherlands	1.0	0.1	0.4	0.2	0.1	0.1
Portugal	10.1	6.9	13.9	13.5	18.0	20.0
Other	2.5	1.3	3.2	1.8	0.8	1.6
Total	21.0	26.4	27.9	29.4	30.0	32.7

Source: IMF

2.4 STP's goods exports are dominated by cocoa (see Table 2.2), has been in long term decline since the early 1920s. The crop's past performance and prospects are discussed in Chapter 3. Small amounts of copra and coffee are also exported, and air transport of tropical flowers, fruits and vegetables to Europe has recently started on a small scale. Europe receives about 85 percent of STP's exports. Most of the remainder is destined for continental Africa, where Angola has been the principle market, with about 3 percent of export sales.

Table 2. 2: Share of Main Export Commodities in Total Exports

(%)*

	2001	2002	2003
Cocoa	83.18	92.30	93.11
Coffee	0.88	0.26	0.09
Copra	1.55	0.68	0.34
Palm oil	0.26	0.00	0.10
Rest	14.13	6.77	6.36
Total	100.00	100.00	100.00

Source: Aldaz-Carroll, Angel-Urdinola and Wodon (2005). "Terms of Trade, Oil Surges, and Poverty: Simulations for Sao Tome and Principe Using the 1-2-3 model and SimSIP", mimeo.

* Shares for coffee in 2003 and of palm oil in 2002 are based on mirror data. Rest of data is that reported by STP in COMTRADE.

2.5 As might be expected, STP's terms of trade depend heavily on the prevailing international price of cocoa (see Table 2.3). The terms of trade deteriorated substantially between 1997 and 2001, but were able to recover most of the lost ground after the international cocoa price rose in 2002.

Table 2. 3: STP'S Terms of Trade and the Price of Cocoa

	1998	1999	2000	2001	2002	2003
Cocoa price (US\$ per kilogram)	1.17	1.38	0.79	1.07	1.47	1.57
Export unit value index*	100.7	68.4	59.4	61.8	97.9	95.9
Import unit value*	88.6	89.3	91.4	85.8	89.0	98.1
Terms of trade	113.7	76.6	65.0	72.0	110.0	97.7
Percentage change in terms of trade	13.7	-32.6	-15.1	10.8	52.7	-11.2

* 1997 = 100

Source: IMF

SERVICES

2.6 Service exports are dominated by tourism, which, although small scale, already brings in about US\$10 million, per year, about twice as much as cocoa²³. Tourism received a significant boost in 2002, when the private Portuguese airline, Air Luxor, began to serve STP from Lisbon with lower fares. For the first two years, the airline operated two flights per week. In November 2004, this was reduced to one flight pending government agreement to offer increased services to and from Lisbon routed through Angola. Before Air Luxor, there had only been one weekly flight from Europe operated – also out of Lisbon -- by the Portuguese national carrier Transportes Aéreos Portugueses (TAP). In 2003, the number of international passenger movements (arrivals and departures) at São Tomé international airport rose from 27,500 to almost 35,000. The

²³ The figures may be slightly exaggerated since no statistical distinction is possible between those who visit the islands for tourism and those who come on business.

development and potential of STP's tourist industry is discussed in more detail in Chapter 3 of this study

2.7 Other than tourism, services remain undeveloped. There have been attempts to generate hard currency by selling flags and passports of convenience. Several dozen ships, ranging from petroleum tankers to container vessels, fly the Santomean flag, while there are a considerable, but unknown, number of holders of Santomean diplomatic passports. However, the proceeds from these initiatives are very insignificant compared to the volume of foreign grant aid and loans.

THE TRADE REGIME

2.8 As is common in least developed countries, STP's central government revenue depends heavily on taxation of international trade. Import taxes (*"direitos de importação"*) have averaged over one-fifth of total tax and non-tax revenues (excluding grants) since 1997, while consumption taxes on imported goods amount to a further 25 percent of total revenues. (See Table 2.4).

Table 2. 4: STP Government Revenues

	(Billions of Dobras)					
	1998	1999	2000	2001	2002	2003
Tax Revenues						
Direct Taxes	12	17	20	24.5	34.9	34.4
Of which corporate profit tax	6.1	7.1	6.7	9.5	20.4	19.7
Indirect Taxes	24.6	37.1	39.3	54.1	60	79.8
Of which import taxes	10.1	18.3	17.9	19.4	23.8	30.9
Import taxes as % of total revenues less grants	18.5	28.3	22.4	21.4	21	21.5
Non-tax Revenues	17.9	10.6	20.5	12	18.4	26.2
Of which fishing royalties	0	0.9	8.1	2.7	1.6	9.8
Grants	27.2	82.2	104.2	159.5	132.2	137.1
Total revenues and grants	81.7	146.8	184.1	250.1	245.6	280.9

Source: IMF

2.9 The 2000 Budget Law introduced significant trade liberalization measures. All non-tariff barriers were eliminated. The import tariff structure was simplified from a significant number of categories to just three. Tariffs were also reduced. The previous range of between 8% and 277% was reduced to three rates: 5% on basic goods, 20% on luxury goods, and 10% on all other imports, which are mostly capital equipment items. Some of these imports are subjected to surtaxes²⁴. Two secondary import taxes (*"emolumentos gerais aduaneros"* and *"contribuição industrial variavel"*) were eliminated. In accordance with the legislation in force, the public sector is exempt from import duties, and the private sector may also qualify for favorable treatment under the

²⁴ Surtaxes are applied to four sets of imported products: petroleum products (144% gasoline, 4.4% kerosene, 317% jet fuel, and 57.9% diesel); alcoholic beverages (beer 41%, wine 25%, spirits 55%); cigarettes 55%; and used vehicles up to a maximum of 55% depending on the age of the vehicle.

provisions of the Investment Code. All taxes on exports were removed. The obligation to surrender export receipts to the central bank was abolished, and current account transactions were liberalized. There are, however, restrictions on the export of wood, stone and sand, for environmental protection purposes.

2.10 On balance, therefore, STP's trade regime has been liberalized to a level which is comparable to that of other countries at similar levels of development. It is favorably rated by the IMF Index of Trade Restrictiveness (3 out of 10, where 10 is the most restrictive mark). Further liberalization is likely to take place in the context of negotiations for WTO accession and for an Economic Partnership Agreement with the European Union. The surtax of 57.9% on diesel fuel should be reduced as this has the effect of increasing internal transport costs for exporters. The surtax on used cars, which rises with the age of the car, would appear to be regressive as it undoubtedly hits lower-income consumers disproportionately.

2.11 A study by international experts should be undertaken to determine the extent of informal international trading activities. According to information received during the main DTIS mission, this activity is on the increase, and there is apparently a substantial amount of smuggling, although precisely how much is unknown.

INTERNATIONAL TRADE RELATIONS AND ACCESS TO MARKETS

Accession to the World Trade Organization (WTO)

2.12 Since 2001, STP has had observer status in the WTO. This enables the country to send its official representatives to participate in meetings, and also to benefit from a wide range of training courses and seminars. In mid 2004, the Government decided to apply for full membership and its communication to that effect was sent to the WTO in January, 2005. This was formally accepted by the Organization in May, 2005.

2.13 There are a number of potential advantages for any country acceding to WTO membership. The application process itself – both the preparation of the Memorandum on the Foreign Trade Regime (MFTR – see Box 2.1) and the subsequent negotiations – makes an important contribution to domestic transparency and to a wider and more open discussion of trade-related issues. These negotiations provide a basis for debating the role of liberalization in development, across government and with other national stakeholders. They should be the task of a committee, in which these stakeholders are represented. The process of reaching agreement on this important statement of trade policy, and then locking it in, is a practical way of encouraging investors, both domestic and foreign. The WTO provides an internationally monitored anchor for credible and appropriate domestic trade-related policies. This would help to insulate the Government from protectionist pressures, thereby increasing policy transparency and reducing market uncertainty. Subsequently, membership allows participation in ongoing policy debates and negotiations at the WTO about international trade issues. It also ensures access to the markets of other members through the guaranteed application of most-favored-nation (MFN) tariff rates and other WTO principles and instruments, as well as access to its

powerful dispute settlement mechanism. Finally, it assists in the creation or improvement of a regulatory framework and institutions conducive to and investment.

Box 2. 1: The process of accession to the WTO

The applicant submits a communication to the Director-General expressing its desire to accede to the WTO. The General Council then considers the application and establishes a working party whose function is "to examine the application for accession to the WTO under Article XII and to submit to the General Council/Ministerial Conference recommendations which may include a draft Protocol of Accession". Any member of the WTO can join the working party. The working party is chaired by a Chairperson selected after consultations with WTO Members and the applicant.

Memorandum

Once the working party is established, the applicant provides a Memorandum on the Foreign Trade regime (MFTR) describing in detail its foreign trade regime, together with information on the currently applicable tariff schedule and copies of relevant laws and regulations in one of the WTO official languages (English, French and Spanish).

Questions

Following the circulation of the MFTR, members of the working party can ask questions and obtain more information about the applicant's foreign trade regime. After the replies to the questions are received, the first meeting of the working party examines the Memorandum, and the questions and answers to study the conformity of the regime with the requirements of the WTO Agreements. Additional questions in writing, replies and further information papers are then exchanged.

Bilateral negotiations

The negotiating phase and the fact-finding work on the foreign trade regime usually overlap and proceed in parallel. The negotiating phase commences either by the applying government tabling its initial offer on goods or services or by interested WTO members submitting their request lists to the applicant. The negotiations on market access constitute the most critical element of the accession process as they usually require some significant liberalization of the economy, notably in the services sectors. The resulting market-access commitments of acceding governments can be considered to be the payment for the entry ticket into the WTO.

Report, Protocol of Accession and Entry into Force

The summary of the discussions in the working party is contained in the report of the working party together with a draft Decision and Protocol of Accession. The Protocol of Accession contains the terms of accession agreed by the applicant and members of the working party. Following the conclusion of bilateral negotiations between interested members and the applicant, the Schedule of Concessions and Commitments on Goods and the Schedule of Specific Commitments on Services are prepared. These Schedules are annexed to, and are part of, the draft Protocol of Accession. Following the decision of the General Council/Ministerial Conference to adopt the package, the Protocol of Accession enters into force. Thirty days after acceptance by the applicant, it becomes a WTO member.

This process can easily last 4-5 years, or longer, and depends largely on the current openness of the applicant's economy and their willingness to make further concessions. However, the process also demands considerable administrative capacity to assemble and organize all the necessary information and laws, and some new laws may have to be drafted and approved. LDCs are supposed to enjoy a more lenient treatment, but there is little evidence of this to date.

2.14 Despite these undoubted advantages, it is not clear whether accession to full WTO membership should be a priority for STP at this time. One of the advantages – more assured access to markets – may not apply to STP. Thanks to its LDC status and close trading relationship with the EU, it enjoys the benefits of both the Everything But Arms (EBA) agreement. Its principal exports, both now (cocoa, coffee) and in the future (oil), face low or zero tariffs in most markets, and its trading partners are unlikely to impose non-MFN rates. As an observer, and as an LDC, STP already qualifies for much of the technical assistance available. Perhaps most importantly, STP's resources for the

formulation and application of policy -- and not only in trade -- are spread very thinly. The Direction of Commerce within the Ministry of Commerce, Industry and Tourism carries the sole responsibility for administering all trade-related initiatives – including organizing and coordinating the WTO application, negotiating the Economic Partnership Agreement with the EU (plus related negotiations with CEMAC) and acting as the Focal Point for the Integrated Framework exercise itself. It is seriously overstretched, and suffers from a shortage of professionally qualified staff.

2.15 In addition to the demand on scarce government resources, there are other arguments or concerns typically raised by acceding countries. First, accession countries are generally expected to commit to further reductions in import duties as well as Other Duties and Charges, which are trade taxes outside the normal schedule of Customs duties. This can pose problems both for domestic producers, and for government revenues. Given its small productive base, STP does not have a large number of producers currently relying on protection, and those which do exist already benefit from some natural protection due to the high transport costs on imports. STP does remain very dependent on such duties and taxes for revenue generation (see Table 2.3), and tax reform would not be easy or costless. However, given the relatively low level of existing tariffs, it may be that significant further liberalization of goods is not required.

2.16 Second, WTO rules restrict the ability of members to subsidize their exports. At present, this is not an important consideration for STP as WTO members with an income per capita below \$1000 are exempt from this rule. However, once oil revenues start arriving in substantial quantities STP will soon pass this threshold. A fundamental concern of the country's development policy in the (temporary) oil era will probably be the encouragement of greater and more diversified non-oil exports, particularly from the agricultural sector, in order to provide enhanced employment opportunities in the rural areas, and lay a more solid foundation for continued balanced development after the oil era comes to an end. Moreover, there will be strong upward pressure on STP's real exchange rate as a result of oil income, and the Authorities may wish to compensate exporters for the concomitant disadvantage. However, the WTO does allow various forms of support to producers, including publicly-funded research and extension, training, infrastructure investments, and marketing assistance as well as other forms of agricultural subsidies, providing the funds are not conditional on actual exports. Thus, this rule should not be a major problem for STP.²⁵

2.17 Third, STP would be obliged, within a certain number of years following accession, to implement fully the provisions of the Agreements on Sanitary and Phytosanitary Measures (SPS), Technical Barriers to Trade (TBT), Trade-Related Intellectual Property Rights (TRIPS), and Customs Valuation. All these Agreements have positive aspects, and important institution-building dimensions. Their implementation is not, however, cost-free, especially for STP which would be starting virtually from scratch in these areas. In the case of the SPS and TBT Agreements, members are encouraged to base domestic regulations on international standards, and principles of “sound science.”

²⁵ It is also unlikely that STP will suffer much scrutiny on this score, given its marginal status in world trade.

National regulations would need to be modified where necessary to embody international standards, or else justified where they are more stringent. They would also need to be designed so as to minimize their restrictiveness on trade. Members are required to notify the WTO of all standards which affect trade and to set up an Enquiry Point where such information can be obtained. They are required to notify others when developing new SPS measures which may affect another WTO member's exports. While all of this is useful in principle, it will take time and effort to implement in practice.

2.18 With regard to TRIPS, studies suggest that international harmonization will, in the near term, lead to substantial transfers of rents from poor to rich countries, in addition to the cost of designing and implementing a national intellectual property regime. The challenge for STP would be to develop an intellectual property rights regime that balances such transfers with the benefits of a greater inflow of foreign technologies as well as the protection of its own intellectual property. It is not obvious how significant such benefits would be for a small LDC like STP.

2.19 Application of the Customs Valuation agreement according to WTO standards will require extensive training for Customs officials in valuation methods, and access to data bases with the needed pricing information²⁶. The experience in many other African countries suggests that it will be difficult to implement this agreement effectively.

2.20 In short, these Agreements would involve reforms of existing institutions, and the creation of some new ones. This would cost money and absorb scarce human resources, even when appropriate technical assistance is provided either by the WTO or other bilateral and multilateral sources.

2.21 Fourth, WTO membership implies liberalization, not only of trade in goods, but in services also. These sectors include business advisory services, communications, construction, education, financial services, tourism and transport. STP would probably have to commit itself to liberalization in at least some of these sectors both for the cross-border supply of services, and for foreign commercial presence in STP, albeit with some restrictions allowed. This is, in principle, very positive. It would help reduce costs for consumers and producers, including exporters of goods, and it would reduce both the possibility and the temptation to grant exclusive market access, a common practice in STP. On the other hand, liberalizing commerce in services is a complicated process. Liberalization commitments need to be accompanied by sound regulatory policy, an area in which STP is only now starting to build its capacity.

2.22 The completion of the process for full WTO membership would thus be complex with both costs and benefits. It would stretch the country's scarce human and administrative resources, especially given that the responsible government department is already overstretched. Although the WTO members have pledged to simplify the

²⁶ Article VII of the General Agreement on Tariffs and Trade (GATT) requires WTO members to apply Customs duties on the value of an imported item based on the price paid or payable in the market. This is known as the "transaction value." The rule is meant to block the use by governments of artificially high or low "reference" prices. Practical application of this excellent principle is not always easy, especially for an LDC.

accession process for LDCs, the recent experience of Nepal and Cambodia has not demonstrated a significant shift in practice²⁷. STP should proceed with the accession process as a means of building its trade policy capacity and eventually rationalizing and improving that policy. But it would be unwise to rush the process any faster than national capacity allows, as this will likely lead to unexpected obligations without compensatory gains.

The Economic Partnership Agreement with the European Union

2.23 STP is a current beneficiary of the Generalized System of Preferences (GSP) as applied by the EU, Japan and the US. This is, however, largely theoretical since the country hardly makes use of the preferences. As an LDC, it is also a potential beneficiary of the EU's Everything But Arms Initiative (see Box 2.2). STP is also a member of the group of African, Caribbean and Pacific Countries (ACP), whose imports are given preferential treatment by the EU under the Cotonou Agreement.

2.24 The Cotonou Agreement, signed in June 2000, is a comprehensive partnership agreement between the EU and 77 ACP countries. It is built on five interlinked pillars: the political dimension, economic and trade cooperation, a participatory approach to negotiations, strengthened focus on poverty reduction, and financial and technical development assistance. The primary objective of cooperation is to foster "the smooth and gradual integration of the ACP states into the world economy, with due regard to their political choices and development priorities, thereby promoting their sustainable development and contributing to poverty eradication."

2.25 Unilateral trade preferences under the Cotonou Agreement are scheduled to cease in 2008. These are to be replaced by the negotiation of Economic Partnership Agreements (EPAs). According to the European Union, the main objective of these EPAs is to modify trading arrangements between the EU and its ACP partners to make them more effective in stimulating trade and investment. Another important innovation is to render them compatible with WTO rules regarding regional trade agreements. The primary building block is the establishment of several free trade areas between the EU and six different regional groupings of ACP countries, in which substantially all tariff and non-tariff barriers to trade between the parties would gradually be abolished.

2.26 One of the key differences, therefore, between the EPA and previous arrangements is that the former will eventually require reciprocal market opening by the developing countries. The EU will thus have nearly equal rights of access to the STP market as STP has to the European one²⁸. The EPAs are full partnership agreements, implying rights and obligations on all parties, and in a variety of fields including trade in services, investment and competition policy.

²⁷ The small island of Vanuatu actually halted its accession process out of frustration over the complexity of procedures.

²⁸ It is not necessary for the degree of opening to be identical. In the case of the South Africa-EU agreement, South Africa removed tariffs on about 86% of trade, while the EU removed 95%.

Box 2. 2: STP and the European Union: Generalized System of Preferences, Everything But Arms, and the Cotonou Agreement

The EU absorbs most of STP'S exports and about one-fifth of all developing country exports. 40 percent of EU imports originate in developing countries. The EU is also the world's largest importer of agricultural products from developing countries, absorbing more than the US, Canada and Japan taken together. As the main trading partner of the developing world, with a preferential trade volume more than three times higher than the US in 2002, the EU is implementing a series of preferential trade regimes with a view to enhancing the access of developing countries' exports to the European market.

Generalized System of Preferences (GSP): under its GSP, the EU is currently granting unilateral tariff preferences to 178 developing countries. Of the preferential imports under this regime in 2002, half were duty free and half enjoyed a reduced duty. In 2002 EU imports under GSP amounted to €3,2 billion.

Everything But Arms (EBA): under this unilateral preferential regime, launched in September 2000, the world's 48 LDCs – out of which 34 are in Sub-Saharan Africa – export to the EU duty-free and quota-free, with the exception of arms and ammunition, and three highly sensitive agricultural products -- bananas, rice and sugar – which will be gradually integrated into the scheme by 2009. In 2002 EU imports under this scheme amounted to €2.2 billion.

Cotonou Agreement: as a result of deeply rooted historic and economic links between Europe and ACP countries, the EU grants preferential treatment to imports from these countries. In 2002 a total of €9 billion entered the EU duty free, whereas another €1.9 billion entered at a reduced duty level. The trade preferences of the Cotonou Agreement will be restricted after 2008 to countries that will have signed Economic Partnership Agreements (EPA) with the EU.

2.27 Another key difference is that the EPAs will not, in most cases, be negotiated by the EU with individual states, but with regional economic trading blocks. STP is a member of the Economic Community of Central African States (ECCAS)²⁹ but this group has thus far achieved only a very limited degree of integration or harmonization. The EU has therefore chosen to negotiate with the Central African Economic and Monetary Community (CEMAC³⁰). STP is not a member of CEMAC, and the extent to which it benefits from market access to CEMAC is currently limited³¹. In 2004, the Government signed a commercial cooperation agreement with CEMAC which established the legal basis for the creation of a free trade area between the group and STP. This could be implemented when the necessity arises and will facilitate the negotiation of an EPA jointly with CEMAC.

²⁹ Along with Angola, Burundi, Cameroon, the Central African Republic, Chad, Gabon, The Republic of Congo, the Democratic Republic of Congo, Equatorial Guinea, and Rwanda.

³⁰ As the grouping, which is composed of Cameroon, Chad, Central African Republic, the Republic of Congo, Gabon, and Equatorial Guinea is more commonly known by the initials of its French name (Communauté Économique et Monétaire de l'Afrique Centrale), we will use these initials in this study.

³¹ Practical difficulties in penetrating, for instance, the Gabonese market, were reported to the DTIS Mission. Agricultural produce from STP was being sold on a small scale in Gabon, but following protests from fellow CEMAC member Cameroon, which wished to supply the Gabonese market with the same or similar products, measures were taken to block STP access. Most trade, mostly with Gabon, continues on an informal basis.

CEMAC countries



2.28 Because of these and other dimensions, the issue of an EPA for STP has been the subject of considerable deliberation and hesitation in the Government. This is appropriate, since the issue is highly complex. It is not yet clear if the signing of an EPA is the most appropriate course for all LDCs, especially an LDC in STP's situation – the country is not currently a member of any meaningful regional trading bloc, and the fact that it will, in all likelihood, be earning major oil revenues within a comparatively short space of time also merits special consideration. A careful analysis is required to ensure that the costs of an EPA for STP do not outweigh the potential benefits.

The main arguments cited in favor of negotiating an EPA for STP are:

- ❖ It would enable STP to preserve its preferences with the European Union in a manner compatible with WTO rules.
- ❖ It would protect, and possibly enhance, the financial and technical assistance provided by the EU for STP's development, as well as encouraging greater private investment from EU companies.
- ❖ It would help STP to develop a deeper relationship with the EU, which is its main trading partner.
- ❖ The EPAs go beyond trade as such and attempt to address supply side constraints to efficiency and the expansion of trade.

- ❖ Through the negotiation with a regional trading bloc rather than with STP individually, both the negotiation process itself, and its outcome, would promote STP's closer integration with its continental African neighbors.

2.29 Each of these arguments may be examined in turn. First, with regard to *preferences*, while the point is generally valid, it is important to remember that, as an LDC, STP already has duty free access to the EU through the Everything But Arms (EBA) initiative³². While the EBA can be said to be less secure than an EPA, which would be enshrined in a formal treaty, it is, nonetheless, unlikely that this initiative would be unilaterally annulled by the EU. The EBA is WTO compatible because it applies to all LDCs, and discrimination on this basis is permitted under WTO rules. Loss of LDC status for STP is equally improbable for the foreseeable future³³ – and certainly until well after oil revenues start flowing. During the oil era, the issue of preferential access to the European, or indeed any other market, would arguably become a lower priority.

2.30 Moreover, the most significant constraints to STP access to the European markets are not directly trade related, and are certainly not the result of trade barriers that would be addressed through an EPA. They include transport costs and the capacity of STP's agricultural exporters to meet the EU's quality and phyto-sanitary standards. These would not be affected by preferences or by an EPA.

2.31 More generally, the value of preferences to the ACP countries is, in any case, declining, and will likely continue to do so. Further trade liberalization along Most Favored Nation lines is being negotiated in the process initiated at Doha in 2001. Preferential access to the EU market has already caused disputes in the WTO, for example in the case of bananas, leading to increased market access for ACP countries. The EU is also revising its rules on sugar access for ACP countries as part of Common Agricultural Policy (CAP) reforms. It is also extending preferential access to other trading partners, notably non-EU Eastern European and Central Asian countries, Turkey, North Africa, and Mexico.

2.32 With regard to *development assistance*, it is not certain that there would be increased financial and technical support linked to the existence of an EPA. It is, moreover, hardly conceivable that STP would be deprived of EU financial and technical assistance in its absence. Nonetheless, there is a risk that the European Commission's priorities would focus on those countries that choose a full commercial and economic partnership. STP may, therefore, enjoy lesser and more problematic access to EU cooperation if it were not a signatory to an EPA. It is difficult to be precise about the

³² The rules of origin under the EBA are not as favorable to the exporting country as under the Cotonou Agreement, but this could be changed by negotiation.

³³ The criteria which determine LDC classification are elaborated by UNECOSOC. They are wider ranging than those used by the World Bank to decide whether or not a country qualifies for its soft term credits under the IDA program. The latter uses essentially GDP per capita. Thus, Equatorial Guinea, for example, "graduated" almost immediately from IDA after oil income dramatically increased its per capita income from one year to the next. Equatorial Guinea, however, remains an LDC. This is because UNDP criteria include, as well as per capita income, social and human development indicators such as literacy, infant mortality, and life expectancy rates.

magnitude of this risk. However, once STP has income from oil, this issue would become less important, since the country would be able to buy high quality technical advice in the open market and it would, in any case, see its level of concessionary development assistance diminish.

2.33 Similar arguments prevail concerning *private investment*. The EPAs are designed to encourage greater interchange and collaboration between signatories, not only in terms of public sector issues – trade promotion, financial and technical assistance and so on – but also in terms of cooperation between the private sector in Europe and that in the other signatory countries. This is an important consideration for STP, which not only urgently needs new foreign investment, but also enhanced relationships with foreign private sector partners who can facilitate access to markets³⁴. Again, however, an oil-producing STP should, in any case, become more attractive for foreign investment irrespective of whether the country has signed an EPA. In other sectors, a wide variety of government policies may have a greater impact on investor willingness to consider STP.

2.34 It is not easy to see what the “*deeper relationship* with the EU” means in STP’s case. As shown above, STP’s exports to the EU, other than cocoa, are very small indeed. Its imports are dominated by Portugal, not because it is a member of the EU, but because it is the former colonial power. This dependence generates costs, and it would almost certainly benefit STP to diversify its trade, especially to Brazil, South Africa and eventually the United States. Among the main barriers to this are sea and air transport links, which are, in turn, strongly influenced (especially in the case of sea transport) by the condition of the existing transport infrastructure (see Chapter 4). It is not clear that the signature of an EPA would help in overcoming these constraints.

2.35 The addressing of *supply side issues* is certainly an important consideration in STP, as in all developing countries. However, an EPA is not necessarily the most appropriate framework for these actions. Development support to help overcome supply side constraints should be allocated in accordance with the priorities set out in STP’s PRSP. If such allocations are made in the framework of a trade agreement, then there is a danger that some of the funding would be diverted to cope with the adjustment costs associated with the agreement itself (reduced tax revenues, impact on certain vulnerable sectors, etc.). Moreover, supply side considerations have always been part of the EU’s relations with developing countries, and funding has been provided for this under the Lomé and Cotonou Conventions. Hopefully, its volume and effectiveness will be improved under the EPA, but there is no guarantee.

2.36 The negotiation of an EPA would likely help to deepen *STP’s integration with other countries of the Region*, notably the members of CEMAC. An important side-

³⁴ The costs to developing countries of exporting to foreign markets are often a greater hindrance to trade than are tariffs. Trade-related transaction costs, including logistical expenses such as freight charges, are crucial to determining a country's ability to participate in the global economy. Technical and phyto-sanitary standards can also be significant barriers. Partnerships with private sector entities in the destination market, whether or not also investors, can be of critical importance in reducing these costs and overcoming these obstacles. Such companies are, for example, much better placed to negotiate freight rate reductions than STP firms would be if acting alone.

effect could well be the formal opening of CEMAC's markets to STP's products. However, it is not clear that EPA negotiations are a necessary or a sufficient condition from furthering such integration. STP could and indeed has negotiated a commercial agreement with CEMAC outside the context of an EPA³⁵. Moreover, it is not clear that CEMAC is, or would become, the highest priority market on the African continent for STP, nor is the extent to which robust and durable benefits of integration with the Group would be attainable short of full membership³⁶. True, Gabon is one of the preferred destination markets for small quantities of STP agricultural products. However, Angola is substantially more important, and is a natural commercial interlocutor for STP thanks to linguistic and cultural ties. Nigeria, already a more important source of imports than CEMAC, will grow in significance as a trading partner³⁷ thanks to the joint exploitation of offshore oil resources. It would also be undesirable for STP to raise its tariffs to the higher level of the CEMAC common external tariff.

2.37 There are, moreover, a number of concerns about the potentially negative impact of an EPA on STP's economy. First, EPAs include a provision for reciprocity in preferential tariff reductions and eliminations. In the case of STP, this would undermine a major generator of tax revenue. A recent study commissioned by the EU³⁸ estimates that tax revenue related to imports of goods originating in the EU amount to just over 21 billion dollars annually (about US\$2.6 billion equivalent or about 20 percent of total current revenues and six percent of GDP). The study stresses the need to compensate for this loss by increasing other taxes or developing new sources of revenue such as a value added tax. The adjustment would not need to occur immediately after the coming into force of the EPA in 2008, and may eventually be softened by the advent of oil revenues. Nonetheless, there would have to be an adjustment. Widening the tax base, while excellent in principle, would not be easy in STP's case.

2.38 Second, there is a danger of trade diversion in favor of more costly EU suppliers. Beneficial trade expansion to potentially cheaper sources such as Brazil and South Africa may be discouraged. There would be less of a possibility of a successful challenge to some of the uncompetitive relationships between Portuguese exporters and the relatively small group of trading houses in STP.

2.39 Third, an EPA would lead to increased competition from European imports for certain vulnerable local activities. This issue is dealt with in some detail in the Metra study commissioned by the EU. In sum, STP has a very small industrial base. Most of the "infant industry" activities were launched by the State after Independence. When the State gave up ownership in the late 1990s, the small industries nearly all foundered in the absence of markets, economies of scale, infrastructure, skilled labor, credit, and most

³⁵ In 2004, STP signed an agreement with CEMAC which creates the legal basis for a free trade zone, although no timetable has been established for its implementation.

³⁶ Full membership of CEMAC would not be a wise option for STP, implying as it would, full monetary union and exchange rate rigidity with the CFA Franc tied to the euro.

³⁷ There are already several cargo flights per month from Nigeria bringing in second hand clothing of European origin, footwear, plastic goods, electric and electronic goods and pharmaceuticals.

³⁸ São Tomé e Príncipe: A Better Order," Metra Economic Consulting Limited, London, August, 2004.

other elements of a friendly business climate. The activities most seriously affected by the full reciprocity stipulation are therefore limited to the following:

- ❖ Horticulture (notably potatoes, onions and tomatoes).
- ❖ Livestock farming
- ❖ Cultivation and processing of palm oil.
- ❖ Beer manufacture

2.40 With the exception of beer, all of these are currently small scale activities. This does not, however, mean that they are without significance, since in many cases poor farmers depend on them to augment their incomes. Moreover, some of them could grow in importance as part of STP's export diversification process. They would likely need special treatment and protection against lower cost and higher quality imports from Europe, and this treatment may need to go beyond the scope of what is contemplated in the Cotonou Agreement. There may, moreover, be a risk that an EPA would lead to an increased risk of subsidized EU food exports which might undermine agricultural diversification efforts.

2.41 Fourth, the potential impact of an EPA on the development of new activities – particularly services such as banking and finance, storage and break-bulk, transshipment, telecommunications, tourism etc. -- in STP is ambiguous. At best, it would stimulate real reforms and increases in efficiency in these sectors. However, there are also dangers. If services are not fully liberalized in the context of STP's WTO accession agreement, an EPA could give preferential access to EU service providers and thereby strengthen the position of incumbent or potential EU suppliers of services, even though they may be costlier and less efficient than competitors from elsewhere. The development and diversification of some activities may even be stifled due to the influence of these incumbents. This is an important issue for STP which would benefit from opening itself to as wide a range as possible of potential suppliers and investors in the development of, for instance, container transshipment and telecommunications-based services, as well as air transport and tourism. Important regulatory and legal reforms will be needed in STP to develop such activities, and these should not be biased in favour of one international source over another.

2.42 Fifth, the EU wishes to include in the EPAs a wide range of issues, including investment, trade facilitation, competition, government procurement, labor issues and the environment. While these themes are undeniably important, a number of developing countries, including a group of African nations, resisted the introduction of rules addressing them for two reasons. First, there was concern over the appropriateness of some of the rules – especially on the labor market and the environment -- given the level of development and the ambitions of the countries concerned. Second, there was a belief that capacity constraints would prevent the countries from responding adequately to agreed international requirements on these issues. Capacity constraints are certainly a key problem in the case of STP. The inclusion of these complex issues in an EPA would require considerable caution and flexibility on the part of the EU, informed by the local

context. Above all, it would be necessary to resist the temptation to apply EU best practice in a context such as that of STP.

2.43 Thus it can be seen that the issue of whether STP should sign an EPA with the EU is a complex one with many dimensions. There is clearly a great deal of pressure on the country to embark on negotiations, and talks with both the EU and CEMAC have already been initiated. If the negotiations do proceed, STP will need to be vigilant to ensure that its special needs and constraints are fully addressed in the EPA. Above all, it should keep in mind that it has an alternative. As an LDC, it will continue to benefit from access to the EU markets through the EBA initiative. And as an eventual oil producer, it will be in a position to exploit a considerably wider scope of options, including geographically diversifying its trade in both goods and services³⁹, as well as attracting investor interest from a broader range of countries and regions. Moreover, entering into the initial stages of a negotiation does not determine the outcome, nor imply an obligation to sign an EPA. The process of negotiation, irrespective of the outcome, will have the benefit of furthering interaction with the countries of the region, learning by doing, and taking advantage of the technical support and training offered by the EU⁴⁰.

Other Trade Relations

2.44 STP has signed trade agreements with Nigeria, Angola and Gabon, but they do not go beyond the Most Favored Nation principle and some trade facilitation provisions. Angola is an important trading partner, and will likely remain so due to close cultural, linguistic and political ties. It is STP's main supplier of petroleum products, and the unloading facility and tank farm at Neves to the north-east of the capital city is partly owned by the Angolan national oil company. Trade with Nigeria will probably increase substantially as STP's own oil production comes on stream as most of the offshore fields are jointly owned by, and exploited in partnership with, that country.

2.45 STP is a beneficiary of the United States' African Growth and Opportunity Act (AGOA – see Box 2.3). This has not yet triggered any significant trade with the US, which imports less than \$100,000 worth of goods annually from STP. This small scale is due primarily to lack of supply capacity and costly transportation routes. None of the exports benefits from either AGOA or the US GSP.

³⁹ Oil revenues may well, for example, attract the necessary investments to achieve major improvements in transport infrastructure, which would in turn facilitate geographical diversion of trade.

⁴⁰In 2004, the EU set up an on-line help desk which provides considerable information and is a useful tool for helping developing country exporters access the European market more easily. It may be found at <http://export-help.cec.eu.int>.

Box 2. 3: African Growth and Opportunity Act (AGOA)

Former US President Bill Clinton signed the African Growth and Opportunity Act (AGOA) into law on May 18, 2000 as Title 1 of the US Trade and Development Act of 2000. AGOA offered tangible incentives for African countries willing to open their economies and build free markets, providing 36 countries in sub-Saharan Africa tariff-free and quota-free access to US markets for some 6,000 products. Duty-free access for eligible countries is provided for more than 1,830 items that were excluded from benefits under the US GSP. In mid-July 2004, President Bush signed legislation to extend AGOA until 2015, thus extending the special rule allowing third-country fabric inputs through September 2007. Referred to as AGOA III, this new legislation also provides the possibility of technical assistance for ecotourism, and funds assistance from the US Department of Agriculture's Animal Plant Health Inspection Service (APHIS) in meeting agricultural product sanitary and phytosanitary standards.

2.46 Other than Nigeria, the most promising future prospects for growth in trade could well be with South Africa and Brazil. South Africa is aggressively pursuing markets throughout the Sub-Saharan Region, and there have already been a number of missions to STP and one to South Africa organized by representatives of private sector groups. Brazil has the advantage of a common language. Closer collaboration with future oil producer São Tomé e Príncipe was of sufficiently high priority to attract the President of Brazil to the Islands for the Lusophone Summit in 2004. In Brazil's case also, there have been private sector missions in both directions, including, in late 2004, a visit to STP from the Brazilian oil company, Petrobrás. There is a considerable potential for attracting investments to STP from these countries if the investment climate could be considerably improved. The most important barrier to developing commercial ties with both countries remains the lack of cheap, regular and direct transport links, especially by sea⁴¹. These would in turn depend upon the completion of urgent improvements to STP's maritime infrastructure (see Chapter 4 of this study).

Negotiating Capacity

2.47 Complex trade-related initiatives such as accession to the WTO, and even more the negotiation of an EPA, require the formation, and technical preparation, of a national negotiating team. A Multi-sector Negotiating Commission for the EPA was created in 2002 through Decree 20/02 to conduct the EPA negotiations. It consists of 13 members, representing the different Ministries concerned, the Presidency of the Republic, the National Assembly and the private sector. Its composition is compatible with the guidelines provided by the regional organizations such as CEMAC. Another Commission is to be formed for the preparation of the Memorandum of Accession to the WTO. It is important to assure an adequate representation of private sector views. There are several private sector groupings in STP, some of them representing small and medium sized enterprises, and these should also have a voice in the Commissions. The existing Commission also meets infrequently, and does not dispose of an adequate secretariat.

2.48 These problems mean that the Commission, as currently constituted, is unable to carry out its task of providing a forum for interchange of views between the Government and the private sector or transmitting the latter's viewpoint to the Administration. In the light of upcoming negotiating tasks, however, the role of the Commission is of central

⁴¹ During the DTIS missions discussions in STP, the possibility was raised of adding STP to the routing of a line which currently serves Dakar and Cabo Verde from Natal in North East Brazil.

importance. The formation of various working groups to deal with specific issues is a good start. In addition, it should be

- ❖ Restructured to reduce the weight of the public sector, and widened to include more private sector and civil society participation;
- ❖ Given a working and effective secretariat; and
- ❖ Provided with technical training in negotiating techniques as well as in the substance of the issues to be discussed.
- ❖ Meet regularly and openly.

2.49 The restructured Commission's main objective would be to determine, in a transparent and consensual manner, the negotiating stance to be adopted by STP in its talks with the EU. As many of the issues will be similar to those covered by the WTO accession process, this Commission should have its mandate extended to include this accession. It will require substantial financial and technical assistance, much of which is expected from the EU, but other funding from donors not directly involved in the EPA negotiations may also be warranted

CUSTOMS ADMINISTRATION AND PROCEDURES

2.50 The Customs Administration has an important role in view of its mandate to enforce applicable laws, collect trade-related tax revenues, ensure security, and prevent illegitimate trade. Traditionally, customs administrations around the world have focused on revenue collection and law enforcement, but recently many have changed their emphasis in order to streamline procedures and facilitate faster clearance of imports and exports. In STP, while Customs do not present a significant barrier to enhanced trade, neither do they fulfil this positive role. A modern and enhanced Administration would require some investments, the approval of the new Code and mandate by the National Assembly, the abolition of outdated requirements, and improved procedures.

2.51 The STP Customs Administration employs 47 persons (37 regular civil servants and ten contract employees). It uses the French-developed customs clearance software known as SYDONIA (version 2.7). Declarations are prepared manually by the traders' representatives (designated customs agents), and are then entered by the Customs Administration into the SYDONIA system. This latter step is in fact obligatory since the entire procedure of invoicing and payment of customs duties is computerized. In the case of power cuts (which occur frequently), customs activities remain suspended. Until the documentation is registered in the SYDONIA system, the merchandise cannot be released.

2.52 Even after the new Code becomes law, a number of weaknesses in the Customs procedures and regulations would remain, including the following:

- ❖ In order to curb smuggling, all containers have to be unpacked in the port or airport area rather than transported intact to final destination. Although this measure is considered necessary to combat fraud, it has significant economic

costs. STP is depriving its importers and consumers of one of the benefits of containerization which is secure door-to-door delivery. Many importers complained to the DTIS mission about the loss of goods either in the port area itself or en route from there to their warehouses.

- ❖ Anyone who wishes to engage in export or import activities in STP is required to apply for a trade licence (“*alvara*”). This must be renewed each year at a nominal cost (100,000 dobras). The licence was created under the colonial regime and is meant to enable the Authorities to control the number and identity of traders. It has no role to play in a modern market economy, and should be abolished.
- ❖ All exports and imports may be declared to Customs. These declarations must be made by a licensed customs broker or agent (“*despachante*”). The cost of this service varies from one to three percent of the value of imports, depending on the size of the consignment.
- ❖ Customs controls are handicapped by the lack of weighing equipment in the port area.
- ❖ Collection and analysis of statistical information is limited. The Administration has no estimate of the extent of smuggling, and in fact lacks the techniques and resources to tackle the problem. It recognizes this as it does the need for greater transparency and for mechanisms to fight corruption.

2.53 To help STP create a modern, trade-facilitating Customs organization, technical assistance would be required. It would support a wide range of measures, among them the following:

Institutional

- ❖ Provide Customs officials with a proper administrative career, improved technical training, better remuneration and working conditions⁴².
- ❖ Institute measures designed to combat fraud and possible corruption, and prepare a Code of Conduct for the Customs Administration.
- ❖ Involve the private sector in the reform of the Customs; establish a permanent consultative committee to be the platform of dialogue between the Customs and private sector associations; create a Customs sub-Commission of the Multisectoral Commission for international trade negotiations.
- ❖ Join the World Customs Organization (fee: US\$12,000 per year) which would enhance the volume and quality of information on how modern administrations function the world over.

Legal

- ❖ Adopt the new Customs Code in 2005.

⁴² There is no reason to separate Customs from the rest of the public service where these measures are required with at least equal urgency. There is, in fact, a profound need for in-depth public service reform in STP.

- ❖ Eliminate the obligation to channel all customs declarations through licensed brokers.
- ❖ Eliminate the free trade zone regime (see Chapter 4 of this study).
- ❖ Eliminate the trade licence (“*alvara*”).

Technical

- ❖ Purchase a generator for the Administration which would enable it to actually use the SYDONIA system it has installed (estimated cost: about US\$30,000).
- ❖ Adopt new techniques for detecting infractions.
- ❖ Invest in weighing scales to enable more adequate control of volumes.

3. EXPORT AND POVERTY REDUCTION POTENTIAL FROM RENEWABLE NATURAL RESOURCES AND TOURISM

INTRODUCTION

3.1 This Chapter examines the potential for increasing output of both traditional and non-traditional products from the agricultural, fishery and tourism sectors in STP. The first section on *The Rural Sector in STP* describes current agricultural production and the possibilities for increasing the income and productivity of the smallholders who form the overwhelming majority of STP's farming population and rural poor. The next section on *Agricultural Production* discusses this potential in more detail – first, for cocoa (the current staple crop) - and then for non-traditional products. *Fisheries and Tourism* considers two sectors where activity has started, but where the prospects for increased income have been barely tapped. The section on *Forest and the Environment* discusses STP's environmental protection policies, especially in the light of potentially expanded agricultural and tourist activity. Finally, we present *An Action Program* for both the public and the private sector in these various areas.

THE RURAL SECTOR IN STP

3.2 Thanks to the comprehensive, though still incomplete, land reform program initiated in the early 1990s, a number of the large “roças” or cocoa estates, owned by the Portuguese colonists and, after Independence, by the State, have been broken up into smaller parcels which have been distributed to smallholders⁴³. Most of these smallholders are former workers on the estates concerned. Some 8,000 families, comprising a total of about 24,000 people are involved. Moreover, farming enterprises which have acquired some of the land previously pertaining to the roças, rely to a large and increasing extent on smallholder out-growers in addition to farming their own land.

3.3 Thus, with a view to numbers and area used productively, sustainable and broad based growth of the country's agriculture depends primarily on smallholders. This has important implications for the choices of policies that are most likely to promote economic growth, including exports, as well as for ensuring that the growth will benefit the poor. The extension of management responsibilities to a wide segment of the population that has never before had to run a farm or any other kind of business, means that extension and education will be extremely important in maintaining the competitiveness and welfare of the single largest part of the population, the rural poor.

⁴³ See Chapter 4, section on the *Public-Private Interface*, of this study for a discussion of the land reform and outstanding issues of land ownership.

3.4 Tables 3.3, 3.4 and 3.5 at the end of this Chapter, contain information on the production of the main crops since 1990. Cocoa, palm oil and copra are the most important cash crops, with cocoa by far the most important in terms of exports. The most important food crops are banana, cassava and matabala (taro) while maize is the most important cereal crop grown domestically. Small ruminants, mostly goats and chickens, are the most important animals, although cattle can often be found “grazing” among cocoa trees. Small animals are raised predominantly by smallholders, while some large estates have herds of up to 100 cattle.

3.5 With fewer than 150,000 mostly poor inhabitants, who in part produce their own food, the local market demand for food and other agriculture products is too small to serve as the basis for a sustainable growth strategy, and hence for the relief of rural poverty. The only viable option for sustained agricultural growth in STP is to base it on an export promotion strategy: exports of crops currently grown and exports of crops which might be promoted in the future. Measures to increase income from the existing cocoa crop have the potential to increase exports and at the same time the earnings of the rural poor. However, and in spite of the fact that the extensive areas under cocoa dictate that it be a part of any short run strategy, comparative advantage studies and volatility in international cocoa prices argue strongly for export diversification in the medium to long run. Similar opportunities for immediate returns based on existing cash crops, and traditional processing into intermediary, tradable, products but with more modest potential can be found in coffee, palm oil, copra, matabala and “farinha de mandioca”⁴⁴. There would also be medium term gains from developing the fishing industry.

3.6 Production of food items that can be exported fresh, is another area of smallholder activity that deserves attention. So far, there has been little emphasis on such products for a number of reasons. First, food imports are substantial, hence import substitution receives attention rather than exports. But, recent comparative advantage studies⁴⁵ show that smallholder food production can be very efficient in São Tomé e Príncipe and compares well with cocoa for smallholders⁴⁶. Second, smallholders have shown a tendency to shift in the direction of food production over the past few years, as a result of market signals. Third, there are several viable markets on the African continent where Santomean traders are already selling food, most notably matabala and green bananas in Gabon. In addition, anticipated offshore oil operations will give rise to demand for food for the crews working directly and indirectly on petroleum extraction⁴⁷. A push to increase food production could very easily result in substantial exports over the medium term, with national self sufficiency achieved en route to this goal. The advantages of an export promotion strategy, for the rural poor, are obvious but will require a strong extension effort focused on smallholders and the creation of conditions that make it potentially profitable for the private trading sector to exploit these opportunities.

⁴⁴ Cassava meal, a staple of the diet in many African countries, obtained by drying rasped cassava.

⁴⁵ see, a.o.: AGRO.GES/CINFORMA, “Estudo sobre as Vantagens Comparativas entre Pequenas, Medias e Grandes Empresas Agrícolas de São Tomé e Príncipe” Lisboa, 1999.

⁴⁶ See Section on *Non-traditional food exports* for further details.

⁴⁷ It is not anticipated that this will be a very large demand. It will mainly be for special horticultural products, which would have to meet very high phytosanitary requirements.

3.7 In the longer run, exploitation of niche markets for crops such as exotic flowers (in addition to an already existing operation), medicinal herbs and aromatics, pepper and vanilla, as well as other tropical fruits and vegetables “contre-saison,” may have the potential to generate export revenues. There is no doubt that selected small holders can grow such crops. However, any exploitation of these opportunities should be based on expressed market demand. Ideally, the potential buyer should extend all production-related technical assistance and financial support to ensure the growing of the type, quality and amount desired by him or her. In particular, it would be unwise to shoulder public sector extension services with responsibilities vis-à-vis such risky, albeit potentially profitable, ventures.

3.8 The following principles, which are discussed more fully later in this Chapter, should underlie an export oriented, indeed development, strategy that focuses on the rural poor:

- ❖ Support, in the first instance, those products, principally cocoa, that have well established marketing channels accessible to the small producer;
- ❖ Support private initiatives that are directly beneficial to small farmers, notably in marketing;
- ❖ Create efficiently functioning public goods and services (for example, roads, extension services) for the small producer that, in the first instance support, and help maintain, the existing production base, including diversification towards increased profitability;
- ❖ Create an institutional and physical framework to support, protect and exploit rationally and efficiently the country’s fishery resources, inter alia alleviating the plight of one of the poorest sectors of Santomean society, the fishermen and women fish traders;
- ❖ Direct aid projects to innovative, and hence risky, projects that extend the production base and the creation of associated public goods.
- ❖ Enhance and encourage private institutions to provide credit to smallholders.

AGRICULTURAL PRODUCTION

Cocoa

3.9 Cocoa is the single most important crop on the islands, accounting for more than half of the total cropped area and for the majority of agricultural exports. However, current annual production is only around half of historic levels prior to Independence. Among the factors that have contributed to this decline are the following:

- ❖ *low return*: even when cocoa prices are relatively high⁴⁸, a smallholder’s one hectare of cocoa trees, yielding an average of 400 kg per year, generates only

⁴⁸ As they are at present, for example, compared with the average price since 1990.

800,000 dobros, approximately US\$ 80, per year at the present buying price of 2,000 dobros/kg⁴⁹. This confirms a conclusion reached as early as 1997⁵⁰, when the model of smallholder family with an average of 60% of its land under cocoa and the remainder under banana and matabala was considered not viable, as the combination of own consumption and cash income failed to satisfy the basic needs of a family⁵¹. These families will have to, either, include chicken and pork breeding among their activities, typically selling 5 chicken and two pigs yearly, will have to find employment elsewhere, or will have to diversify production⁵².

- ❖ *lack of maintenance*: the low return of smallholder cocoa provides little incentive for tree renewal, planting of shade trees, combating of diseases or fertilization. As a matter of fact, cocoa production by the average small holder is probably closer to an extractive activity than it is to sustainable agriculture.
- ❖ *absence of marketing channels*: the country's cocoa economy was transformed overnight from an activity where the state owned all assets and where marketing was limited to the physical transport and delivery onto a ship, to one where the production assets are dispersed and where collection, processing, transport to the port and sales into the world market have to be arranged competitively. The latter system did not develop overnight, indeed is still in its infancy, while large numbers of small producers remain far removed from an entry point into this marketing system.
- ❖ *land reform*: substantial areas under cocoa remain without smallholders or business operators, either because redistribution is still to be effected, the land was leased for other purposes, or because they are too remote or on such steep slopes that there is little interest in trying to collect the product, particularly given its limited value as shown earlier. In other words, substantial areas that were harvested under labor conditions as they prevailed before and immediately after independence are not attractive to the free smallholder and his family, or are simply not accessible.

3.10 For these reasons, it is unlikely that cocoa will attain the dominant, even pervasive, role in the islands' economies that it had under the colonial regime. Nevertheless, the existence of a huge area under cocoa, with its attendant sunk costs, and the absence of alternative sources of cash income for many small holders, justifies an effort aimed at maintaining much of the production potential for cocoa in the country, at

⁴⁹ Diogo Vaz's cash buying price at producer's farm gate for "goma" as offered. Assumed smallholder's yield is as achieved on average on Diogo Vaz's 600 ha. plantation where tree renewal, planting of shade trees and disease combating measures are practiced.

⁵⁰ See: AGRO.GES/CINFORMA *op. cit.*

⁵¹ Calculated as 215,600 dobros per month in 1997, as against an income of only 149,405 dobros, for a family of four, and defined as: (i) food: daily requirements of fruits, matabala, vegetables and occasional meat from own production, and purchased kerosene for lighting, soap, oil and salt, as well as daily bread, weekly fish, beans and rice, (ii) clothing, (iii) education, (iv) health, (v) furniture, (vi) housing maintenance, (vii) acquisition and maintenance of rudimentary farming equipment. Alcoholic beverages are not included with basic needs, but their consumption may cut into the budget of basic needs.

⁵² See the following sub chapter for a consideration of these alternatives.

least in the short run. There may also be scope, in the more medium term, for enhancing the quality of the product to reach niche markets. For these things to happen, the small cocoa producer must have, first, a reliable outlet for his or her product and, second, some assistance in maintaining the cocoa trees under his stewardship. Given post land reform experiences in STP, as well as experiences elsewhere, the following may be suggested with particular reference to cocoa:

- ❖ Facilitate the creation of buying enterprises for cocoa by offering remaining properties, such as selected “dependencias” of the main “roças”, to individual entrepreneurs or to voluntary associations of cocoa producers established for marketing purposes. Use the examples of successful buying operations as models for further creation of similar enterprises⁵³.
- ❖ A weekly rural radio program should include international and local cocoa buying prices as well as exported quantities. It should list the premia received by other countries as compared with the STP exports and should explain why these exist⁵⁴. This would begin to instill a “quality notion” and provide a reason for spending money on such activities as maintaining and improving existing cocoa stands.
- ❖ The feasibility of moving fermentation and drying operations to the village level, as is common in cocoa growing areas on the African continent and elsewhere, should be investigated in STP. This would both reduce transport requirements by approximately 60%⁵⁵, and enable farmers to retain a greater share of value added at the farm level. It is likely that this movement to village level processing would need the support of the cocoa buyers⁵⁶, as well as technical assistance and financing to facilitate the construction and operation of village level processing.

Non-traditional Food Exports

3.11 With the lack of profitability of cocoa, it comes as no surprise that producers look for alternatives. Many beneficiaries of the land reform have replaced part of the cocoa trees on their holdings with banana trees and “matabala” gardens⁵⁷. However, even a conversion of 40% of the cocoa area to readily marketable bananas and matabala, on the

⁵³ These are operations where a business has a relatively small farm itself, and purchases the bulk of its sales from out-growers to whom it supplies technical assistance and credit as well as a guaranteed market outlet.

⁵⁴ e.g. the New York Board of Trade [NYBOT] recognizes three grades of cocoa, based on origin: group A, which includes a.o. Ghana, Nigeria and Ivory Coast, gets a premium of \$160/ton over par; group B, which includes shipments from Bahia in Brazil and from Venezuela, gets a premium of \$80/ton, all other origins trade at par.

⁵⁵ Given an average transformation ratio of raw to dried cocoa of between 34 and 43%.

⁵⁶ At present, the typical buying price for “goma” is 2,000 Dobros/kg, the price for dried beans is 8,000 Dobros/kg. Most buyers prefer to buy “goma” since they then control the processing and hence the final product quality. Still, the price signal appears the most important incentive to induce village level processing.

⁵⁷ They have also often cut down the old shade trees, cashing in on the value of their timber.

typical small family holding, fails to generate enough income to satisfy basic needs. Others have started horticulture, often imitating neighbors who were already producing fruits and vegetables well before the land reform⁵⁸. There is anecdotal evidence that horticulture production quickly runs into the constraint presented by the small size of the local market. The typical seesaw behavior of product prices, in step with seasonal supplies, is said to be highly pronounced on the islands. Livestock and meat production are other alternative agriculture activities available to small holders, in addition to off farm employment, as sources of cash income.

3.12 If the produce can be marketed, a typical holding of 3 to 4 ha⁵⁹, will also have about 40% of its land under bananas and matabala, similar to the situation of the “cocoa holding” described earlier, but will produce a variety of vegetables and other root crops such as potatoes. These holdings are said to generate more than twice what is needed to satisfy basic needs. However, it should be noted that these farms in most cases employ non-family labor, in addition to the family. The figures presented here for the two alternative smallholdings, predominant cocoa, and horticulture can be summarized as follows: (See Table 3.1)

Table 3. 1: Summary Smallholder Farm Budget (1997 dobros/month)

	Cocoa Holding	Horticulture
Gross Production Value	209,375	848,125
Equipment Related Costs	-16,476	-32,140
Production Inputs	-39,744	-257,960
Net Production Value	153,155	558,025
Basic Needs	215,600	215,600
Shortage/ Excess	-62,445	342,425
Livestock Revenue ¹	60,417	
Off Farm Employment	62,500	

¹ 5 chicken and two pigs sold yearly
Source: AGRO.GES/CINFORMA *op. cit.*

⁵⁸ And whose title to the land used has, paradoxically, never been regularized.

⁵⁹ Note that this is slightly higher than the average of 2.4 ha of holding that resulted from the privatization, see “Background”. The figures presented here, though, from AGRO.GES/CINFORMA *op. cit.*, are based on a survey of 16 holdings that apparently on average were somewhat larger than the overall average of post land reform small holdings. It should also be noted that the surveyed holdings all are at elevations of about 1,000 m [3,000 ft] and that it is uncertain whether good growing conditions for horticulture crops exist on lower, much drier and hotter land.

3.13 It would appear that horticulture production, indeed food production, is economically attractive in São Tomé e Príncipe. However, the crucial question is the size of the market, also considering that many Santomeans produce some food themselves or have friends and relatives doing so, taking them out of the food market, at least in part. The inherent profitability of food production, though, points to an export possibility if only that can be realized. Experience elsewhere indicates that such opportunities can be brought to fruition if a trader is identified who extends technical assistance and some credit, for the production of what he, or she, can sell. The individual small holder can simply not go further than carrying his, or her, produce to the local market and hope for the best. The motto for sustained growth of profitable agriculture is to “produce what the market demands” rather than to try and market what you can produce. A combination of food export activities already observed in STP, and experiences from elsewhere, lead to the following three models:

- i. **a domestic trader** has identified an export opportunity and seeks to satisfy that with local produce. Recent exports of palm oil and cassava meal [“farinha de mandioca”] for the Portuguese ethnic food market are one example. Past exports of goats to the mainland market of Muslim communities is another example⁶⁰. Such export efforts should be vigorously supported. The best kind of support would be to listen, albeit critically, to the comments and demands of the trading community, and take corresponding measures to facilitate trade. These would include reducing the bureaucratic paperwork involved in exporting, providing import duty drawbacks for packaging material, facilitating the acquisition of small scale processing equipment, and issuing reliable and internationally recognized quality and sanitary certificates.
- ii. **a foreign trader** has a demand to fulfill for which São Tomé e Príncipe may be a competitive source. In the area of food products, a recent example is a budding fruit and vegetable producing enterprise, reportedly with the intention to cater for the demands of the crews on oil exploration platforms. In this case, the trader will bring seeds and other production inputs, in addition to investment and working capital, so as to produce exactly what his market demands. Also, initial production will be on land leased by the production enterprise. Once sufficient experience has been gained with production, handling and exports, and the market has been confirmed, the firm intends to contract selected out-growers. Such ventures have, thus, a direct impact on the local economy and on employment, as well as benefiting the smallholder. Again, government should vigorously support such initiatives, in the first instance by listening to the demands of the trader and relieving the bottlenecks complained about. In addition, there are systemic problems linked to the starting and running of a business in STP which are discussed in Chapter 4 of this study.

⁶⁰ Reportedly, local traders took goats to the mainland as a source of trading capital when the dobra was highly overvalued and currency exports were not allowed. These exports reached such high levels that government had to limit them, reportedly to safeguard local meat supplies. Still, the example shows an apparent market and a local production capability for a main food item.

- iii. **an association of local smallholders** is formed to produce for an identified export market. This opportunity to create an export industry is dependent upon the ability of association for the common good of the members concerned. Effective association must be based on local traditions; competent management is the usual bottleneck. Important, though, is the identification of the product and the market, around which the association can be formed.

FISHERIES

3.14 The fisheries sector of São Tomé e Príncipe presents a sad story. On the one hand, foreign fishing vessels and fleets extract valuable catches from Sãotomean waters. A careful study should be made of the compensation that STP receives for this, which, *a priori*, has considerable scope for enhancement . On the other hand, an artisanal fishing sector exists which is typically an activity of last resort for a number of otherwise unemployed people. The artisanal sector lands catches of low quality, almost exclusively pelagic⁶¹ fish that on most days exceed demand, resulting in a severely depressed economic activity.

3.15 Anticipating the UN Law of the Sea Convention, in the mid-1970s, an increasing number of coastal states extended their exclusive economic zones (EEZs) from territorial baselines out to 200 nautical miles. This brought almost 90 % of exploitable fish resources under the control of coastal States. The fleets of the large fishing countries, such as the US, Russia, Japan, Korea and EU Member States, which had traditionally fished in the waters of other countries, suddenly found themselves barred from them. In the case of the EU and to ensure continuity of access for its fishing fleets, “temporary” fisheries agreements were concluded between it and many third countries concerned, notably in the context of the ACP, including with Senegal in 1979, Guinea Bissau in 1980, and the Republic of Guinea in 1983. When Spain and Portugal joined the European Community in 1986, their national bilateral agreements were phased out and replaced by “Community agreements”. At present, European and other fishing fleets gain access to the stocks of countries such as São Tomé e Príncipe through 3 main channels:

- i. **EU bilateral fisheries agreements** which, in the case of the ACP states, are all “cash for access” agreements⁶². Although access costs are taken care of by the EU in the case of a bilateral fisheries agreement, an EU operator may find more favourable conditions under private arrangements. The current bilateral agreement with São Tomé e Príncipe, mainly focusing on tuna, can be summarized as follows:

⁶¹ Species that can be caught with simple surface nets or with lines.

⁶² It is alleged that linkages exist between these access agreements and EU development aid.

Agreement Period [member states]	Financial Compensation (Euros/year)	Main Components	Sustainable Development Main Issues
01/06/02 – 31/05/05 [Spain France Portugal]	700,000 + premium 50,000 Euros for an evaluation study of crab fishery	<i>Access</i> 36 seiners 25 surface long liners 2 pole and line + experimental crab fishery <i>Targeted Actions</i> Local fisheries sector; scientific research; surveillance.	Surveillance /control tuna fleets activities Reporting of catches/by- catches Develop/improve conditions in local small scale sector

Source : Béatrice Gorez and Brian O'Riordan: An Examination of Fisheries Relations between the European Union and ACP Countries; paper Submitted to the Joint COMSEC – CTA Meeting on ACP-EU Fisheries Agreement: Towards a Greater Sustainability 7-9 April 2003, ACP House Brussels.

- ii. **Vessel transfer arrangements through subsidized joint ventures** was introduced in the EU, in 1990, to assist the reduction of fishing fleet capacity in European waters. This capacity, at the time, was 2,3 million Gross Registered Tons, estimated to be 40% larger than justified by then available fish stocks. This gave rise to the first “second generation” fisheries agreement concluded by the EU, with Argentina in 1992, as compared with the “first generation agreements” described above. Fisheries access in Argentina waters was achieved through establishing joint venture “Argentine” companies, into which EU vessels were transferred (and reflagged). This agreement was to prove disastrous for the Argentine hake fishery and the Argentine authorities were forced to take drastic action to prevent complete resource collapse. The agreement has not been renewed, and neither has any other second generation subsequently been concluded.
- iii. **Private arrangements** by individual fishing companies with the country concerned, which by their nature are not transparent and about which no more than anecdotal evidence exists.

3.16 The first generation bilateral fishery agreements have been costly to the EU⁶³, while they have received much criticism, notably from the NGO community⁶⁴, for being economically unfavorable for the country with the fish resources and for leading to often severe depletion of fish stocks. Hence the proposal for "Fisheries Partnership Agreements" (FPAs), under which the EU proposes to make an investment in sustainable fisheries policies rather than paying for fisheries access. The latter is left to private agreements, such as mentioned above, in essence “privatizing” the access issue, and *inter alia* removing it from democratic control, under the bilateral agreements.

⁶³ The commission subsidizes 80% of the costs of these agreements.

⁶⁴ Led by Greenpeace and by the CFFA, the “Coalition for Fair Fisheries Arrangements”, who referred in a 2001 paper to: “Pirate Fishing – Plundering West Africa” [see: <http://archive.greenpeace.org/oceans/reports/wafricapiratefish.pdf>]

3.17 The EU is driven by its large demand for fish on the one hand, and on the other by the needs of an industry with considerable overcapacity. The EU's fishing fleets are among the world's largest and most efficient, and some would say the most destructive⁶⁵. Large numbers of people are employed in the fishing industry both on sea and on land. Rather than being driven by the policies of, and its "agreements" with, the countries that consume the fish, STP should take a pro-active stand with respect to one of its most important renewable resources and adopt a strategy with actions (see para. 3.25 below).

3.18 Artisanal fishing in STP is true to its name. Individuals or small groups employ dug out canoes that are mostly paddled or have a make shift sail; very few have an outboard engine⁶⁶. Fishing is by means of a simple throw-in net with the fisherman or his helpers often swimming in the water to chase fish into the net. Some also employ lines for bigger fish such as marlin. The resulting catch is landed on the nation's beaches and sold to housewives and itinerant traders. A part of the catch is dried and salted by "fish traders", mostly women, for transport to, and sale in, in-land locations. Occasionally some of this dried and salted fish is exported to the mainland by individual traders.

3.19 There have been several development projects over the last 15 years that have targeted what is considered the poorest sector of Santomean society, fishermen and, particularly, women fish traders. Despite these efforts, the situation of the sector has not improved. A 2001 IFAD project document⁶⁷ lists annual per capita income of people in the artisanal fishery sector as the equivalent of US\$ 162. The same report lists the contribution of the artisanal fisheries sector to GDP as less than 2%, in 1995, having fallen from about 4% in the early '90's. Nonetheless, artisanal fisheries provide about 90% of the estimated annual catch of 3000 tons⁶⁸, which is said to represent 70% of the population's animal protein consumption. The target population of the IFAD project's artisanal fisheries component is 18,000, with 3,000 women fish traders alone.

3.20 STP's fishery sector as a whole is capable of generating the resources necessary to promote the economic and social development of the significant percentage of the population which depends on it. This is at the heart of the proposed action program (see para 3.25 below) which recommends using enhanced revenues from foreign fishing operations to (i) improve the fishing know how and employment opportunities of the local fishermen, (ii) create a partially self policing system through the growing employment of Santomeans on foreign vessels, (iii) pay for effective patrolling of territorial waters and (iv) finance development programs for local artisanal fishermen and women fish traders with the country's own resources (from foreign fishing revenues), rather than relying upon donor largesse and being subjected to donor demands.

⁶⁵ For example, modern shrimp fishing vessels employ suction devices that completely "vacuum" the ocean floor. As much as 80% of what is sucked up is returned, mostly dead, destroying entire marine habitats.

⁶⁶ Prevailing high fuel prices are such that, in many cases, the fuel cost of a fishing trip is not covered by the value of the catch.

⁶⁷ IFAD: Report and recommendation of the President to the Executive Board on a proposed loan to the democratic republic of São Tomé e Príncipe for the participatory smallholder agriculture and artisanal fisheries development programme; Rome, April 2001 – document # 175703.

⁶⁸ This can be compared with the 9000 tons of tuna catch alone that was allowed under an earlier EU bilateral fishing agreement.

TOURISM

3.21 There are no reliable statistics for tourism in STP since the data do not permit a systematic distinction between holiday tourists and other short term visitors. The number of foreign visitors from Europe, Africa and elsewhere has increased substantially in recent years, as the Table 3.2 shows. This reflects increased interest in the Archipelago following the discovery of oil potential, and efforts to attract tourists from Europe, notably through the introduction of new air transport services⁶⁹. It is informally estimated that about half of the total number of visitors may be holiday tourists.

Table 3. 2: Number of foreigners visiting STP between 1998 and June 2003.

	1998	1999	2000	2001	2002	2003 (6mth)
EUROPE	3 491	4 333	3 818	4 624	5 827	3 297
AFRICA	1 417	1 159	1 141	2 615	2 596	1 205
OTHERS	676	218	2 178	573	907	370
TOTAL	5 584	5 710	7 137	7 812	9 330	4 872
Average annual growth rates (in %)		+ 2.3	+ 25.0	+ 9.5	+ 19.4	

Source: Directorate of Tourism and Tourism Strategy Document

3.22 Current reception capacity consists of about 250 hotel rooms, of which 145 are in four 4-star hotels, 49 in 3-star hotels, and the rest in other accommodation. Of the 4- star establishments, two are aimed entirely at the tourist market, while the others accommodate both tourist and business visitors. Except for the main 4-star hotel in São Tomé city, which has benefited from the increased commercial interest in the Archipelego, tourist facilities suffer from very low occupation rates. Despite this, there has been a surprising amount of recent investor interest in tourism in STP. Both Air Luxor and the Portuguese hotel group, Pestana, have announced plans to invest in new hotels on the islands. The latter group is proposing, *inter alia*, the construction of a new 5-star luxury hotel and casino, at an estimated cost of some US\$30 million, in São Tomé city. The hotel is expected to be ready by the end of 2006, and will offer about 600 employment opportunities. This follows the approval of new legislation by the National Assembly in February 2004, permitting gambling in the country. Pestana have been granted a 30 year exclusive concession for offering gambling facilities in STP. In October 2004, the group announced that it would also be taking over the resort at the Isla das Rolas off the south of São Tomé Island. In March 2004, the Government decided to sell by public tender the residences on the previously Portuguese-owned cocoa plantations, or

⁶⁹ In 2002, the private Portuguese airline, Air Luxor, began to fly to STP from Lisbon at substantially lower fares than the once a week service on offer from TAP. Between 2002 and November 2004, Air Luxor operated two flights per week. Since November 2004, this has been reduced to once a week pending a government decision on a proposed new routing to and from Lisbon via Angola.

roças, for tourist purposes⁷⁰. Investors are obliged to maintain the attractive, colonial style architecture unchanged. By mid 2004, three of the residences had already been sold. In August 2004, a Portuguese engineering and construction firm (Capa), that specializes in prefabricated structures, announced plans to build a new tourist resort in the north of São Tomé island. This strong investor interest, despite low current demand, may be partly explained by the desire to establish a footing in STP before the onset of the oil era exerts strong upward pressure on the cost of real estate.

3.23 The sector's current small size, the low occupation rates of existing facilities, and the archipelago's natural assets, all indicate considerable scope for expansion. According to its tourism strategy, the Government's goal is to welcome 25,000 foreign visitors by the year 2010, of whom 20,000 would be tourists. The additional 15,000 visitors are expected to create some 1,500 direct and indirect jobs and to double the share of tourism in GDP to about 4.5 percent. They are expected to create a need for about 350 additional hotel beds, although it is not clear whether existing unused capacity has been taken into account in arriving at this figure. The Government's strategy is to focus primarily on adventure/cultural/eco-tourism, rather than on mass tourism in beach resorts. This approach is sound in view of STP's comparative advantages and the need to protect its attractive but fragile natural assets. Beach resort tourism is highly competitive internationally. It is unlikely that STP would fare well in it, given the relatively low quality of its beaches and the high cost of reaching them. Moreover, the development of such tourism could well undermine the country's sustainable development goals. Adventure/eco-tourism, on the other hand, could generate additional income for the local population who could provide services as guides, park wardens and providers of hospitality. It would also increase incentives to participate in the management and protection of the natural resource base and historic sites.

3.24 Reaching the goal of 25,000 visitors will not be easy. Although apparent investor interest, combined with current excess capacity, should ensure sufficient hotel accommodation, there are a number of other constraints to be overcome. Chief among these are health concerns, particularly the prevalence of malaria, water-borne diseases and acute respiratory infections. The Government campaign to fight malaria, launched in 2003, has the support of a number of donor agencies. The risk of water-borne diseases needs to be reduced through improvements in the potable water supply and sewerage systems (see Chapter 4 of this study). As the tourism strategy recognizes, there is also a need to strengthen emergency care provision in STP, and establish an evacuation service for tourists in view of the infrequency of regular air services to and from Europe.

3.25 Air transport quality and price improvements are also critical to the development of the sector. A number of options are worthy of consideration, among them increasing the frequency of regular services from Europe by making STP an additional destination on some routings; chartering operations; and further integrating STP into the regional market to take advantage of its proximity to other tourist destinations on the African continent. The São Tomé international airport is also in much need of improvement.

⁷⁰ With one exception, which will remain state property, and in which the Spanish Cooperation is planning to invest in a tourism school at a cost of some US\$3 million.

Although an expansion project is currently being studied (see Chapter 4), consideration could also be given to interim enhancements, especially to terminal building facilities.

3.26 Further investments in tourism-related infrastructure (roads to sites, improving roças and making them more accessible, enhancing the city centers of São Tomé and Santo Antonio on Príncipe Island) would improve the attraction of STP as a tourist destination. Moreover, there is a need for substantially increased training of personnel working in the industry. Basic school education and most on-the-job-training is insufficient for a sector that encompasses not only hostelry but also a diversity of leisure and service activities.

3.27 Finally, the institutional structure and capacity supporting the tourism sector needs strengthening. Although the combination in 2002 of tourism, commerce and industry in one Ministry has provided the sector with more active official support than in the past, a larger tourism office, staffed by trained professionals, would enable a more thorough analysis of the needs of the sector and of the viability of investment projects. It would also enhance regulatory and supervisory capacity, which would ensure the sector's sustainable development through adequate attention to environmental protection and analysis of the industry's social and economic consequences.

3.28 The Government already intends to take a series of measures to increase the attraction of STP as a destination for ecological and adventure tourism. These include a campaign to reduce and control the incidence of malaria, improvements in water supply and sanitation services, exploring the possibilities for further reductions in the price of air travel, and interim improvements at the São Tomé international airport.

3.29 The private sector is demonstrating considerable interest in participating in the increase in hotel accommodation and leisure activities for tourists. This could be complemented by investments in local development, such as previous cocoa plantations ("roças") and other historical attractions, as well as training of local personnel, in collaboration with the Authorities, for supplying tourism related services.

FORESTS AND THE ENVIRONMENT

3.30 About a third of the land area both islands of São Tomé and Príncipe is still under its natural vegetation, consisting of humid tropical rain forests, a zone of primary formation. Due to its climatic characteristics, its hilly terrain, and its lack of substantial exploitable timber resources, this zone has not been the object of intensive exploitation. The uniqueness of the biodiversity, and the zone's role as a protector of water reserves for the country, mean that these resources are the object of in-depth scientific study, and constitute an ecosystem that warrants classification as a protected zone. Much of this terrain is, in any event, not usable for annual crops. It is hilly, with very steep slopes while the high rainfall makes erosion a serious danger. It is for this reason that the historical dependence on tree crops such as cocoa or other perennials such as coffee makes environmental sense since these products do not present the same problems with respect to soil retention that annual crops do. In addition, both cocoa and coffee in STP

are shaded crops, grown under the canopy of tall trees, adding to an environmentally friendly agriculture.

3.31 The introduction of the new ownership system and consequent land redistribution has been one of the principal causes of unrestrained exploitation of forest resources in recent years. Timber started to play a more significant role in the economy following the development of industry and construction; it is used not only as construction material, but also as a domestic fuel, in bakeries, and to fire drying operations for the coffee and cocoa industries. A number of studies have been carried out to determine the country's wood consumption requirements; these oscillate between 129,000 cubic meters (Interforest AB, 1990) and 220,000 cubic meters (Martin Geiger, 1995). It is obvious that these figures imply pressure on forests, which will increase as population rises. Policies to address this problem include dissemination of more efficient designs for stoves as well as investigation of alternative energy sources⁷¹. In the light of these needs, and taking into account area currently under forests and the productivity of forest resources, it is clear that the demand-supply balance will lead to a deficiency unless an effort is made to increase the supply of wood from fallen trees, other remains of forest exploitation, and waste material from pruning and similar operations. At present, one of the greatest dangers for the environment and for over-exploitation of forest resources, is not only the threat to virgin forests, but also recently established smallholder properties, whose owners have few income generating options beyond selling the few assets which they possess. Logging for export is less of a problem at present – a prohibition of log exports is in force, and in any case profitable exporting would be difficult in view of current infrastructure constraints. There is, however, an eventual danger that improved port infrastructure may facilitate and encourage the export of tropical timbers.

3.32 The government has stated its intention to police forest removal via a dedicated forestry force. As part of this policy, there was a training program for forest guards in 1995 with the objective of creating an active corps of rangers to combat the unrestrained felling of trees. As time went on, it became clear that the number of rangers was insufficient to cope with the growing pressure on forestry resources. A major worry is the increasingly widespread use of mechanical saws which facilitate penetration of the virgin forest as well as causing enormous wastage of forest material. Another important concern is the link between roads and deforestation. Experience in many other countries has shown that road construction can lead to timber extraction. Recent experience in São Tomé confirms that this is as true there as it is in other parts of the world. Given the key role of road improvement in any strategy of agricultural growth, the danger of increased deforestation cannot be ignored. Any project with a road building component must, therefore, also allow for measures to protect forested areas. Giving the local population a stake in preserving the forests, by allowing and expanding the extraction of renewable resources such as honey and by enlisting them in forest related activities such as tourist visits, etc. is probably the most effective way to protect the forests. Government may wish to offer special incentives to traders to induce them into buying selected forest products.

⁷¹ The price of firewood, at about 10,000 Dobros for 3 pieces of an estimated 2 kg. each, already reflects the sketched relative scarcity of fuel.

3.33 Environmental protection is of particular concern on Príncipe, which is at the moment a beautiful and unspoiled tropical island. This is particularly so in view of the island's potential as a center for ecotourism, which represents the best hope for an alternative source of income which could truly benefit its inhabitants. In addition to tourism, there are opportunities for development in fishing and agriculture. The population would also benefit from the elimination of bureaucratic obstacles to trade between the islands – these include high port fees (goods imported into Príncipe must first, at least in theory, pass through São Tomé), taxes and unnecessary regulations. Care, however, must be taken not to cede large areas of the island to so-called free zone developments which – if they ever materialize -- promise to be enclaves bringing little benefit to the local population, and posing a major threat to the island's environmental equilibrium. The issue of free zones in STP, including two possible projects to establish enclaves on Príncipe, is discussed in Chapter 4 of this study.

AN ACTION PROGRAM

3.34 The discussion above suggests an action program involving both public and private sector components.

Public Sector

3.35 As a result of the privatization of the key productive asset, land, and the concomitant abolishment of the erstwhile, institutional, activities in support of raw material production there is now an urgent need for public goods and services to take the place of the former institutional activities. This is a common requirement of agriculture and fisheries activities in market economies and is the more acute in STP because of the absence of private sector activities in this domain⁷² and the small size and underdeveloped nature of most of the producers. Among the most urgent measures to be taken are the following:

- ❖ Expand and strengthen the national institution for applied research and development, CIAT. This institution should expand its activities with a long term program to introduce further high yielding varieties, adapted to local conditions, for the key export products, notably cocoa, coffee and their natural support, appropriate shade trees⁷³. It is likely that CIAT needs additional research stations, strategically located on both islands so as to adapt varietal selection and the production of seedlings to local conditions. A development and strengthening program for CIAT should not stop at the need for physical means to assist research and development, but should include a long term program of staff training and development and funding to acquire both goods and expertise from abroad.
- ❖ Expand and strengthen the agricultural extension service, arguably the single most beneficial action government can take in direct support of the smallholder. An

⁷² Such as extension provided by input suppliers or research and development done by food companies.

⁷³ A secondary, social, benefit of making available more shade tree seedlings is a certain measure of reforestation.

- effective extension service will provide the link between CIAT and the producer, between agricultural credit, once available, and the producer, while it will transmit other production enhancing knowledge from local and foreign sources. Again, as mentioned for CIAT, it is likely that an effective extension service will need geographically dispersed bases of operation, possibly from CIAT locations. Extension staff should be drawn from the ranks of those known and trusted by the rural population and should be provided with appropriate physical means, and an adequate operational budget, to do their work, which is quintessentially in the field, rather than in an office. Given the nature of the country's terrain and the precarious state of its roads, extension staff should probably be equipped with all terrain motorcycles rather than with four wheel drive vehicles⁷⁴.
- ❖ In support of marketing and, in particular to curb monopolistic tendencies, government should consider financing a weekly "rural program" on the most popular local radio station⁷⁵. This program should deal with the "issues of the week" and should list average product and input prices for the most important products of the small producer, notably the cash crops, as well as volumes exported of, in the first instance, cocoa. In order to operate such a program, government would have to develop a market intelligence capability with, *inter alia*, a credible way to collect prices. It may be considered to put this entire effort under the extension service.
 - ❖ Rationalize the exploitation of the country's fishery resources through measures including the following:
 - renegotiate the agreements allowing foreign fishing vessels to operate in the country's territorial waters, and base annual payments on the estimated value of the catch⁷⁶;
 - earmark a predetermined percentage of the annual payments under these agreements for support of the local fishing industry;
 - obligate foreign vessels operating in Santomean waters, under the fishing agreements, to employ a gradually increasing number of Santomean crew, in part based on on-the-job training;
 - equip and train the navy for sustained patrolling of the territorial waters in view of enforcing the fishing agreements⁷⁷;
 - include in this training, and add to the navy's equipment if necessary, a search and rescue capability for local fishermen.

⁷⁴ Motorcycles have the added advantage of being less attractive for off duty services and use than cars and are far more efficient in fuel use.

⁷⁵ Possibly: "Radio Nacional de São Tomé e Príncipe" - state-run national broadcaster

⁷⁶ see:

http://www.panda.org/about_wwf/where_we_work/africa/where/western_africa/ecoregion/wamer/project/agreements.cfm . It is likely that government will need specialized, probably foreign, expertise to make these estimates.

⁷⁷ And, probably in the future, to patrol the oil exploration in Saotomean waters and enforce, specifically, anti pollution rules.

- ❖ Create a “community building” capacity, in conjunction with the extension service. Small farmers anywhere can only sustain themselves in the long run if and when they work together, both for acquisition of inputs and to market product. Resulting collaborative efforts take many forms, as appropriate for, and dictated by, local customs and culture. These range from cooperativism in European cultures to tribal and family based associations in Africa and the Americas, to religiously based associations elsewhere. The DTS mission cannot judge what would be an appropriate form of association for the common good in STP, but it is clear that Sãotomean society has gone through tumultuous times that probably have made imprints on people’s minds with respect to how to work, or not, with one’s neighbor. This society has gone from slavery, through indentured labor and concomitant immigration of people from far away lands, through a period of central state control to the current market economy and a measure of personal freedom. It is crucial that the Sãotomeans themselves decide upon the form and extend of collaboration without which the small rural producer, and his or her family, cannot survive⁷⁸.
- ❖ In addition to direct support for productive activities, the extremely poor state of physical infrastructure has an important bearing on the profitability, indeed often viability, of a small holder’s production. Foremost among these issues is the one of rural roads, notably to allow access to markets. The state of the country’s rural road system is poor, both with respect to coverage and with regard to its state of repair, or disrepair. Many roads, even large parts of main roads⁷⁹ can only be used by 4 wheel drive vehicles. A large percentage of small holdings can be reached only on foot, or by sea. Further down the marketing chain the condition of the port and airport is also inimical to export development. These issues are discussed in Chapter 4 of this study.
- ❖ It would be of great interest to the economy and by extension to the small producer and rural poor, if more value could be added locally to export products⁸⁰. The entrepreneurial spirit of many Sãotomean exporters, or potential exporters, is stifled by the lack of knowledge about value adding technologies and the equipment and processes to achieve that. Palm oil is exported in bulk in 200 liter drums, while the European importer has expressed interest in receiving retail packaged oil, in bottles and in 20 liter cans. Cassava meal for export is collected from individual households in minute quantities, as an overflow from the housewife’s production for family consumption. The exporter is looking urgently for small scale appropriate equipment to produce the product more efficiently and in larger quantities than what can be collected now, etc. It is recommended that

⁷⁸ The Government is attempting to encourage the development of cooperative, towards which it is directing extension services.

⁷⁹ Such as the one from the capital to Porto Alegre.

⁸⁰ Chocolate production from locally grown cocoa is a prime example. The buying price of raw, “goma”, cocoa beans destined for traditional exports is now about 2,000 dobros/kg. at the farm gate on São Tomé. Selected beans destined for chocolate production fetch 6,000 dobros/kg on Príncipe, albeit delivered at the buyer’s purchasing station. Even if bean selection would eliminate 10% of the offered product, the purchasing price difference remains considerable and is due solely to the added value of chocolate production.

Government create a technical advisory service that can cater to this demand for appropriate technology. It is further recommended that this be created as a virtual service offered by a qualified source abroad, rather than through a local office.

- ❖ The Government already envisage taking a number of steps to enhance the attraction of STP as a destination for adventure/eco tourism. These include a campaign to reduce and control the incidence of malaria, improved potable water supply and sewerage services, exploring the possibility of increasing and cheapening international air transport services, and carrying out urgent interim enhancements to São Tomé international airport. Regulation and supervision of the industry could also be strengthened through the establishment of a specialized tourist development office, staffed by trained professionals.

Private Sector

3.36 The privatization of the 15 “*roças*,” or large cocoa plantations along with their supporting assets and services, has been achieved only in part. As of the end of 2004, only four of them⁸¹ were back in operation at anything approaching the levels prior to privatization. Even for these four, and more for the others, there are important gaps in the supporting infrastructure of input supply, technical assistance, initial processing and, above all, marketing. To address this, the following is recommended:

- ❖ Renew efforts to privatize remaining processing and marketing assets. As the experience of the few operating enterprises shows, when in competent hands, they are the focal point for marketing by the small producer. Diogo Váz with 600 ha of cocoa leased for 20 years has bought, last year, 3 times as much cocoa from “out-growers” as it produced on its own 600 ha. Agua Izé buys exclusively from out-growers, so does Terreiro Velho on Príncipe. The flower exporter “*Floraespeciosa*”⁸², now producing on 3 ha, intends to further expand its cadre of selected outgrowers to produce on its behalf and with its technical assistance. It appears that the model of “core enterprise” with outgrowers works in STP⁸³. The core enterprise produces, in house, only part of its requirements, but doing so gains production expertise that it then extends to its affiliated small holders.
- ❖ The model described immediately above is very likely the one that should be adopted for future ventures producing “new” crops aimed at the export market. Given the high risks involved, such ventures should be promoted by experienced entrepreneurs who are capable of providing credit, technical assistance and, guaranteed market access (including the handling of transportation, standards and other logistical requirements).

⁸¹ Diogo Vaz, Bellavista and Agua Izé on São Tomé and Terreiro Velho on Príncipe. The single most important coffee processing enterprise, Monte Café, remains to be privatized in spite of, reported, substantial rehabilitation investments through loans from the African Development Bank.

⁸² see also: <http://www.floraespeciosa.com/> .

⁸³ It works best, elsewhere and by extension probably in São Tomé e Príncipe as well, when outgrowers have little or no market outside the core enterprise. If they have, the third party buyer can outbid the core enterprise for products as he, or she, has not incurred the costs of supporting the outgrower.

- ❖ Offer a banking license to a privately owned investment bank, preferably with substantial Santomean capital, that specializes in financing agro-industry with long term lending. This is different from the commercial banks now active in the country, which mostly finance working capital for traders with loans of up to 60 days and interest rates around 40%.
- ❖ Attract specialized warehousing companies⁸⁴ that will issue warehouse receipts for produce stored that can be used as collateral for lending by the owners of the goods stored. This is of particular importance to exporters who would obtain pre-export financing to ease their cash flow, well in advance of receiving the proceeds of exports proper. The existence of discountable warehouse receipts would allow the exporter access to part of the value of his, or her, product well in advance of shipping⁸⁵. This would alleviate some of the uncertainties inherent in timing of exports by virtue of the unreliability of the port of São Tomé. More important, though, it would allow new exporters, including associations of small producers, to ease their cash flow before they have established the relationship of trust that allows the well known, trusted, exporter to obtain 50% of the export value before the shipment is made. In other words, it would put a dent in attempts to create, for example, cocoa buying monopolies⁸⁶. Once warehouse receipt financing is available in STP, this could become a magnet to attract warehousing and transshipment for all kinds of goods destined for nearby markets. Sellers would obtain credit for goods stored in STP well before the goods are sold in the countries of final destination, again easing trade financing. It may well be that piece meal supply to final destinations, from entrepots in São Tomé e Príncipe that issue warehouse receipts, will be preferred over landing large quantities of goods all at once in risky markets.
- ❖ The private sector is already showing considerable interest in increasing hotel accommodation and related leisure activities for tourists. These could profitably be complemented by investments in site development, including roças and other historical attractions, and in carrying out, in close collaboration with the authorities, training of local personnel in the provision of tourism-related services.

⁸⁴ See: <http://www.zaca.com.zm/> for an agricultural commodities based warehouse receipts system in Zambia.

⁸⁵ Reputable exporters of cocoa who have an established relationship with buyers now may receive up to 50% of planned export proceeds in advance of shipment. A further 45% is paid against the bill of lading, the balance of 5% is paid once the cocoa is received by the buyer. Discountable warehouse receipts would expand the availability of financing and increase competition in the pre-export financing market.

⁸⁶ In addition, the 50% advance payment now received by the established exporter, comes at a cost, i.e. a somewhat lower product price than would be obtained without it. The cost of warehouse receipts would compete directly with this “discount”. If appropriately “costed”, warehouse receipts might increase the overall price received for the export product, increasing total export proceeds and, if trickling down, total small holder revenue.

Table 3. 3: Sao Tome and Principe: Production of Main Agricultural Products
(in metric tonnes)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Cacau	3,600	3,600	4,100	4,300	3,400	4,600	3,500	3,100	3,900	3,200	2,900	3,700	3,500	
Copra	1,200	600	700	700	600	500	500	400		200	900	n.a.	n.a.	
Palm Oil	200	1,000	1,500	1,000	700	700	1,200	1,200	1,000	900	400	300	300	
Banana	7,100	10,000	12,000	13,000	13,700	12,700	13,500	25,000	34,600	38,100	38,200	n.a.	n.a.	
Breadfruit	1,900	900	1,500	1,800	1,500	1,600	1,800	2,000	2,500	2,800	2,900	n.a.	n.a.	
Maize	2,700	3,600	4,000	4,000	4,300	4,000	4,500	4,000	1,400	1,500	1,600	n.a.	n.a.	

Sources: (i) Steven Kyle: *We're Rich!! or Are We? Oil and Development in Sao Tome and Principe*; staff paper 2003-02, Department of Applied Economics and Management, Cornell University; May 2003, (ii) Ministry of Agriculture, (iii) mission estimates.

Table 3. 4: Sao Tome and Principe Agricultural Exports
(in metric tonnes)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Cacau	3,245	4,759	4,363	3,725	3,716	3,400	3,170	2,840	3,800	3,300	3,768	2,605	3,275	3,356
Coffee	0	4	0	5	6	0	0	5	6	n.a.	n.a.	11	4,100	n.a.
Copra	453	159	0	200	200	200	180	0	100	0	0	491	484	367

Sources: (i) Steven Kyle op.cit , (ii) INE, (iii) mission estimates.

Table 3. 5: Sao Tome and Principe: Crop Mix, 1996

	<u>Metric Tons</u>	<u>Breakdown (%)</u>
Food Crops - 88%		
Banana	12,865	27.41%
Cassava	8,500	18.11%
Matabala	8,245	17.57%
Tomato	4,500	9.59%
Maize	4,000	8.52%
Breadfruit	1,600	3.41%
Selected Horticulture Crops	1,385	2.95%
Total	41,095	87.57%
Cash Crops - 12%		
Cacau	4,578	9.76%
Palm Oil	720	1.53%
Copra	507	1.08%
Coffee	29	0.06%
Total	5,834	12.43%

Source: Steven Kyle: op.cit

4. IMPEDIMENTS TO TRADE EXPANSION AND DIVERSIFICATION

INTRODUCTION

4.1 STP possesses considerable potential – as an exporter of tropical food and other products, of fish and fish products, as a center of eco-tourism, and as a provider of shipping and other services to the Gulf of Guinea region. Realizing this potential, combined with the productive use of future oil resources, would enable STP to emerge from its current poverty trap and narrow economic base which provides little opportunity for gainful employment outside stagnant or declining sectors.

4.2 To achieve this breakout, however, STP requires massive investment in both physical infrastructure (electric power, water and sanitation, roads, airport, sea port) and in human capital (primary, secondary, vocational and university education, as well as preventive and curative health care). Even these investments would be only a necessary, and not a sufficient, condition to encourage the private entrepreneurship, both local and foreign, which would be required to diversify exports and create jobs. The investments would need to be accompanied by a parallel program of actions designed to improve the business environment and investment climate in STP, which are currently negative and discouraging. This reform program would focus especially on, but would not be limited to, transparency and accountability in public affairs, improving the relationship between public and private sectors, enhancing governance in sensitive sectors such as telecommunications, agriculture and fisheries, and addressing the issue of private property rights, especially land ownership. It is an imposing program. But it can be realized, provided STP makes good use of its coming oil riches.

4.3 This chapter considers the main constraints which impede higher levels of investment, employment and hence trade-related activity in STP under five broad headings: infrastructure and finance services; the public/private interface; the land issue; conflict resolution; and human capital considerations.

INFRASTRUCTURE AND FINANCE SERVICES

4.4 This section analyses the main factors which determine the cost of operating a business in STP compared to that in a number of other African countries, and identifies the key actions necessary to make STP more competitive. Key factor and service costs in STP and in a number of its main actual and potential competitors in the West and Central African Regions are summarized in Table 4.1. STP can be regarded as competitive in only a few areas, and in many cases costs are substantially higher than the average for the other selected countries. This section of the study deals first with infrastructure costs and services, and then discusses other factor costs.

Table 4. 1: Comparative Data for Factor Costs in Selected African Countries

	Benin	Burkina Faso	Ivory Coast	Togo	Senegal	Gabon	STP
Cost of vacant land for industrial Purposes (US\$/square meter)	6.0	1.0	NA	NA	9.0	NA	10.0
Construction costs (US\$/square meter) office building	500.0	240.0	600.0	240.0	360.0	NA	475.0
Unskilled wage rate (US\$/day)	2.8	2.8	4.2	1.6	4.0	7.8	2.7
Interest rate on short term bank loans (%)	13.7	10.5	10.5	NA	15.5	18.0	31.0
Cost of electricity per kwh (basic tariff, US cents)	15.9	26.0	11.2	12.0	16.6	13.0	15.0
Cost of water per cubic meter (basic tariff, US cents)	58.0	172.0	NA	NA	126.0	49.0	20.0
Cost of a local telephone call (US cents/minute)	4.4	2.0	1.9	1.7	3.8	2.1	5.0
Cost of diesel fuel (US cents/liter)	44.0	57.0	63.0	57.0	69.0	58.0	94.0
Local road transport costs (US cents per ton/km)	5.7	9.5	5.4	5.5	5.8	NA	10.0
Air freight to Europe (US\$/kilo)	NA	NA	4.3	4.3	3.6	NA	3.6
Maritime freight charge for a Container from Europe US\$/TEU)	2,624	NA	NA	NA	1,800	NA	6,500

Sources: DTIS Mission research
Various DTIS Reports for other African countries
World Bank, IMF.

Electricity and Water

4.5 Access to competitively priced and reliable infrastructure services is critically important for the competitiveness of a country's exports. Enterprises in STP do not have this access. From Table 4.1, it can be seen that electricity tariffs are at about the average, while water tariffs are significantly lower than the average for the selected countries. This, however, means little since coverage is very low, and services are notoriously unreliable.

4.6 The current situation with regard to electricity supply in STP is summarized in Box 4.1. The challenge is complex but clear: how to increase electricity supply and coverage in the relatively short term, in a cost effective manner, which is compatible with the protection of STP's valuable environmental resources?

Box 4. 1: Electricity Supply in STP

STP's electricity sector faces substantial challenges. Generation and hence supply costs are high, and efficiency is diminished by illegal tapping and a system that is highly prone to brownouts and blackouts due to insufficient peak capacity, a variable hydro-supply and old and poorly maintained equipment and infrastructure. Coverage is low, and a little less than 40 percent of all households on São Tomé island have no access to electric power. Coverage is higher on Príncipe now that the main town there is being supplied with electricity. Connection costs are unsubsidized and high and limit the poor's access to service. Industrial and commercial users who require a reliable source of electric power are obliged to invest in their own generating equipment, a factor which adds substantially to the cost of doing business in STP.

Electricity is provided by the Empresa de Agua e Electricidad (EMAE), a 100 percent state-owned company which falls under the jurisdiction of the Ministry of the Environment, Infrastructure and Natural Resources.

EMAE's total theoretical generating capacity is about 11.6 MW, of which 9.2 MW come from diesel-fired plants and the remainder from hydro-powered generators. Total production in 2003 was registered at 35 GWh, up from 31 GWh the previous year. The company's main distribution system covers the North West part of São Tomé island (where the capital city is located). The company also possesses an isolated diesel based generator and transmission system in São Joao dos Angolares with circa 100 clients; a diesel generator based system with circa 500 clients; and a small diesel generator on the Monte Café plantation. From these figures, it may be roughly estimated that about 80,000 people (out of a total population of about 150,000) are supplied with electricity from EMAE on São Tomé e Príncipe. There is also privately owned micro-hydro system on the Augustino Neto plantation.

EMAE has a number of projects currently in view for the short and medium term. These include the acquisition of two new thermal generators with a capacity of 2 MW, the repair of the Contador Central thermal generator, and rehabilitation of distribution infrastructure. The company also proposes to construct a heavy fuel generator with the intention of reducing fuel costs.

In addition, EMAE intends to develop mini-hydro power plants to supply remote areas or areas of difficult access. For example, in the Pagué district of Príncipe, more than 95 percent of the population already benefits from such a project. Available funds are, however, still inadequate for the rehabilitation of existing hydro plants, such as that already mentioned on the Augustino Neto plantation.

The average tariff in 2004 was 1,500 dobras (about 15 US cents) per kWh, though there is a special "lifeline" tariff of 1,150 dobras (about 11.5 US cents) for households that consume less than forty kWh per month.

EMAE reportedly paid 4,500 dobras (about 45 US cents) per liter at the end of 2004 for diesel fuel from the 49 percent Angolan-owned oil company ENCO which supplies practically all of STP's liquid fuel requirements. This includes a 15 percent tax but it is below the cost of refined diesel fuel to the consumer, which is over 90 US cents per liter. The price paid by EMAE is nonetheless substantially above the international diesel fuel price of about 23 US cents per liter which prevailed for much of 2004. The price differential is in part due to high transport costs to STP (reflecting the small size of the market), and in part to the pricing policy applied by the Angolan supplier. The average cost of diesel based generation (including fuel, maintenance and other costs) to EMAE is estimated at 1500 dobras/kWh, which leaves no margin above the average tariff.

The ENCO fuel storage facility at Neves on the west side of São Tomé island is fed from tanker ships through a 50 meter long pipeline. The on-shore storage tanks have a capacity equivalent to 45 days consumption at current rates. There is no strategic reserve for emergency purposes, nor any facilities for storing it.

The lack of an adequate profit margin, combined with substantial illegal tapping of electricity, poor rates of bill collection, and the fact that EMAE (in common with other publicly-owned companies in STP) is obliged to transfer 80 percent of its pre-tax profits to the Government, means that no surplus is created to finance new investments.

4.7 In order to meet an anticipated growth in demand from tourism and trade, it would be useful to explore cheaper alternatives to diesel fired plants, such as gas-fired turbines, which may become viable as demand for electricity increases. These generating technologies could be supplemented by hydro-power, wind velocity and solar energy

systems, though it is unlikely that any of these could replace thermal generation as the main source due to high cost, environmental consequences, or both.

4.8 It is important that technical improvements in generating capacity be accompanied by necessary institutional and other changes. Despite the fact that the State owns EMAE 100 percent, and has a majority stake in ENCO which provides all its fuel needs, there is little or no long term planning of fuel requirements. EMAE seems to be at the mercy, not only of the vicissitudes in the international oil market, but also of the monopoly enjoyed by its supplier⁸⁷. There needs to be greater private sector involvement in electricity production in STP involving, inter alia, the creation of a truly independent company capable of eventually generating a sufficient financial surplus to fund at least part of its investment requirements. The transformation of the sector, however, needs to be very carefully studied so as to increase access and affordability for the poor while at the same time creating an expanded and more reliable service for the needs of industry, trade and tourism. This will involve substantial injections of donor capital on concessional terms at least until a basic minimum of investment has been carried out and the system can reach the threshold of viability. Once the necessary investments have been made, considerable benefits could accrue to the economy, and not least to the poor, by expanding access to the system. At the moment, new connections are provided on a full cost recovery basis, and there may eventually be scope for a subsidy for connecting lower income consumers, provided the necessary external financing (either from donors or eventually from oil revenue) can be found.

4.9 In order to give due weight to all these factors, it is strongly recommended that these and other measures, both short and medium term, be included in a national energy strategy that addresses the future of the sector. The preparation of such a strategy could be supported through existing World Bank-financed technical assistance. The strategy would consider ways of increasing system capacity, diversification of primary energy sources, decreasing dependence on imported fuel, and ensuring greater energy efficiency. The strategy would also help to inform decisions of how oil revenues might help to cover the costs of future infrastructure development in the sector.

4.10 Unfortunately, there are indications that the Authorities are taking important decisions in the electricity sector on a short term, ad hoc basis, prior to the development of such a strategy. In November 2004, an agreement was signed between the Government and an Anglo-Portuguese electric power company called Sinergie Investments. The company undertakes to repair the existing hydroelectric facilities at Contador in the north of São Tomé Island and to build a new 25 gigawatt hydroelectric plant on the river Yô Grande in the south of the island. Total investments of some US\$50 million are foreseen. Although there seems to be no indication as to how Sinergie Investments would raise these resources, the Authorities have declared that the agreement would lead, not to an increase, but to a significant reduction in the cost of electric power to consumers. This contract seems to have been awarded in the absence of any competitive bidding. A highly

⁸⁷ For example, in April 2004, ENCO cut off supplies of fuel oil to EMAE because the latter's debt to the former exceeded US\$ 1 million. The debt had accumulated because the Government had not paid its energy bills. In June 2004, ENCO increased fuel prices by 25 percent, thereby provoking increased blackouts and brownouts in an attempt to avoid higher consumer tariffs.

critical review of the contract, performed by local consultants at the request of the Authorities, points, inter alia, to (i) the lack of a proper feasibility study; (ii) an imbalance in obligations, with the Government committing itself to buy the electricity at a predetermined price, but without any engagement on the part of the strategic partner with regard to construction costs, operating costs, output, or other performance indicators; (iii) the absence of a competitive bidding process for the contract; and (iv) the lack of adequate due diligence regarding the financial, managerial and technical credentials of the strategic partner. Neither these criticisms, nor those of a special Commission appointed to analyze the contract, appear to have been fully taken into account in the final agreement, though this has not been seen by the DTIS Mission.

4.11 Irrespective, however, of the weaknesses in the agreement itself, its very existence is indicative of a tendency to react hastily to a critical situation in the electricity sector, made all the more urgent by recent substantial increases in the price of fuel oil supplied to EMAE. The affair underlines the high priority that should be given to the development of a full sector strategy.

4.12 With regard to water supply, there is also a major issue of access. According to its own reports, EMAE has 6,000 clients connected to the network, which is translated into about 25,000 people (about 16 percent of the population). The company estimates that about 70 percent of the population has access to drinking water through the public standpipes provided and maintained by EMAE. The rest of the people drink untreated water. Even the EMAE treated water is of generally poor quality, and in five of the company's 15 isolated systems it is hardly treated at all. EMAE is attempting to address these problems through a number of projects, for example the Clear Water and Water Distribution Rehabilitation Project for the capital city and its environs. Investment in sanitation is also sorely needed. The shortage of adequate sewerage facilities pollutes beaches and contaminates the water supply. Unsurprisingly, water-borne diseases, such as amoebic dysentery and acute diarrhea, are highly prevalent and, along with malaria, are a major cause of high infant mortality rates. A number of commercial enterprises and hotels are forced to make provisions for their own water supply. Those who can afford to do so drink imported bottled water.

4.13 As with electric power, it is strongly recommended that a strategy be developed as soon as possible for the water sector. The strategy should identify short term priorities as well as estimating investment needs for achieving the PRSP target of greatly increased access to potable water by 2015.

Telecommunications

4.14 A modern, competitive telecommunications service is an essential attribute of any country wishing to become competitive in today's global market. This is even more true for a small, vulnerable island economy such as STP. STP does not currently offer its public and foreign investors a service which meets these requirements. Telecommunication services are currently the monopoly of the Companhia Sãotomense de Telecomunicações (CST). 51 percent of the capital is held by the Portuguese enterprise, Portugal Telecom Internacional, and 49 percent by the Government of STP.

The service offered is fully digitalized, and is reasonably efficient from a technical point of view, though there is a serious shortage of internet capacity⁸⁸. It is, however, expensive. The average price of a local call is close to double the average for the other African countries shown in Table 4.1, and international calls are very much more expensive than the African average⁸⁹. Coverage is quite low (more than 60 percent of the population does not benefit from either the fixed or mobile services provided by CST), and is largely confined to the capital city and its surroundings. Mobile phone use has expanded rapidly, but thus far benefits only wealthier members of the community.

4.15 The high cost of telecommunication services reflects CST's monopoly position. The sector is being gradually liberalized through two new laws. The first, which is due to come into effect during 2005, permits competition in so-called non-basic services such as the internet. Effective January 2006, limited competition will be allowed in mobile and eventually also fixed line services. However, given the small size of the market, and the firm grip which CST has upon it, it is unlikely that opening the market to other operators will, in and of itself, have a significant impact on costs. In order to maximize the benefits from greater competition, and to develop possibilities for future investment by telecommunications-intensive industries and services, the opening of the market needs to be accompanied by a number of parallel actions:

- ❖ CST's license under the new competitive regime needs to be carefully examined and the company's obligations and benefits precisely defined.
- ❖ There is a law setting up a regulatory agency. However, the application of this law and the establishment and practical operations of the regulatory agency will be of the utmost importance in ensuring competitiveness. In particular it will be crucial to ensure that the Regulator does not become "captive" to the CST.
- ❖ Given that the regulator will be new to her/his task, and that there is no practical experience of utility regulation in STP, it is important that the agency be supplied with the necessary technical assistance in order to be able to meet its responsibilities, at least during the initial years. Regulatory training has been financed by ANACOM, ITU, ANATEL and the Government. In addition, the World Bank has financed the training of an engineer, an economist and a lawyer to staff the technical unit of a new, independent regulatory agency.
- ❖ Expansion of the network, notably into rural areas, with a view to increasing the access of the poor, should be regarded as a priority. Private sector provision of rural services through the output-based aid approach⁹⁰ has been effective in a number of countries, and could well be promising in STP.

⁸⁸ Although CST's prices for regular internet access are about the average for Sub-Saharan Africa, service is in fact so limited and slow that those who are able to do so subscribe to a dedicated line. This costs an initial fee of US\$500 plus a monthly charge of US\$75.

⁸⁹ Calls to Portugal from the fixed network cost about US\$1.22 per minute and calls to other West European destinations cost over US\$1.50 per minute.

⁹⁰ Output-based aid seeks to avoid the weaknesses associated with public sector provision combined with soft financing. It does this by delegating service provision to a third party (a private company or an NGO) under contracts that link payment of subsidies to the outcomes or results actually achieved to the benefit of target populations. The approach is meant to provide a sharper focus on objectives, improve incentives for

- ❖ Future competing mobile and fixed operators will need to obtain access to CST's national and international network facilities at a reasonable price. This would be with the Regulator's remit; however, technically complex questions are likely to arise in this domain, and it will be important that the Regulator has access to the necessary expertise.
- ❖ It is strongly recommended that the deliberations concerning the future of the sector be conducted with the maximum of transparency and the widest possible stakeholder participation. Public hearings should, for example, be conducted on issues such as interconnection, universal access and CST's license obligations.

Internal Transport

4.16 The poor state of the local road network is a major impediment to STP's economic development. About 35 percent of the total road network is paved, compared to 78 percent for Cabo Verde (another small African island economy) and an average of 25 percent for Sub-Saharan Africa as a whole. About 10 percent of paved roads have deteriorated to such an extent that circulation is difficult and costly, and can become impossible during heavy rains. The extremely poor state of roads throughout much of the islands, as well as the complete absence of any road access in some zones, results in a situation of almost total isolation for many rural people. Road improvements are the single most important factor in improving effective farm gate prices and lowering the costs of getting needed farm inputs. Geographic conditions are, moreover, extremely difficult. The terrain is exceedingly steep in many areas of São Tomé island, and rainfall can be as much as 7,000 millimeters per year. In these circumstances, packed earth roads, even when reinforced with other materials, must be not only properly constructed with adequate drainage, but must also be rigorously maintained if they are to be kept usable. At present, this is not the case and many roads are washed away within six months of being constructed or rehabilitated.

4.17 With the support of the European Union (EU), STP is embarking on a major reform and construction program in the road sub-sector. Over the life of the program (2005-2009), it is envisaged that 235 kilometers of paved road will be subject to regular periodic maintenance, and a further 12 kilometers of paved road rehabilitated. In addition, it is intended to rehabilitate 715 kilometers of rural earth roads. Work is expected to start immediately on 75 kilometers of earth roads, and a further 76 kilometers have been designated as high priority. The EU contribution will be about US\$12.5 million equivalent, accounting for over 90 percent of EU financial assistance to STP up to 2009. In addition to the construction, rehabilitation and maintenance program, the EU project also supports the preparation of a road sector strategy for STP and the establishment of a "second generation" road fund⁹¹ to ensure durable financing for

efficiency, and increase the mobilization of private financing for projects which would normally absorb substantial public funds.

⁹¹ A second generation road fund is an autonomous agency responsible for financing (though not implementing) the annual road maintenance program. Its administration reports to a board of directors on

maintenance. The strategy has already been drafted, as has the legal documentation for the establishment of the road fund.

4.18 The poor quality of the roads combines with the high cost of imported fuels and vehicle spare parts to raise the cost of local transport of goods significantly above the Sub-Saharan African average – about 10 US cents per ton/kilometer compared to 6.4 cents for the average of the countries shown in Table 4.1. Thanks partly to taxes, but also to high import prices, the cost to the consumer of both diesel and gasoline – at 94 and 99 US cents (April, 2005) respectively – are among the highest in the African Region. It is recommended that the Empresa Nacional de Combustíveis e Óleos (ENCO), which has a monopoly on the importing, storage and distribution of all oil products in STP, be subjected to an independent external audit, the results of which should be made public.

4.19 Consideration should be given to other ways of reducing internal transport costs through encouraging the further development of small transport operators to serve rural areas. Although a number of communities, especially those on or near the main paved road network, are served by minibuses, the DTIS mission was informed that these services are high cost (the fleet is very old), and inefficient for the transport of goods. Moreover, more remote communities, even where roads exist, are not reliably or regularly served. Perhaps producers themselves could be assisted to form cooperative transport ventures which would ensure a cheaper and more rapid transportation of their goods to the market. There could also be a role for the donor community in assisting with the leasing of more modern vehicles which are less costly to operate.

Port and Airport Facilities

4.20 If São Tomé e Príncipe is to base its long term growth strategy on development and diversification of exports, it will be essential to improve its port and airport facilities. The existing sea port, which is located within São Tomé city, is antiquated, inefficient and inappropriate for the needs of modern maritime transport. The current state of the port, and the situation with regard to cargo operations there, are summarized in Box 4.2.

The existing port infrastructure imposes a number of costs on the economy:

- ❖ It prevents STP from benefiting fully from the container revolution.
- ❖ It imposes the use of smaller, uneconomic vessels which are rarely used for international maritime transport, including other Gulf of Guinea ports.
- ❖ The method of loading and unloading cargo into barges is inefficient and high cost.
- ❖ The slow speed of the operation and the delays caused by either weather conditions, by the poor condition of the port's equipment, or both, impose high

which the private sector and civil society are represented as well as the Authorities. The fund's financial requirements are assured by road user fees and/or earmarked taxes, normally on petroleum products.

costs in the form of demurrage payments which substantially increase the cost of imported cargo into STP⁹².

- ❖ It contributes to the restriction of the sources and destinations of STP's trade to those traditional partners who are prepared to provide the rather specialized shipping services necessary. This puts further upward pressure on costs of imported goods and limits export possibilities⁹³.

4.21 Aware of the need to find a solution to these problems, the Government of STP has commissioned a feasibility study of a new deep water port, which is being undertaken by consultants financed by the United States Trade Development Agency. The consultants completed their Phase I Report in November, 2004. It contains preliminary cargo forecasts and the site selection study. With regard to traffic, the consultants' main conclusion is that export and import cargo volumes to and from STP alone would not be sufficient to justify the cost of a deep water port. Such a facility would only be financially viable provided STP could develop a regional transshipment center for containers transported to and from West and Central African ports. The consultants analyzed container traffic movements to and from eleven continental African ports (all the CEMAC ports plus three WAEMU ports, plus Angola, Democratic Republic of Congo, Ghana and Nigeria). They calculate traffic in 2000 to have been about 1.5 million containers (Twenty Foot Equivalent Units or TEUs). Although traffic has almost doubled since 1990, the consultants base their forecasts on the 2000 movements and make no allowance for growth since then. They believe that a deep water transshipment facility at STP would be viable if it could capture 15 percent of the 2000 traffic or about 225,000 TEUs per year. They consulted with European shipping lines who reported to them that such volumes would be feasible.

4.22 The belief that there is a potential demand for a deep water container transshipment facility at STP is based on a number of considerations. First, the latest generation of high capacity (4,000 plus TEUs) container vessels have draft requirements (13 to 14 meters when fully loaded) which are beyond the capacity of all but a very few relevant continental African ports. Second, these high cost vessels require very rapid turnaround time, which is thought unlikely to be on offer in the continental African ports even if they had the draft. Third, ship-owners are increasingly reluctant to send fast, modern vessels into Sub-Saharan African ports because of security issues and related high insurance costs both for equipment and for crew.

⁹² For example, in the case of a rice shipment made in September 2004, *additional* demurrage charges (i.e. over and above those caused by normal delays at the port) are estimated to have increased the cost of the product to the consumer by nearly six percent.

⁹³ Informal estimates suggest that the predominance of Portugal as a source of imports may be costing STP an average premium of as much as 15 percent over what imports would cost if the country were capable of tapping other sources on a regular basis. Several examples were mentioned to the DTIS Mission – sugar is purchased from Portugal, though it would be cheaper at source in Africa; and a 5-liter can of white paint from Portugal costs US\$45 to the consumer in STP, compared to US\$25 for the same product from Brazil. Portugal's predominance is reinforced by the small number of trading houses operating in STP, most of which have strong ties to Portugal. Expansion of this sector would only be feasible with trade diversion which could follow improvements in port infrastructure.

Box 4. 2: Current Conditions in the Port of São Tomé

The port of São Tomé is situated in a small natural bay, the Baía de Ana Chaves, on the east coast of São Tomé island. The port's land side is close to the center of the capital city. Although it is a maritime port, the depth of water is shallow. Only at high tide can ocean-going vessels berth at the quay, and even then their draft must be no more than four meters. Cargo loading and unloading operations from ships with a deeper draft than this are carried out at a distance of between one and one-and-a-half miles from the coast, using barges and tugs.

The port is equipped with two tugs and six barges; one of the tugs and four of the barges (including one motorized barge) belong to the public enterprise, ENAPORT, which administers the port. The others are privately owned. The ENAPORT barges have the capacity to transport 200 tons of general cargo or 10 full containers or 12 empty containers between the quay and the ships.

The unloading of ocean-going vessels is slow, and is often made difficult by climatic conditions (swell and the direction of the winds). Not infrequently, it is necessary for the ships to seek a calmer anchorage off Fernão Dias, some six nautical miles distant from the quay.

The port possesses a small land area behind the quay which is used as a parking place for full and empty containers. The containers are stacked according to ownership – shipping line or shipping agent. Serious space limitations and the lack of necessary equipment makes the use of forty foot containers difficult. Along the 200 meters of quay there are five storage areas and equipment for electricity generation needed for cold storage containers.

The port's mobile cargo handling equipment consists of one crane with a 30 ton lifting capacity for moving containers, a fork-lift crane for stacking containers with a 24.5 ton capacity, two light mobile cranes, four light forklift trucks, and tractor capable of towing three container-carrying trailers (the truck is more appropriate for agricultural than for port use). This equipment is all obsolete; maintenance costs are consequently high. This is a major financial burden for ENAPORT.

Despite the many constraints which it has to face, most importantly the fact that cargo handling has to take place at a considerable distance from the quay and often under difficult climatic conditions, the port has managed to achieve significant improvements in operating efficiency. About a decade ago, it took an average of thirty days to unload a typical incoming shipment; this is now reduced to less than a week. The average time a ship spends in São Tomé port is between three and four days. It takes approximately as many days to unload cargo as it takes hours to load it in the European port of origin. If everything goes smoothly, it is possible for a ship to unload 70 TEUs in less than three days.

The poor condition of the port's infrastructure and equipment reflects the fact that no investments have been made since the early 1990s, when a European Union project financed most of the existing equipment. The quay was constructed 60 years ago and was designed for coastal vessels going to and from Angola. According to ENAPORT's legal statutes, the State is entitled to take 80 percent of gross operating profit before tax, but also has the obligation to invest. It has not met this obligation for a considerable number of years, which explains in large measure the current condition of the port.

56 ocean going vessels called at the port in 2003, an average of just over one per week. A total of 3,250 TEUs were handled (2,708 unloaded and 542 loaded), The average number of TEUs per ship call is about 75 (allowing for the fact that some ocean going vessels carry only non-containerized cargo. The total volume of cargo handled, containerized or otherwise, was about 93,000 tons).

4.23 The construction cost estimates have still to be refined, and these, of course, would depend on the site chosen by the Authorities. The site strongly recommended by the consultants is at Fernão Dias, a few kilometers to the north-west of São Tomé city. The cost of the port development at Fernão Dias is currently roughly estimated at \$200 million. This would cover only the cost of the port itself, and would not include any rehabilitation or construction of the road network which may prove to be necessary. About 75 percent of the cost would be accounted for by basic infrastructure, with the rest covering buildings and equipment. Preliminary enquiries among European container

terminal operators have indicated some interest in investing in the movable equipment and perhaps a few buildings. There would, however, be no interest in investing in the basic infrastructure. This poses an issue for the STP Authorities, who had been hoping that the entire facility could be financed on a Build, Own and Operate or Build, Own and Transfer basis.

4.24 Even if this difficulty can be overcome – and it is frankly not easy to envisage STP being able to mobilize over \$150 million from either the private sector or the international donor community to finance the port infrastructure – it would still, on the most optimistic assumptions, take at least another four years for the new port to become operative. It is estimated that construction would take about three years, and that another year would be required for the launching of the bids and the award of the contract. Even this would involve a considerable acceleration of the norm for public decision making in STP involving projects of a much lesser magnitude. The issue therefore arises of what to do in the interim period of at least four years, and probably considerably longer, before a new port becomes operational. The current state of the port and of port operations impose a high economic cost on STP and continuing with them would be a very undesirable option. The issue of an interim solution was not included in the consultants' terms of reference. It is strongly recommended that a study be conducted as quickly as possible to examine the options. There are broadly two alternatives: improvement of the current port operation or construction of a cheap and temporary facility elsewhere which could provide easier access to deep water⁹⁴. The DTIS mission did discuss this issue with stakeholders in STP and with the shipping lines currently serving the islands. The consensus was that improvement to the existing facilities would be preferred. This would involve renewing the existing port equipment (cranes, barges, tug boats) plus some minimal rehabilitation work on the quay. The total cost would be roughly estimated at about US\$5 million, assuming used equipment in good condition could be acquired. However, this issue, and possible alternatives, needs to be urgently studied in more depth.

4.25 The international airport is also highly inadequate and an impediment to expanded trade. The facilities include a single runway, 2,160 meters long and 45 meters wide, and a small, cramped terminal building. There are no facilities at the airport for storage of perishable or other cargo. The length of the runway limits the size and configuration of intercontinental jet aircraft which can use it. At present, equipment up to 160 tons (the Airbus A 310) has been using the airport, but this imposes high costs – because of the shortness of the runway and its poor condition, aircraft tires must be fully changed after every three landings. Security conditions are poor. The runway is not isolated from pedestrians living in nearby villages who regularly attempt to cross it; staff have to be assigned by the airport administration to make sure that local dwellers keep a safe distance from aircraft operations.

⁹⁴ This latter alternative was suggested, for example, in the Master Plan for STP's development prepared by the Taiwanese Cooperation. They proposed a simple temporary jetty, which would cost between US\$5 million and US\$10 million, and which could serve as a facility for national cargo until a larger transshipment center proved to be financially justified. This proposal requires, however, a more in-depth technical and financial appraisal than that provided in the Master Plan.

4.26 Table 4.2 shows some performance indicators for the airport. International passenger traffic showed a substantial increase in 2003, which reflects the increasing interest in STP as a destination thanks to increasing interest in STP as a tourist destination as well as to the promise of oil revenues. This was not, however, reflected in an increase in the number of flights which suggests that the larger number of passengers were absorbed through higher aircraft load factors. Until the end of November 2004, there were three regular flights per week from Europe, all from Portugal, two operated by Air Luxor and the other by Transportes Aéreos Portugueses (TAP). There are also regular flights on smaller aircraft from Gabon, Angola and Nigeria. Air Luxor informed the DTIS mission that they would like to increase the frequency of their flights to three or four per week, but including Luanda, Angola, in the routing (Lisbon-São Tomé- Luanda-São Tomé-Lisbon). This would provide STP with additional frequencies to both Europe and to Angola and also create some 30 additional jobs locally. The Government of STP had not, by the end of 2005, agreed with Air Luxor on this increased service. This is because the Angolan national airline objected to the new routing on the grounds of the increased competition it would face on its flights between Luanda and Lisbon. Air Luxor responded by reducing its frequency from Lisbon to São Tomé to one flight per week. The Government of STP has apparently lobbied the Angolan Authorities to change their position, but so far without success.

Table 4. 2: São Tomé International Airport Selected Indicators

	2001	2002	2003
Airline operations	2,373	2,229	2,472
of which international	1,682	1,442	1,600
domestic (Principe)	446	559	536
Other	245	228	336
Number of passengers	31,918	32,306	40,473
of which international	26,825	27,425	34,915
Export cargo (tons)	38.4	28.8	38.0
Import cargo (tons)	3,280	2,942	2,771

Source: Airport Authority

4.27 Cargo shipments, overwhelmingly imports, remained stagnant between 2001 and 2003. Export cargo is so small that there would be considerable scope for negotiating reduced freight rates to Europe. This has already been accomplished by the few tropical product exporting operations which have been established in recent years.

4.28 The United States Trade and Development Agency (USTDA) is also financing a feasibility study for modernizing the international airport, including lengthening and widening the runway, constructing a new terminal building and cargo storage facilities, and improving air navigation and security equipment and provisions. The improvements would not involve a change of site, and it is estimated that they could be completed within 24 months of the contracts being awarded.

Finance

4.29 As well as the poor quality and high cost of infrastructure, the lack of credit, and its expense, are major impediments to expanded economic activity, including trade, in STP. Even established businesses find themselves constrained by the lack of credit and by its price; for most smaller enterprises, or those wishing to start a new venture, relying on the local credit market is not a viable option. Either credit can be obtained from abroad or not at all. The financial sector is very underdeveloped. Until 2003, the Banco Internacional de São Tomé e Príncipe (BISTP), whose principal owner is the Portuguese Caixa Geral de Depósitos, was the sole banking institution in STP and enjoyed largely unrestricted bargaining power in an uncompetitive market. The anticipation of oil revenues has induced recent new arrivals: the First Afriland Bank in 2003, owned by Cameroon interests, and the Banco Commercial do Equador, whose shareholders are Angolan, in 2004. Two further deposit money banks had opened by the end of 2004. The enhanced competition has reportedly induced BISTP to become more aggressive in its lending policy, while the Banco Commercial do Equador informed the DTIS mission of its intention to open a micro-finance department providing loans with a ceiling of US\$6,000 to small businesses. Nonetheless, at present, credit remains restricted to mostly short term loans to well-established clients for commerce facilitation purposes.

4.30 The country has no developed formal savings and credit associations and no urban micro-credit system. In rural areas, the embryonic rural micro-finance system that was started by the Caixas Rurais had virtually collapsed by 2001 due to government pressure to increase lending during the pre-election period, and is being revived slowly through a fledgling NGO called Micondo.

4.31 Interest rates tend to be very high. As tables 4.1 and 4.3 show, STP has the highest lending rate (although these have diminished slightly as inflationary expectations have been reduced), and also the highest spread between deposit and lending rates, among all the countries shown except Angola. In real terms, the lending rate averaged 27 percent between 1998 and 2002, dropping to 19 percent in 2003, perhaps reflecting the introduction of limited competition. The real spread has hardly diminished at all, however, and was still 18 percent in 2003, roughly the same as the average for the previous five years. These figures are indicative of a dysfunctional credit market in which inefficient institutions are prepared to lend, if at all, only at extortionate rates. This in turn reflects, first, the lack of any meaningful collateral due, in essence, to the absence of a land market and related property rights issues (as shown in the section on *The Public Private Interface* in Chapter 4 of this Study) and, second, an ineffective and unreliable judicial system without any satisfactory alternative dispute resolution mechanism. Commercial banks also complain, with some justice, that the lack of experience in running formal businesses in STP often leads to requests for credit that are not supported by proper business plans or projections.

Table 4. 3: Nominal Bank Deposit and Lending Rates in Selected African Countries

	1998		2000		2003	
	Deposit	Lending	Deposit	Lending	Deposit	Lending
Angola	37	45	40	103	23	96
Cameroon	5	22	5	22	5	18
Cabo Verde	5	13	4	12	4	13
Mozambique	8	24	10	19	14	25
Nigeria	10	18	12	21	14	21
STP	32	45	15	36	11	31
South Africa	16	22	9	15	10	15

Source: World Bank: World Development Indicators

THE PUBLIC-PRIVATE INTERFACE

4.32 STP's historical legacy has shaped an institutional setting that still constrains competitiveness and export diversification. The institutional framework remains characterized by a lack of incentives for individuals to engage in entrepreneurial activities, and a related shortage of inducements to use resources efficiently. The former colonial power, Portugal, organized the economy of STP, as in the other African areas it colonized, around extensive plantations based on very cheap indentured labor⁹⁵ and the unsustainable exploitation of natural resources. Like Portugal's other African ex-colonies, the newly independent STP established itself after Independence in 1974 as a centralized, socialist economy with close political and diplomatic ties to the countries of the then Communist bloc.

4.33 The socialist experiment did not end until the early 1990s, a decade during which there were efforts to promote a more favorable environment for productive activities. Business activity was, until 2004, largely regulated by the "*Diploma Legislativo* No. 669," which dates from November, 1964. New legislation to streamline procedures and to stimulate new businesses, or the upgrading of existing ones, is still to be approved. The Direction of Industry (*Direcção de Industria*) of the Ministry of Commerce, Industry and Tourism is a fully staffed department, the principal job of which is to issue or renew licenses to a very small number of industrial activities.

4.34 The time and bureaucratic difficulty required to establish a business in STP are substantial. There are six administrative units that deal with different aspects of a request to register a new business and each of them has up to thirty days to deal with those aspects of the request which fall within its area of competence⁹⁶. In principle, some simultaneous processing of the steps is possible. However, this is not guaranteed, nor is the respect of the stipulated deadline within an agency. This leads to a high degree of unpredictability regarding the successful completion of the registration process.

⁹⁵ Although cocoa was already in long term decline since the 1920s, the precipitation of the collapse following Independence was due in considerable part to the dissolution of an apparatus of cohesion of the labor force (see Frynas, Wood and Soares de Oliveira, 2003).

⁹⁶ The original regulation on the issue is the *Estatuto do Funcionario Publico* (Regulation of the Civil Service), Decree Law 46,982 from April 27, 1966. The new *Estatuto do Funcionario Publico*, Law 5 from December 1, 1997, kept unchanged this particular aspect of the colonial times regulation.

Businesses have also complained about the difficulty of obtaining reliable information concerning the status of their application and consequently how much longer they may have to wait.

4.35 It is urgent that STP tackle this issue as soon as possible. It has been a subject of complaint from the local and foreign business communities for a considerable number of years, as well as the subject of discussion with the country's external partners. The prevailing situation harms STP's image, since it is difficult to avoid the conclusion that the main reason why these antiquated and apparently purposeless regulations are allowed to persist is because of the rent seeking opportunities they provide.

4.36 The reorganization and streamlining of these procedures would not be a demanding task. There has been some discussion of establishing a "one stop shop" or "guichet unique" in STP. This might be a positive step, but experience elsewhere shows that it is no panacea. There is a danger that the guichet unique can even become a supplementary step so long as nothing is done to address the roots of the problem – outdated and inappropriate legislation and regulations. Under such circumstances, a guichet unique may do little more than improve matters at the margin through supplying, for example, more up-to-date and reliable information about the status of an application. Rather than relying exclusively on a guichet unique, STP should also undertake a major overhaul of the procedures to establish a business in the country, making these as simple as possible. A number of African countries (e.g. Cabo Verde, Senegal, Madagascar) have succeeded in reducing the time needed to establish a new enterprise to a few days.

4.37 A related area of the public-private interface that is also in need of reform concerns the public disclosure of key information to help markets work more efficiently and to empower civil society. Information disclosure in STP is inadequate, infrequent and slow. There is a visible reluctance on the part of the public Authorities to share information. There are many examples. One relates to the disclosure of state-owned enterprise accounts, another to the paucity of data on the implementation of the budget and the control, monitoring and auditing of public expenditure. Poor information disclosure renders the routine interactions between Government and business even more problematic; it also undermines the wider participation of the educated public in the discussion and formulation of a development policy for the country⁹⁷.

4.38 The problem is not easily solvable through new legislation or regulations, since it stems, in essence, from a certain idea of the prerogative of the public sector which dates from STP's days as a socialist republic and even from the traditions which it inherited from the former colonial power. A special effort should nonetheless be made to change these attitudes, since they are inimical to a modern society forced to compete in today's global market place. A start could usefully be made by publishing basic statistical information on a government website⁹⁸. A great deal of this information is already

⁹⁷ For example, a new investment code was discussed in the STP Congress Committee analyzing the 2004 Budget Law but at the last moment was withdrawn from the law sent for approval in the body of the National Assembly. The draft became protected by an unwritten privacy tradition: it was not made available for the public at large, including the DTIS mission team, in spite of all our efforts.

⁹⁸ Like the Cabo Verde National Statistical Institute does at www.governo.cv.

available in spreadsheet form, and would require no further processing to be put onto a website. This first base could gradually be expanded and applied to a multitude of other areas of public/private interface such as business registration, license applications, customs procedures and tax administration.

SPECIAL REGIMES

4.39 Three specific regimes are of particular importance in terms of the incentives and signals they provide to existing and potential investors – the tax code, the investment code, and the free zone regime. With regard to the *tax code*, STP's system includes the normal range of direct and indirect taxes (see Box 4.3). The main issue concerns corporate profits tax, which, at an effective 45 percent, is considered to be so high as to be a disincentive to private investment. In 2000 and 2001, the IFC's Foreign Investment

Box 4. 3: São Tomé e Príncipe's Current Tax Regime

A flat rate of 13% is levied on earned annual wage income with exemption set for earnings up to Db 480,000, approximately US\$ 480. A tax on profits is levied on all domestic income from any commercial, industrial, service, or agricultural business or independent profession, with a flat rate of 30% on all taxable profits, and an additional rate of 15% on profits in excess of Db 12,000,000 (approximately US\$ 1,200). There is also a minimum value tax that all commercial, industrial, and artisanal businesses have to pay whether they record profits or not – deductible from the tax on profits: the amounts vary from Db 18,000 (approximately US\$ 1.8) to Db 636,000 (approximately US\$ 63.60). Indirect taxes: Domestic taxes on goods and services are levied on a small set of products – the rates range from 42% to 149% for petroleum products, 10% to 35% for motor vehicles, 25% to 55% for alcoholic drinks; the charges for tobacco and services are set as 55% and 2%. Taxes on imported goods range from 5% (basic goods) to 20% (luxury goods), and real estate transfer tax varies from 5% for barter deeds to 10% for cash acquisitions of properties, rural or urban.

Advisory Service (FIAS) carried out an analysis of STP's tax code with a view to improving incentives.⁹⁹ FIAS recommended upgrading the tax code as an alternative to providing tax holidays and fiscal incentives whether or not in the context of a free zone regime. As well as a reduction in the corporate tax to a flat rate of 25 percent on profits, FIAS recommended a number of other measures to simplify the tax code and to make it fairer and more transparent, including: (i) tax tribunals at different levels of government to handle tax issues and disputes; (ii) stiff penalties and fines for underpayment, late payment, and other tax violations; and (iii) more adequate resources for tax collection and enforcement.

4.40 A new tax code, including these and other reforms¹⁰⁰, was presented to the National Assembly along with the new Budget Law in 2004. It failed, however, to get passed. It will be resubmitted during the course of 2005 in accordance with STP's engagements under its PRGF Arrangement with the IMF.

⁹⁹ São Tomé: *Système d'Imposition des Entreprises et Régimes d'Incitation : Analyse et Recommendations*, FIAS, October, 2001.

¹⁰⁰ The streamlining and simplification of minor taxes such as the urban property tax, inheritance taxes, taxes on grants, and taxes on asset transfers, and continuing to enforce the widespread use of taxpayer identification numbers throughout the territory.

4.41 The 1992 *Investment Code* grants fiscal incentives to new investment for a pre-defined number of years. The size of the incentive is positively correlated with that of the proposed business operation (see Box 4.4) The code has been manifestly ineffective in

Box 4. 4: The 1992 Investment Code

Investors that bring at least 30% of their own resources to projects up to US\$ 100,000 have a 50% reduction in their tax on profits during the first 5 years of operations, tax exemption on imports of equipment, in general taxed at the 10% rate, and reduction of 50% in real estate transfer tax on assets related to the projects; investors that bring at least 50% of their own resources to projects valued between US\$ 100,000 and US\$ 1,000,000 have the same tax exemption on imports of equipments but the 50% reduction in profits tax is extended to the first 7 years of operations and the reduction in real estate transfer tax on properties associated with the operation is set at 75%; investors in projects amounting to more than US\$ 1,000,000 have fiscal incentives at the level of the second category, and additional advantages negotiable with government. Foreign investors have a total exemption on tax due on profits re-invested in the country. Project eligibility for fiscal incentives requires detailed feasibility studies, and involves diverse government agencies. Only investors with projects worth more than US\$ 1,000,000 have lately applied for and made use of fiscal incentives, which suggests that the code does not serve to encourage medium-size and small-scale investment projects.

attracting investment to STP, and the Authorities have been working on the preparation of a revised code for some years. A new version, which was first drafted in 2001, would provide a simplified and more accessible set of rules for investors. The application/approval process would be simplified: four documents would be required for submission to the Ministry of Finance and Planning (MoFP). The proposed 45-day approval delay, however, would still be too long by international standards. There are also other aspects of the 2001 draft code which would need to be modified to make the legislation compatible with international norms¹⁰¹. The presentation to the National Assembly of an updated and improved version of this new code, which would also eliminate preferential tax regimes, is one of the actions supported under STP's PRGF arrangement with the IMF.

4.42 The chief characteristics of the *free zone regime* are summarized in Box 4.5.

Box 4. 5: STP's Free Zone Regime

The legal basis for the promotion of investments under a free zone regime dates from the mid 1990s. The regime is defined by three decrees: Decree Law 61/95, Decree Law 70/95, and Decree-Law 33/98. The last of these is described as a "free zone code" meant to facilitate the application of the laws, although some of its provisions are, in fact, new. It creates in particular the Free Zone Authority, which is in charge of promotion and the granting of free zone regime licenses. It also distinguishes between physically demarcated free zones, and companies operating under the free zone regime but not located within the borders of a free zone (these are called "offshore companies." The free zone regime is granted only to companies creating new activities, and which export more than 80 percent of their production sales, whether measured financially or by volume. In addition, there is a decree/law of 1995 governing offshore banking activities.

The free zone regime is more favourable than the investment code on many important issues. It promises a rapid and unencumbered registration process, as well as complete tax exemption and international arbitration in the case of disputes.

¹⁰¹ *Inter alia*, there is a clause permitting expropriation at a "fair price" but without sufficient clarification of the judicial and financial conditions surrounding expropriation. Also, there is lack of clarity concerning sectors in which investment would not be allowed.

The Free Zone Authority (FZA), stipulated under the 1998 Law, became officially active in August 2003, although it had been operating de facto for some considerable time before this. Its Chief Executive is a former Minister of Commerce.

At present, the FZA foresees three free zone developments:

❖ An *Airport Free Zone*, which would house mainly trade and service companies. An area of about 230 hectares has been set aside and transferred by the Government to the FZA. The main target market would be the supply of lighter goods such as medicines and electronic goods and spare parts by air to the Central African market. Initially, there would be no processing or packaging activities, though that may follow later. Apparently, a company has already expressed interest in setting up a break bulk operation to supply Central Africa with medicines. The project, however, would be unable to develop without significant improvements in the airport infrastructure, which in turn would depend on the growth of international visits, mainly for tourism, to STP.

❖ A *Logistical Free Zone* at Bahia das Agulhas on Príncipe island. This project would serve as a center of logistical support for the oil platforms operating in the Gulf of Guinea. It would take advantage of what the FZA describes as STP's strategic location midway between Angola, Gabon, Equatorial Guinea and Nigeria. One of the many questions raised by this proposed project is why it should be located on Príncipe rather than São Tomé island, given that the latter will be the locus of the proposed new deep water port and other export-related infrastructure and services.

❖ A *Tourism Free Zone*, with its epicenter in Porto Alegre, but reaching as far as the island of Rolhas, for a total of between fifteen and twenty thousand hectares.

4.43 Preparation of a Free Zone Development Plan for STP is currently under way. In addition, after a study was carried out by a company with offshore status in STP (“Development Company of São Tomé e Príncipe”), this same company was given a concession for establishing Center for Offshore Activities, the headquarters of which would be in a proposed free zone area near to the international airport. A bidding process has, moreover, been launched for the setting up of a free zone in the Baía de Angulas on Príncipe. Unfortunately, only two companies expressed interest, one of which proposed a concrete project worth some US\$200 million. Given that the other company has yet to present its detailed studies, and also taking account of the project as presented, it is likely that the former company will be awarded the concession. An earlier concession for the establishment of a zone on a large part of the island of Príncipe (around one third of the island's total area) was granted in 1998 to a South African Enterprise called the West African Development Company (WADCO). Like one of the Free Zone Authority (FZA) projects described in Box 4.3, this concession permits the construction of a logistical service center for offshore oil platforms; unlike the former, it also permits extensive logging¹⁰². It is difficult to obtain a clear picture regarding the status of this concession. According to some verbal reports, it has been cancelled; but others say it is merely on ice. WADCO has been restructured, and is said to have expressed renewed interest in the Príncipe concession. Negotiations apparently stalled because of the company's request that the Government finance a feasibility study estimate to cost US\$400,000. A further project is also under consideration for Príncipe. This would be mainly for logistical support for offshore petroleum platforms, but may also include the construction of a shipyard for the construction and repair of ocean-going vessels, as well as a tourism component.

¹⁰² This is doubly worrying since WADCO is reportedly associated with Malaysian interests which have been involved in unsustainable logging activities in a number of Sub-Saharan African countries, including Equatorial Guinea (see Frynas et al, 2003).

4.44 Despite these possibilities, there is, nevertheless, considerable doubt about the wisdom of pursuing free zone development in STP. It makes little sense for a micro-island economy like STP to devote scarce administrative resources to the establishment of such zones. It would be much more productive to overhaul trade and other taxes, as well as business registration and related legislation for the islands as a whole rather than offering to provide special treatment to selected companies, whether or not they are physically located in a designated free zone. The economy is already very open, tariffs are relatively low and are, moreover, evaded on a substantial scale. Success stories among free zones world wide, and especially in Sub-Saharan Africa, are few and far between, and tend to be concentrated in countries with strong institutions and well developed administrative capacity. There is a good chance that free zones will simply become centers for tax evasion and corruption.

4.45 A free zone regime should not be confused with physical facilities, such as enterprise parks, which can offer companies common infrastructure and other advantages. There may be a case for providing these in STP, although their construction and operation should be left to the private sector. The cost of services such as electricity and water, whether provided by the state or private suppliers, should be met by the occupants of the parks.

4.46 Unfortunately, and despite its importance as part of the agenda in formulating a national strategy to attract needed investment, the issue of free zones and their alternatives has not yet been fully and openly discussed either within the Government or with the private sector.

4.47 STP's 1995 legislation enabling the establishment of free zones also sets the country up as an *offshore tax haven*. The cost is competitive: US\$75 initial fee, US\$150 for name registration, and an annual renewal fee of \$50. Thus far, thirty companies have availed themselves of this so-called tax optimization scheme. The world-wide business of offering tax shelters is becoming highly competitive. The Tax Justice Network, an international NGO, estimates that the number of offshore tax havens more than doubled between 1970 and 2004, and play host to over 15,000 corporations from the US alone. The question arises whether STP should be part of this market or not. The financial benefits to the country are likely to be marginal. Given the increasingly strong and unified response of OECD countries to such havens – which are frequently used not merely to evade tax, but also for money-laundering purposes as well – STP should carefully consider the negative effects which offering such a service has on its image.

GOVERNANCE

4.48 STP's image is among its major assets. It portrays itself, with some justification, as an island of tranquility in a neighborhood stricken with civil war, oppression, violence, instability and corruption. This image is of great importance in keeping and enhancing the goodwill of the international donor community, and even more in attracting foreign investors and visitors. It requires, however, constant nurturing, and can be quickly tarred, if not destroyed, through accumulating evidence of poor governance practices.

4.49 The reality of STP's favorable image is rooted in a number of advantages and achievements in the governance area:

- ❖ It is a democratic country which enjoys free and reasonably fair elections (Section on *Political Background and Recent Development* in Chapter 1).
- ❖ The written media, albeit with considerable scope for further development, are free; they are able to criticize the Authorities openly, and frequently do so. Foreign, lusophone, electronic media is easily available for those who can afford it. Recent legislation permits the establishment of private radio and television stations, although for the moment the public monopoly in broadcasting remains *de facto* unchallenged¹⁰³.
- ❖ STP is peaceful; it does not have the traditions of ethnic violence which plague so many continental African countries. Even incidents such as the attempted *coup d'état* of 2003 have, until now, passed peacefully, with no deaths or serious injuries.
- ❖ There are no *de jure* restrictions on the development of civil society, although this remains *de facto* weak, reflecting the state of institutions in the country as a whole.
- ❖ STP is making a clear and visible effort, as reflected in the ambitious and far-reaching Oil Revenue Management Law, as well as in the Joint Declaration of Abuja signed by the Presidents of STP and Nigeria, to avoid the governance-related pitfalls of other oil-producing countries in Sub-Saharan Africa and elsewhere.
- ❖ Through the Forum of National Reconciliation in 2004 the Government has listened to the nation's stakeholders in an attempt to build a consensus for STP's future development, and has seized the opportunity to explain oil industry issues clearly and in manner accessible to the population.
- ❖ As shown below in this section, the Attorney General and Auditor General (head of the public Audit Office) have been extremely active in pursuing allegations of corruption and malpractice.

4.50 These assets and encouraging developments must, however, be set against a number of reports and recent incidents which suggest that governance remains a major and increasing problem in STP. A considerable number of private sector representatives complained to the DTIS mission of the need to offer bribes for a wide range of public services, not least in relation to business registration (as shown in section on *The Public-Private Interface* in Chapter 4) and obtaining access to land (as shown in section on *The*

¹⁰³ The Government grants the opposition political parties free air time on both television and radio, though this privilege may, of course, be withdrawn at any time. There are no legal restrictions on the opening of competing stations, and their absence may be due to lack of economically effective demand, and/or *de facto* difficulties in obtaining a license. If the problem is the former, there may be scope for donor action to support standard or community radio stations.

Land Issue on Chapter 4). A recent study¹⁰⁴ shows that the anticipation of oil-related wealth in STP has been accompanied by a clear increase in perceived corruption in recent years. The incidence, according to the study, is especially felt in health care, education, police, Customs, public sector employment, and in vote buying.

4.51 The political crises of 2004, which culminated in a change of government in September, were closely related to several important governance issues which had arisen during the preceding three years. Alleged corrupt practices (in some cases the allegations are contained in audits commissioned by the Office of the Auditor General) have been associated, *inter alia*, with the management of the Gabinete de Gestão da Ajuda (GGA)¹⁰⁵, a department of the Ministry of Trade which administers the funds received from the sale of food aid; the granting of licenses, without the competitive bidding process which the law stipulates, in telecommunications and electricity generation; sale of public owned buildings in São Tomé city; and conflicts of interest in nascent petroleum sector. There are also governance issues in the health sector: an audit of the country's only hospital revealed weak financial management and malpractice.

4.52 In September 2004, in the wake of the GGA crisis, the head of the Audit Office told the press that recently revealed cases of malpractice were “only a drop of water in the midst of a vast ocean of corruption that affects all levels in STP.” In addition to the disclosed cases, which he described as “insignificant,” he said there were many more, as yet undisclosed¹⁰⁶.

4.53 Such statements, and the ability of a free press to publish them, indicate a healthy degree of awareness and public candor in STP about governance problems, which is a *sine qua non* for tackling them. If the Attorney General, the Auditor General and their institutions, as well as others dedicated to the fight against corruption, are able to widen and deepen their work, then there is a real chance of achieving a genuine moralization of politics in STP. This is vitally important in the light of the strong temptations that will accompany the approaching oil era.

4.54 It is strongly recommended that all concerned stakeholders in STP – public and private sectors and civil society -- develop, in partnership with the donor community, a national program for good governance, that would incorporate a strategy and action plan for addressing the issue. This would build upon previous and ongoing efforts¹⁰⁷ to update laws and strengthen the capacity of the judicial system to implement them. Enhanced capacity and institution-building in the legal and judicial domains will be critical

¹⁰⁴ Pedro Camarinha Vicente: “Does Oil Corrupt? Theory and Evidence from a Natural Experiment in West Africa,” draft paper, Department of Economics, University of Chicago, November, 2004 (pvicente@uchicago.edu).

¹⁰⁵ The GGA has long been a cause for concern regarding transparency. In 1992, its predecessor organization, UNIGEC, was accused of “managing” counterpart funds without the consent of the donors who had provided the food aid. In 1996, the World Bank reported that only 43 percent of food aid proceeds went through regular channels into the state coffers. In 1997, the Bank recommended the abolition of the GGA and a thorough revision of the management of food aid. This was not carried out.

¹⁰⁶ Press conference by Mr. Francisco Fortunato Pires, Head of the Audit Office, September 13, 2004.

¹⁰⁷ Including technical assistance from the World Bank and UNDP, and a current capacity building grant provided by the World Bank (see Box 4.8)

components of the good governance strategy. The existing institutions throughout the judicial sector are too weak and under-resourced, even given the energy and commitments of their current top officials. Reforms also need to focus on reinforcing the independence of the judiciary from the executive branch and on developing alternative dispute resolution mechanisms.

4.55 An effective strategy for good governance would, however, go beyond the requirements of the judicial sector alone. Experience in a number of countries indicates that such a strategy needs to be comprehensive, and to embrace or take into account a range of parallel policies and actions including, but not limited to, the following:

- ❖ Strengthening the public service through improved compensation, better working conditions, and the introduction of a merit-based recruitment and career structure.
- ❖ Reinforcing civil society and civil society oversight: strengthening and widening dialogue between government and other stakeholders, holding open hearings on matters of public interest such as major utility investments, providing fuller access to information by both electronic and other means, reinforcing an already free press through training of journalists and encouraging the establishment of competing radio and, eventually, television stations.
- ❖ Increasing the public accountability of political leadership through (i) systematic disclosure of the wealth and income of all elected (and perhaps also senior non-elected) officials; (ii) establishment of an anti-corruption agency, which should be as financially, politically and administratively independent from government as possible; (iii) assuring adequate campaign financing and press, television and radio coverage for opposition political parties (this latter already exists in STP); and (iv) enhancing the capacity of the National Assembly.
- ❖ Building upon previous efforts (including those supported by the IMF and World Bank) to improve further public sector financial management including transparency and full public disclosure of public accounts¹⁰⁸, fully published independent audits of all public entities, and reform of public procurement procedures and practices¹⁰⁹.
- ❖ Minimization of public bureaucratic procedures, simplification of the essential remainder, and removal, wherever possible, of the right of individual civil servants to exercise discretion.

4.56 If STP is not to follow the path of its oil producing neighbors, and is to become more attractive to private investors, the governance issue must be dealt with decisively and energetically. The development and implementation of a good governance strategy is, therefore, an area where well-coordinated donor assistance could yield major developmental dividends. It is, however, critically important that this be a “demand-

¹⁰⁸ An increasing number of developing countries, including some in Sub-Saharan Africa, are making the public budget fully accessible through the internet.

¹⁰⁹ The urgency of this in STP is indicated by a number of recent significant public contracts which have been awarded without any competitive bidding.

driven” exercise and not something imposed from the outside. The demand must, moreover, come not just from one sector of society, but from all STP’s stakeholders.

CONFLICT RESOLUTION

4.57 There is a widespread perception among the business community in STP that the country’s system of conflict resolution urgently needs upgrading. The inadequacies of the judicial system undermine contractual relationships and fail to provide proper legal support for upholding property rights. Like other public sector institutions in STP, the justice sector lacks the resources and tools to ensure the rule of law. This places the country in a precarious situation, especially given the advent of oil revenues, and prejudices its attractiveness to foreign investors. The Judiciary has two tiers, with first instance courts located in various places on the islands of São Tomé and Príncipe, and the Supreme Court housed in the capital city, São Tomé. Judges and prosecutors must work throughout both islands with a staff of only eighty (only thirty of whom are lawyers), and are poorly equipped to ensure a stable legal and judicial framework. Inevitably, the court system works slowly and inefficiently, and it frequently takes two years or more to reach a decision. Public disclosure of cases, whether completed or otherwise, is inadequate. In over 90 percent of cases, parties abandon the system and attempt to resolve their disputes outside the courts.

4.58 Recourse to the judicial system for purposes of credit recovery is especially difficult. First, lack of full land titling prevents the use of real estate as collateral in most cases. Second, debt collection through the courts can be slow and problematic even where property title is clear and the property concerned has been placed as security for the debt. The complexity of the 1992 Law which established the framework for the land reform project makes it relatively easy to challenge or question any particular aspect of a loan agreement.

4.59 STP’s Authorities are very conscious of the urgent need to reform the country’s judicial system, in particular as it relates to commercial and economic matters. The Ministry of Justice, the Prosecutor General’s Office and the Judiciary have simultaneously requested World Bank grant funds to pursue a strategic program of reform and capacity building to improve the sector’s overall functioning (see Box 4.6).

Box 4. 6: Capacity Building in the Justice Sector

At the request of the Ministry of Justice, the Office of the Prosecutor General and the Judiciary, the World Bank has authorized a grant of US\$326,000 to STP to pursue a strategic program of reform and capacity building in the justice sector. Each of the three key institutions have formulated their own reform proposals, among which are revisions to key legislation, such as the civil and civil procedure codes, the criminal and criminal procedure codes, the commercial code and the civil registry. Also, the grant will support improvements in the sector’s human resources through local capacity building and training exercises. Alternative ways of legal reform and alternative dispute resolution methods will also be reviewed and discussed with a view to defining potential areas for future reform.

The first step in implementing the grant will be a general diagnosis of the sector, which will provide practical recommendations for prioritizing reforms, building on practical examples from other Lusophone, Sub-Saharan African countries. The diagnosis will be discussed with relevant stakeholders to build consensus for a multi-year reform strategy.

THE LAND ISSUE

4.60 Land ownership and property rights are difficult and sensitive political issues in STP. They are, nonetheless, closely related to a number of other dimensions of the investment climate, including governance and transparency, agricultural productivity and efficiency, and the development of an adequate financial sector and credit market. They need, therefore, to be urgently tackled.

4.61 At the time of Independence, the Government assumed ownership of a total land area of over one thousand square kilometers, comprising most of the national territory. This included the previously Portuguese-owned cocoa plantations. After running the plantations as public enterprises for some 18 years, the Government embarked in 1992 on a major land reform project intended to distribute most of the land in the plantations in small parcels to the estate workers. Although a few of the early beneficiaries received clear title to their land, the bulk of smallholders have only provisional titles, which are in essence user rights of the plots allocated to them. The legislation (Decree-Law 30-1992) which establishes the framework for the land reform is complex: it includes 46 articles, a description of a system for classifying agricultural lands, and a detailed form which defines the profile of the potential provisional title holder. For the title to remain in force, holders are meant to pay an annual leasing fee. The title contract also stipulates the use to which the land would be put in terms of the crops to be grown on it. Sub-leasing is allowed; however, the title itself cannot be transferred for five years. After five years, the transfer of a title requires official notification to the Government and the preparation of a new contract in the name of the succeeding title holder.

4.62 About 43,500 hectares were assigned for redistribution. By 2003, over ten years after the reform was initiated, out of a total gross area of about 45,600 hectares, some 19,800 hectares had been distributed to smallholders in average lots of a little over two hectares, and a further 8,568 hectares had been distributed to 223 small and medium sized agri-businesses with an average holding of 38.5 hectares¹¹⁰. Just over 17,000 hectares consist of forest, and about 128 hectares remain to be distributed to smallholders. The 28,000 hectares distributed are spread over some 150 rural communities. Of the 9,129 families benefiting from land distribution, between 75 and 80 percent were wage workers on the estates and about two thirds were local residents of the communities. It should be noted that nearly all the estate workers who became smallholders knew little or nothing about farming or about running an agri-business. Most of the rest of the plantation lands, as well as the other land nationalized at Independence, remain dormant.

4.63 There are a number of reasons why the Authorities should consider revising their policy on the land reform and the land ownership issue in general. First, farmers need the unequivocal signal that the land they work on is theirs and is for their benefit and for that of their family. This argues strongly for the conversion of the provisional titles into clear and unambiguous titles of ownership. Second, the temporary nature of the titles and the

¹¹⁰ According to the legislation, only that land designated as “surplus” to the main land reform would be available for allocation to agri-businesses on the basis of competitive bidding. The provisional titles for the agri-businesses are, according to the Law, for 20 years only.

complex *de jure* restrictions on their application and trading, impedes the growth of a market in land in STP. Third, the lack of a land market constrains credit and the development of an effective financial sector because of the non-availability of land property as collateral for bank loans. This limits the investment present title holders can make in their properties.

4.64 Fourth, the way in which provisional titles are allocated and administered is non-transparent and gives rise to corruption. The complex 1992 legislation, which is guided in principle by equity considerations, is not always applied in practice. Provisional titles have been granted to businesses in areas which were not designated as part of a “surplus available for the competitive bids of business ventures.” Several titles have been allocated to businesses for periods much longer than the 20 years stipulated in the legislation. A number of leases have reportedly been awarded without competitive bidding, in accordance with non-economic criteria, and have been sub-let for purposes other than those indicated in the original title. Although paper records of the distribution of land titles apparently exist, these are not computerized and are not easily available for public scrutiny. In fact, detailed knowledge of who holds provisional titles seems to be confined to a very few people. The *de facto* existence of a speculative and trading market in land titles does not contribute to economic efficiency because of the non-transparent and illegal nature of these transactions.

Box 4. 7: The Land Question and Foreign Investment in STP

A potential investor is interested in establishing an agri-business in STP with a view to exporting tropical fruits and vegetables by air to the European market. He is a serious investor with a long period of successful farming and agri-business experience behind him in Southern Africa. His enterprise would create immediate direct employment for about 100 people, a number which would grow substantially in the future as he intends to have a fairly small operation which he would farm himself, relying increasingly over time on out-growers for the bulk of his sales.

He arrives in STP, where he already has a number of private sector contacts and potential business partners, and is introduced by them to Ministers and other key figures in the Government. The question of land soon arises. It is explained to the investor that, in general, foreigners cannot purchase land in STP but are allowed to rent it on a long term lease that will enable them to engage in productive activities on the land. The visitor looks around the island and finds two sites that would suit his purposes well. He is informed that, unfortunately, both are already leased. He is, however, put in contact with one of the lessees, who is a close friend and associate of one of the Ministers to whom the investor has been introduced, and is led to understand that the affair would be open to negotiation. He is, indeed, able to cut a deal with the lessee to sub-let the land which he needs. He unfortunately fails to double-check the credentials of the holder of the provisional title to the land. In fact, there doesn't seem to be an updated or publicly available register of provisional land titles in which he can verify the bona fide of the title holder. He returns to his home in Portugal to prepare matters at that end, anticipating being able to start business in STP within the foreseeable future.

One day he receives a call from his business partner in STP who is arranging the registration of the enterprise and other formalities. The partner advises him to travel to STP as soon as possible, as something of a crisis has arisen. Upon his arrival, the investor discovers that the partner is proceeding – through no fault of his own – at only a snail's pace with the enterprise registration and other related matters. But the real difficulty lies with the land question.

Since the investor's first visit to STP, the Minister who introduced him to the land title holder has been forced to leave the Administration under somewhat inauspicious circumstances. The alleged land title holder, who was a close associate of the disgraced politician, has also fallen out of favor, and with him his entitlement to the land in question. It is explained to the investor that the man with whom he negotiated a sub-lease on the land never possessed an indisputable provisional title, but was merely allowed to speculate with one as a favor from his friend the Minister. The investor is therefore faced with a choice: either to start the whole process of searching for a suitable plot of land and negotiating a lease or a sub-lease again, or abandoning his investment project along with the not insignificant expenses he has already incurred. Not surprisingly, he opts for the latter course of action.

4.65 Lack of transparency also leads to uncertainty and discourages the right kind of foreign investment in agri-businesses in STP. Box 4.7 is based on events which were reported to the DTIS mission as having occurred during the course of 2003/2004. The story has been somewhat simplified, and some details have been left out for the sake of brevity, but it is typical, in essence, of a number of recent cases.

4.66 A properly functioning and transparent land market would help to address many of these concerns. It would grant smallholders and other farmers the clear title that they need to their land. It would allow the most successful farmers to acquire more land, either through purchase or lease, and thus increase the overall efficiency of land use. It would also allow those who have non viable small plots to “cash out” and move on, hopefully to remunerative employment elsewhere. It would encourage the development of a modern credit system by allowing land to be used as collateral for bank loans. If accompanied by appropriate legal safeguards, it would end the current practice whereby provisional land titles have become speculative instruments in the hands of the well connected, enabling them to extract rent from the productive activities of others. Concern has been expressed that a land market would lead to the acquisition by foreigners of too much of the desirable real estate. This could, however, be easily addressed by declaring certain areas of land to be off limits to foreigners.

4.67 In order to create a working land market, two actions should be taken. The country should establish a contemporary cadastre for all real estate and should have the entire country surveyed and mapped into the cadastre. At the same time, a zoning system should be created that divides all real estate in certain categories, each one with predeteeed uses, e.g. agricultural land, national parks, urban areas, public lands etc. The Government has undertaken to make a first tentative step in this direction. As part of its upcoming PRGF Arrangement with the IMF, it has agreed to launch a study to analyze the factors that may be obstructing the development and diversification of the agricultural sector, including the economic effects of a lack of complete property rights for land holders.

HUMAN CAPITAL

4.68 Human resource capacity is a serious constraint to STP’s development. The country does benefit from a relatively high literacy rate, though by 2000 the rate was reported to have fallen from over 75 percent five years after Independence to 64 percent. However, the quality of *primary and secondary education*, especially at secondary level, is weak and declining. Although access to the first year of primary education is practically universal, nearly a quarter of the children fail to reach fourth grade, and less than half (47 percent) reach sixth grade. Repetition rates are high and effective learning time is insufficient. With over a third of primary schools operating under a triple shift system, average class time is severely curtailed. Teaching is weak. Teachers’ motivation is adversely affected by very low wages (about 1.5 times the average per capita income) and the lack of a career structure. The Ministry of Education lacks the capacity to monitor and supervise teachers effectively and school inspections are virtually non-existent.

4.69 The education system is unable to provide the kinds of *vocational skills* which the economy needs. While unskilled workers in STP earn wages roughly equal to, or less

than, the average for most Sub-Saharan African countries (see Table 4.1), there is a shortage of workers with manual abilities, which is reflected in the relatively high wages these workers earn – just under US\$150 per month equivalent compared to about one third of that for an unskilled worker. Despite this, there is a lack of interest on the part of secondary school students in obtaining training in these skills. During the last ten years there were more places on offer in technical training programs --for skills in areas such as construction, plumbing, electricity, mechanics, automated systems and metallic structures – than students wishing to fill them. The low appeal of such programs among students of the relevant age groups is attributed by local observers to poor advocacy on the part of the school system and the traditionally low esteem in which technical, manual work is held in STP. However, the poor quality of the training programs – most of which are offered by the public sector – and the low estimation of their worth by potential employers, likely also play a role. Unless addressed, this shortage of core skills will not only continue to limit development, but also reduce the income which the country could earn through the provision of basic services to future oil industry employees and their families. There is, moreover, a strong capacity building need for the owners and managers of small and medium-sized enterprises in such basic business management skills as bookkeeping, stock control and pricing, as well as in the preparation of requests for credit.

4.70 STP is addressing concerns in primary and secondary education through a Ten Year Education Strategy covering the period 2003-2013. The Strategy aims to lay the foundations for a better managed and integrated six year primary education program, together with improved learning and service delivery and more equitable distribution of educational opportunities across geographical areas. The implementation of the Strategy is to be supported by a number of donors¹¹¹, including a US\$5 million IDA credit and \$1.5 million IDA grant, which will also assist reforms in the health sector.

4.71 This is indeed essential, since a good basic level of education, particularly minimal literacy, has a strong positive effect on agricultural productivity. It facilitates the adoption of new technologies and the understanding and acceptance of ideas and methods conveyed by extension services. Important as they are, however, improvements in primary education will do little in the short term to address the problem of key technical skill shortages. It is recommended that the Government, in close consultation with the private sector, develop a strategy to address this shortage, which can be presented to the donor community for support, but which should rely to the maximum extent on the private sector itself.

4.72 Other than the Instituto Superior Politécnico (ISP) which offers four year courses in accounting, business management, languages and secondary school teaching, there is no *tertiary education* available in STP. Those high school graduates who are willing and able to pursue their studies at university level must therefore travel abroad to do so. There are two main issues regarding these studies. First, there is a great deal of anecdotal evidence that the method of selection of students who receive government or donor financed scholarships to study abroad may not be entirely fair or free from considerations

¹¹¹ Including AfDB, Portugal and Taiwan.

such as family or political connections. Second, there is continued reliance on higher education in Cuba¹¹² and, to a lesser extent, in countries of the former Soviet Union; this is an inheritance of the pre 1990 socialist administration in STP. This does not necessarily signify that these students receive a poor quality education. Cuban training in such technical fields as health care and agronomy is reputed to be very good. However, continued and exclusive exposure to centrally planned economies by a significant proportion of the Sãotomean intellectual elite, will not prepare the future cadres adequately for leading positions in what is now a market economy. Indeed, limited understanding of the basic tenets of market economics is obvious when dealing with many governmental officials.

4.73 Reportedly, Brazil offered 140 places in various universities and other institutions of higher learning for Sãotomeans in 2003. The Government submitted 140 applicants, of which only 46 were considered acceptable, leaving 94 places vacant. A more concerted effort should be made to take advantage of all opportunities for higher education of qualified Sãotomeans, particularly in countries that have market economies. There is, of course, a risk that many students will not return to STP after graduating – indeed, this is already occurring on a substantial scale. This is a difficult problem to tackle¹¹³.

4.74 Brazil will soon offer short higher education courses in São Tomé, taught by staff from the Getulio Vargas Foundation¹¹⁴ who will visit São Tomé for the duration of the courses. UNDP offers *ad hoc* courses in a number of subjects. CIAT, the agricultural research station, has great need for dialogue with, and knowledge transfer from, similar institutions elsewhere. All these efforts at education, training and knowledge transfer could be leveraged by the use of videoconferencing and the availability of associated web-based material. Although the locally available Internet connection does not allow for videoconferencing, it may be possible to use the UNDP's satellite connection for this purpose. If so, it might be considered as an appropriate entity for membership of the World Bank sponsored "Global Development Learning Network" (GDLN)¹¹⁵. This would, at once, give São Tomé access to a world wide network of more than 70 partners, including many in Brazil. It would greatly facilitate, and add value to, such activities as the Fundação Getulio Vargas' sponsored courses, and direct contacts between CIAT staff and colleagues in the Brazilian agriculture research institute, EMBRAPA¹¹⁶.

SUMMARY OF RECOMMENDED MEASURES

❖ Elaborate strategy for improving electricity and water supply

¹¹² Reportedly, approximately 200 students went to Cuba in 2003 for full higher education, lasting six years.

¹¹³ One possible approach is that developed by Mexico in partnership with the United States. Legislation requires all Mexican students who acquire certain critically needed skills at foreign higher education institutions to return to their country and – if they obtain work – to remain there for a certain number of years. This legislation is backed up by bilateral agreements with the destination country (in Mexico's case, the United States) not to issue work permits to the students concerned until they have worked for the required time in Mexico.

¹¹⁴ see: http://www.fgv.br/principal/idx_principal.asp

¹¹⁵ see also: <http://www.gdln.org/>

¹¹⁶ see: <http://www.embrapa.br/>

- ❖ Increase private sector involvement in electricity production
- ❖ Refrain from awarding ad hoc licenses and contracts for utility services in the absence of a competitive bidding process as stipulated under law.
- ❖ Strengthen telecommunications regulation.
- ❖ Examine the possibility of expanding the telephone network into rural areas, using mobile technology and an “output-based aid approach.
- ❖ Finalize and apply new strategy for the road sector
- ❖ Consider reducing taxes on diesel fuel and other measures to reduce transport costs to rural areas.
- ❖ Urgently examine a solution to the port problem to cover the period before a new deep water facility would become operational.
- ❖ Intensify negotiations to open up new international air services to and from Europe.
- ❖ Substantially reduce the time and number of procedures required to establish a business in STP.
- ❖ Improve the disclosure and dissemination of information concerning the financial operations of the public sector and of public enterprises. Establish a government website.
- ❖ Press for approval of the new tax and investment codes and make them operational as soon as possible.
- ❖ Abolish legislation attempting to establish physically demarcated free zone.
- ❖ Elaborate a national strategy and action plan for improved governance. Reforms need to focus on reinforcing the independence of the judiciary and on developing alternative dispute resolution mechanisms.
- ❖ Resolve the land issue: convert provisional titles into titles of ownership; rigorously apply the law and transparent procedures in the attribution of land titles; establish a contemporary cadastre for all real estate; and elaborate a zoning system.
- ❖ Strengthen vocational training in close collaboration with the private sector, and obtain access to the “Global Development Learning Network.”

5. THE IMPACT OF TRADE ON POVERTY

INTRODUCTION

5.1 STP had some of the best social indicators in sub-Saharan Africa since its independence in 1975 and throughout the 1980s. However, the worsening of its terms of trade, deteriorating economic performance and weak capacity in the 1990s led to a decline in the socio-economic conditions of its population (World Bank 2005a).

5.2 Poverty in STP is now prevalent: the latest household survey of 2001 indicates that 52.4% of the population are poor. Poverty is higher in rural than in urban areas, and is more concentrated in the North and South Regions of the island of São Tomé and on Príncipe than elsewhere. The government's PRSP goal of halving poverty by 2010 and reducing it by two-thirds by 2015 would require a substantial fall of around 26 and 35 percentage points, respectively.

5.3 STP is likely to be hit again by a worsening of its terms of trade. The forecast decline of real cocoa prices will cause a further deterioration of STP's terms of trade since its commodity exports are concentrated on cocoa (93 percent of total commodity exports in 2003).¹¹⁷ This decline will likely worsen the plight of the poor since agricultural exports are predominantly performed by the poor (70 percent of agricultural exporters were poor in 2001). While it is estimated that the forecast relative decline of cocoa prices during the period extending to 2011 will have a small poverty impact on the population as a whole, it will have a significant impact amongst households in the export sector (who constitute 22 percent of households). Poverty amongst these households could increase by 3.3 percentage points.¹¹⁸ Sharper declines than forecast would lead to greater poverty. For example, a fall in the terms of trade of 40 percent would increase poverty amongst households in the export sector by 15.8 percentage points. There is therefore a pressing need for cocoa exporters to increase in the short run the productivity of their land and labor, which would increase production and compensate for the expected fall in cocoa prices - a strategy successfully followed by Indonesia. There is

¹¹⁷ Based on World Bank (2004). "Commodity Price Data (Pink Sheet)" DEC Prospects Group, <http://web.worldbank.org/WBSITE/EXTERNAL/EXTDEC/EXTDECPROSPECTS/0,,contentMDK:20268484~menuPK:556802~pagePK:64165401~piPK:64165026~theSitePK:476883,00.html>.

¹¹⁸ The simulation results of the impact of the worsening terms of trade and the surge in oil money are taken from Aldaz-Carroll, Enrique, Diego Angel-Urdinola, and Quentin Wodon (2005), "Terms of Trade, Oil Surges, and Poverty: Simulations for Sao Tome and Principe Using the 1-2-3 model and SimSIP", mimeo. The simulations are only based on first effect impacts. Due to lack of elasticity data, the poverty impact of the decline in terms of trade and of the construction of a deep-water port is based only on the impact of the change in prices and not on the impact of the change in quantities imported, produced domestically and exported resulting from the change in prices. In the case of the decline in the terms of trade, this omission is unlikely to affect the results significantly since the little data available indicates that the elasticity of exports to prices is close to zero (note that cocoa producers are unlikely to cut or plant cocoa trees in the short to medium run if cocoa prices change). In the case of the construction of the deep-water port, the non inclusion of the impact of changes in imports implies that the estimated positive impact on the poor is an upper value of the impact.

also a need for cocoa exporters to diversify into other types of exports so that they are not as hurt by and as highly dependent on the evolution of cocoa prices.

5.4 STP could well face a window of opportunity for substantial poverty reduction in the beginning of the next decade with the possible construction of a deep-water port and substantial surge in oil revenues. A new port would decrease significantly STP's import and export transport costs, which could translate into lower import prices and larger earnings for exporters. While this is likely to benefit the poor, the non-poor are likely to benefit more than the poor because of non-poor's higher import propensity. A fall in import prices and in the cost of exports of between five and 15 percent (and, as the analysis in Chapter 4 of this study shows, this is a conservative estimate of the benefit of a new port) could reduce poverty in the best scenario by between 1.1 to 3.3 percentage points. To increase the benefits more towards the poor it would be important to increase competition to encourage more passing on of lower freight charges for exporters, which would imply higher export earnings, of which the poor benefit disproportionately. Indeed, the savings from the new port could offset falling cocoa prices if passed on to the producer.

5.5 Oil extraction is forecast to start in about 2012. The payments made by the oil companies to the STP government would represent a very large monetary inflow. The subsequent increase in government spending would increase the demand for imports and domestic goods, drawing resources from the export sector – thus reducing exports – and leading to increases in domestic prices and wages causing a real appreciation of the exchange rate – standard features of what is known as the “Dutch disease.” The impact on poverty will depend on the impact of price changes and on the wealth impact of the huge increase in government resources. The increase in domestic prices and wages would benefit net producers of domestic goods and wage earners in the domestic sector, but it would particularly harm households in the export sector, as they would see the cost of consumption increase but not their export earnings.¹¹⁹ The magnitude of the change in domestic prices and wages and the impact they will have on poverty depends on the extent of the real exchange rate appreciation. An appreciation ranging from ten to 40 percent would contribute to increasing poverty from three to eleven percentage points. The final effect of the oil money inflow on poverty will crucially depend on the impact of the increase in wealth, which depends in turn on how the government spends the oil money. If the poor are affected directly or indirectly by the increase in government resources, poverty could fall substantially.

5.6 The government will be most successful in reducing poverty if it spends and invests the oil inflows in a pro-poor manner. An analysis of pro-poor public spending is to be included in the World Bank's next assistance strategy documentation for STP, which is due for completion in 2005. Preliminary results from this analysis indicate that increasing public sector wages would not be pro-poor, although it would have some limited impact on poverty. This reflects the fact that most civil servants and other public employees are not among the ranks of the poor. By contrast, carefully targeted public transfers could have a strong pro-poor impact.

¹¹⁹ Net domestic producers are those that produce more domestic products than they consume.

5.7 Such pro-poor spending would include appropriate technical assistance, transfers and subsidies to increase land and labor productivity of the poor (which would increase production and agricultural wages) and better access to markets through rural infrastructure improvements (an approach followed successfully by Indonesia at the same time that it enjoyed an oil boom); as well as assisting them to diversify exports towards products with better price prospects than cocoa (which would increase export earnings). Promoting exports of, for instance, food and horticultural produce would also help to even out the seasonal variability of domestic prices of these products to which the poor are particularly vulnerable.

5.8 Tourism is a sector that could also play a significant role in poverty reduction if expanded over the next years. It is an activity that could lead directly and indirectly to an increase in employment of poor workers both in urban and rural areas. Due to lack of sufficient data, the impact of an increase in tourism on poverty could not be evaluated in this study.

5.9 The rest of this Chapter examines the extent of poverty in STP, the sources of income of the poor, their regional distribution and their pattern of consumption, and presents the results of the simulations of the impact of the worsening terms of trade, reduced international transport costs, and a surge in oil revenues.

POVERTY IN STP

5.10 The 2000-2001 National Household Survey (Inquérito sobre Condições de Vida das Famílias, ECVM) is used to examine the poverty profile of STP.¹²⁰ The survey collects information on 2,372 households from all four STP's regions (the Northern, Southern, and Central regions of São Tome island, and the island of Príncipe). Poverty in STP is prevalent, as reflected by a headcount index of 52.4%, an extreme poverty headcount index of 18.9% and a poverty gap of 20.7%.

5.11 The main sources of income for households in the sample are, by order of importance, wages, trading, animal husbandry, public transfers, agricultural non-exports and agricultural exports (see Table 5.1). This ordering is generally preserved across the four quintiles. Relative to the non-poor, the poor (who are captured by the first three quintiles) depend more on wages (wages constitute around 52% of their income), public transfers (15%), agricultural exports (2%), and agricultural non-exports (8%); and they depend less on business (12%) and pecuary activities (3%).¹²¹ Exporting agricultural goods tends to be an activity of the poor: 70% of the households that export are poor. While 13.3% of poor export, only 5.6% of the non-poor do so.

¹²⁰ For an in depth review of STP's poverty see World Bank (2005) "Sao Tome and Principe - Poverty Diagnostic," Washington DC.

¹²¹ Values are unweighted averages of the first three quintiles.

Table 5. 1: Share of Various Income Sources by Income Quintile

	All	Poorest Quintile	Second Quintile	Third Quintile	Fourth Quintile	Richest Quintile
Agricultural exports	1.11	3.67	1.81	1.88	1.48	0.64
Cocoa	0.86	3.12	1.32	1.61	1.15	0.46
Coffee	0.18	0.50	0.19	0.15	0.20	0.16
Palm oil and copra	0.07	0.05	0.30	0.12	0.13	0.02
Agricultural non exports	6.42	9.20	7.98	7.89	7.90	5.37
Wages	44.76	45.67	55.86	55.87	50.38	39.60
Agriculture	7.74	12.22	14.33	9.06	4.63	3.43
Manufacture	9.66	6.50	19.08	9.83	11.13	7.84
Services	21.91	24.12	16.20	31.21	26.36	21.71
Public Administration	3.53	1.82	4.35	3.44	5.12	4.49
Other	1.91	1.01	1.89	2.33	3.15	2.14
Business	27.68	6.80	13.26	16.56	26.77	32.82
Pecuary	8.55	1.40	3.24	3.74	7.02	10.91
Public transfers	7.66	22.86	12.03	8.62	3.58	7.44
Private transfers	2.11	8.71	5.04	4.10	2.48	0.94
Rents	0.34	0.91	0.45	0.66	0.20	0.29
Other sources	1.36	0.80	0.34	0.68	0.18	1.99
Total production	100	100	100	100	100	100

Source: Based on World Bank (2005) "Sao Tome and Principe - Poverty Diagnostic," Washington DC.

5.12 Table 5.2 considers urban and rural poverty from a regional perspective. Poverty is highest in the rural areas of the island of Príncipe, Northern São Tomé (ST) region, and Southern ST region, in that order. Poverty is lowest in the small urban area of Príncipe and in the urban and rural area of the Center ST Region, in that order. While agricultural exports are a weak source of household income (even for the poor), agricultural wages is an important source of income particularly for the poor. Though 9% of the households in the sample earn income from agricultural exports (see Table 5.2), such exports only constitute 1% of the sample's total income (see Table 5.1). In contrast, 13% of households in the sample earn agricultural wages and they constitute around 8% of the sample's total income (12% of total income of the poor). Since cocoa does not provide most smallholders with enough income to meet basic needs, many of them also work as wage earning laborers and/or supplement cocoa with other crops or livestock. Agricultural wage earners tend to work on the cocoa roças that have been turned into agribusinesses, assist other smallholders, work on coffee plantations, and to a smaller degree work in vegetable gardens, or on various other agricultural activities, such as cattle raising and flower production.

5.13 Agricultural exporters are concentrated in the rural areas of the North and South ST regions. Income from agricultural wages affects both the rural and urban poor. In particular, as suggested by Table 5.2, around 20 percent of all rural households and of all urban households in the Northern and Southern ST regions (the two poorest urban areas) earn agricultural wages.

Table 5. 2: Descriptive Statistics by Strata

	Percent of household obtaining revenues								
	RURAL AREAS				URBAN AREAS				ALL
	North %	Center %	South %	Principe %	North %	Center %	South %	Principe %	%
Poverty Indicators									
Headcount	79.64	54.64	69.38	84.02	67.19	37.57	66.59	23.13	52.41
Poverty Gap	34.22	21.61	29.00	41.40	30.74	12.06	24.26	7.78	20.66
Squared Poverty Gap	18.77	11.25	15.43	25.00	17.05	5.49	11.85	3.84	10.61
Share of households obtaining income from									
Agricultural Exports	21.43	6.60	19.03	12.50	14.00	2.28	11.36	1.67	9.23
Cocoa exports	20.83	5.33	18.06	11.67	14.00	1.87	9.09	0.00	8.47
Coffee exports	2.08	1.52	4.52	3.33	0.00	0.52	5.68	1.67	1.77
Other exports	0.89	0.51	1.94	0.00	0.00	0.41	4.55	0.00	0.80
Wages	48.81	59.14	54.84	51.67	59.00	57.99	62.50	53.33	56.24
Agricultural wages	18.75	15.23	22.26	18.33	20.00	5.50	20.45	3.33	12.94
Number of Households									
Weighted	3,632	4,615	3,105	1,023	1,284	12,171	881	486	27,196
Unweighted	337	394	309	120	100	964	88	60	2,372

Note: Sample is weighted by the household weights.

Source: Aldaz-Carroll, Angel-Urdinola and Wodon (2005) "Terms of Trade, Oil Surges, and Poverty: Simulations for Sao Tome and Principe Using the 1-2-3 model and SimSIP", mimeo.

Table 5. 3: Share of Various Expenditures by Consumption Quintile, 2000-01

	All	Poorest Quintile	Second Quintile	Third Quintile	Fourth Quintile	Richest Quintile	Share of consumption that is imported
Total food	58.3	78.8	76.7	74.3	68.2	48.2	22.1
Vegetables & grains	16.1	26	22.7	22.3	19.8	12.3	15.0
Fish	15.3	18.9	17.7	16.1	14.4	14.8	0.7
Beverages	10	11.6	13.7	13.4	12.9	7.8	95.0
Bread	5.2	6.6	7.6	7.7	7	3.7	5.7
Meat	4.9	3.1	4.6	5	6.2	4.7	8.3
Palm oil	3.3	7	5.3	4.4	3.8	2.5	0
Fruits	2.7	5.2	4.3	4.3	3.2	1.9	3.1
Rest of food	0.8	0.4	0.8	1.1	0.9	0.5	10.0
Energy	16	5.7	5.6	6.9	8.3	22.2	90.9
Transport	5.7	1.8	3.2	3.5	5	6.9	80.0
Health	3.6	3	2.7	3.1	4.3	3.7	100
Education	3.5	1.2	2.3	2.6	4.4	3.7	100
Clothing	3.2	2.9	3.2	2.9	3	3.4	76.1
Water	2.7	0.1	0.2	0.5	0.4	4.4	0
Soap & detergents	2.6	5.4	4.4	3.6	2.9	1.9	30.8
Other consumption	5.1	1.6	2.5	3.7	4.4	6.1	15.0
Total consumption	100	100	100	100	100	100	43.1

Note: Data on the share on consumption that is imported is not precise as smuggling is significant in some commodities.

Source: Aldaz-Carroll, Angel-Urdinola and Wodon (2005) "Terms of Trade, Oil Surges, and Poverty: Simulations for Sao Tome and Principe Using the 1-2-3 model and SimSIP", mimeo.

5.14 The population's main expenditures by order of importance are food, energy and transport (see Table 3). Food and energy are also the main expenditures of the poor (76% and 6%, respectively), but soap and detergents (5%) replace transport (3%) as the third expenditure with largest share. There is a high dependence on imports (43% of household consumption in the sample was imported in 2000).¹²² The estimated shares of imports for the different expenditures are presented in the last column in Table 5.3 above.

SIMULATIONS OF THE IMPACT OF TRADE SHOCKS ON POVERTY

5.15 STP will probably face three important trade-related changes in the relatively near future that are likely to affect its development and poverty levels: a worsening of its terms of trade, reduced international transport costs through the construction of a deep-water port and a surge in oil revenues. The rest of this section simulates their possible impact on poverty.

5.16 To assess the impact that these trade shocks will have on the poor, the 1-2-3 model¹²³ is employed, and simulations are carried out using the SimSIP program¹²⁴ on the 2000-01 national household survey and on COMTRADE trade data. The 1-2-3 model captures the impact that a macroeconomic change, like a terms-of-trade shock, a decrease in import and export transport costs or a large revenue inflow would have on export, import and domestic prices and quantities. The effects of these price and quantity changes on households' consumption and income are then analyzed. Imputing this information into the SimSIP program enable the quantification of the impact of these three shocks on poverty. The estimations are therefore first effect impacts: the analysis only focuses on how the changes affect households' income and consumption and how these change poverty. No account is taken of how the changes in income and consumption would feed back into changes in prices and quantities and how these would affect poverty.

Impact of worsening terms of trade

5.17 STP's terms of trade are expected to worsen due to the lower growth of export prices relative to import prices – mainly due to the decrease of cocoa and coffee prices from 2002 onwards.¹²⁵

5.18 Revenues from cocoa exports are a significant source of household income, especially among agricultural wage earners - a very poor and large group of the population.¹²⁶ Cocoa has long been STP's main export (see Table 2.2 in Chapter 2) and main source of agricultural employment. Fluctuations in export prices (mainly cocoa)

¹²² Calculation based on COMTRADE and ECVI data.

¹²³ Devarajan, Shantayanan, and Delfin S. Go (1998). "The Simplest Dynamic General Equilibrium Model of an Open Economy." *Journal of Policy Modeling* 29(6): 677-714. Devarajan, Shantayanan, and Delfin S. Go (2004). "The 123PRSP model," chapter 13, Tool kit, The World Bank, mimeo.

¹²⁴ Ramadas, Krishnan and Quentin Wodon (2002) "SimSIP_Evaluation: Measuring the Impact of Programs and Policies on Poverty, Inequality and Social Welfare," mimeo, World Bank, Washington, DC.

¹²⁵ World Bank, "Commodity Price Data (Pink Sheet)" DEC Prospects Group 2004.

¹²⁶ Agricultural wage earners are employed in some properties to collect the cocoa.

have an effect on agricultural wages and employment. Thus the expected fall in terms of trade between 2002 and 2011 is likely to be translated into lower export earnings and agricultural wages, and lower agricultural employment. Data availability only permits to estimate the impact of the lower export earnings and of the lower agricultural wages, but not the impact of lower agricultural employment. To capture the impact of unemployment indirectly, a high rate of transmission of falls in cocoa prices to falls in agricultural wages is set.

5.19 Estimates of the projected changes of international prices for cocoa, coffee, palm oil, copra, and manufactures in US dollars and in nominal terms are taken from the Development Economics Prospects Group (DEC-PG) database at the World Bank (see price changes in Table 5.4 and price levels in Appendix 1).¹²⁷ The IMF's exchange rate projections for the 2001-2011 period are employed to express the projected changes of international prices in local currency.¹²⁸ Projected inflation is taken from the same source.

5.20 Relative to domestic inflation, the price of cocoa¹²⁹ and coffee exports is expected to decline over the period and to translate into a fall in STP's terms of trade (cocoa accounted for 93% of total good exports in 2003, and coffee 0.09%, see Table 2.2 in Chapter 2).

Table 5. 4: Change of commodity prices and exchange rate from 2001 to 2011

	2001-2011		
	Cocoa	Coffee Arabica	Palm Oil & Copra
Nominal change in current US\$ (%)*	26.3	23.7	52.9
Real change in current dobres (%)**	-36.5	-41.0	8.4
		2001-2011	
Expected nominal depreciation of dobre/US\$***		68.8	
Domestic inflation***		149.7	

Notes: * Calculated taking the averages of 2000-2002 and 2010-2012 as the starting and final values.

** Real change is calculated as the nominal change in local currency minus domestic inflation over the period.

*** IMF (2005) estimates.

¹²⁷ World Bank (2004). "Commodity Price Data (Pink Sheet)" DEC Prospects Group, <http://web.worldbank.org/WBSITE/EXTERNAL/EXTDEC/EXTDECPROSPECTS/0,,contentMDK:20268484~menuPK:556802~pagePK:64165401~piPK:64165026~theSitePK:476883,00.html>.

The growth rate of prices for non-cocoa and non-coffee exports was estimated as the average of the growth rate of the copra price and the growth rate of palm oil prices, since these two products are the second and third most important exports.

¹²⁸ International Monetary Fund (2005) "São Tomé e Príncipe: 2005 Article IV Consultation," Staff Report, Washington DC.

¹²⁹ The price of cocoa is projected to fall in both real and nominal terms from 2002 onwards (See Appendix 1). If the average of the value between 2000 and 2002 is taken as the starting date and the average between 2010 and 2012 as the ending date, the nominal cocoa price over that period increases. However, this increase just reflects that the coca price grew dramatically in nominal terms between 2000 and 2002, though it dropped from 2002 to 2004 and is projected to continue dropping from then on.

Source: Aldaz-Carroll, Angel-Urdinola and Wodon (2005) "Terms of Trade, Oil Surges, and Poverty: Simulations for Sao Tome and Principe Using the 1-2-3 model and SimSIP", mimeo.

5.21 Due to lack of elasticity data, the poverty impact of the decline in terms of trade is based only on the impact of the change in prices and not on the impact of the change in the quantities produced domestically and exported resulting from the change in prices. This omission is unlikely to affect the results significantly since the little data available indicates that the elasticity of exports to prices is close to zero (cocoa producers are unlikely to cut or plant cocoa trees in the short to medium run if cocoa prices change).

5.22 Estimation results are presented in Table 5.5. The first two columns of Table 5.5 present the baseline poverty estimates for the overall sample as well as for the sub-sample that is directly affected by the changes in the terms of trade (i.e., households receiving income from exports or agricultural wages). As presented in Table 5.5, the baseline headcount index is 52.4% for the entire population and 75.5% for the affected sample. Simulations presenting the change in poverty due to the shock include four scenarios. The first scenario is based on World Bank export price projections (see third and fourth columns in Table 5.5). To examine alternative scenarios, the impact of a deterioration of the terms of trade of 10, 20 and 40 percent is analyzed (note that the impact of an improvement in the terms of trade of 10, 20 and 40 percent would have simply the opposite sign¹³⁰).

Table 5. 5: Effect on poverty of adverse terms of trade – all exports and cocoa only

	Baseline		Forecast		10 percent		20 percent		40 percent	
	All Sample	Affected sample	All Sample	Affected sample	All Sample	Affected sample	All Sample	Affected sample	All Sample	Affected sample
ALL EXPORTS										
Moderate Poverty	%	%	<i>Change in Percentage Points</i>							
Headcount	52.41	75.53	0.23	3.34	0.22	3.13	0.43	6.63	0.86	15.77
Pov. Gap	20.66	36.92	0.25	3.18	0.23	2.90	0.46	6.07	0.92	13.79
Sq. pov. Gap	10.61	21.88	0.21	2.71	0.19	2.44	0.38	5.14	0.77	11.67
Extreme Poverty										
Headcount	18.86	39.64	0.36	3.91	0.33	3.56	0.65	7.26	1.30	15.79
Pov. Gap	4.98	13.53	0.21	2.59	0.18	2.30	0.37	4.84	0.75	10.70
Sq. pov. Gap	1.77	6.07	0.11	1.79	0.10	1.57	0.20	3.45	0.42	8.31
COCOA ONLY										
Moderate Poverty	%	%	<i>Change in Percentage Points</i>							
Headcount	52.41	75.53	0.22	3.21	0.20	2.99	0.40	6.29	0.80	14.66
Pov. Gap	20.66	36.92	0.24	3.08	0.22	2.79	0.43	5.81	0.87	13.05
Sq. pov. Gap	10.61	21.88	0.20	2.62	0.18	2.35	0.36	4.93	0.73	11.09
Extreme Poverty										
Headcount	18.86	39.64	0.34	3.80	0.31	3.42	0.62	6.98	1.23	15.04
Pov. Gap	4.98	13.53	0.19	2.50	0.17	2.22	0.35	4.66	0.71	10.26
Sq. pov. Gap	1.77	6.07	0.11	1.72	0.10	1.51	0.19	3.31	0.40	7.90

Source: Aldaz-Carroll, Angel-Urdinola and Wodon (2005) "Terms of Trade, Oil Surges, and Poverty: Simulations for Sao Tome and Principe Using the 1-2-3 model and SimSIP", mimeo.

¹³⁰ Assuming that agricultural wages are as sensitive to increases in export prices as to decreases in export prices. If agricultural wages are less sensitive to increases in export prices, the wage effect will be of a smaller magnitude.

5.23 Separate results are shown in Table 5.5 for all agricultural exports and for cocoa exports only, assuming in the latter case that the scenario only applies to cocoa exports. This is in order to examine the extent to which the results for agricultural exports are driven by cocoa exports.

5.24 Simulations indicate that while the overall impact of price shocks on poverty is mild for the overall population, it is very large for the affected households. In particular, while a 10 to 40 percent fall in export prices would increase overall poverty by 0.22 to 0.86 percentage points, it would increase poverty among the affected group (a group that represents 22 percent of households and is already well poorer than average) by 3.13 to 15.77 percentage points. As presented by the coca simulations only, a fall in cocoa prices would produce similar (but slightly lower) changes in poverty. This implies that the overall effect of export price shocks is mainly driven by what happens to cocoa prices, which is not surprising given that cocoa is by far the main agricultural export and source of agricultural wage employment in STP.

Table 5. 6: Effect on poverty of adverse terms of trade decomposed into wage effect and export earnings

	Baseline		All Sample		Affected Sample			
	All Sample	Affected sample	Wage effect	Earnings effect	Total Effect	Wage effect	Earnings effect	Total effect
Moderate Poverty	%	%	<i>Change in Percentage Points</i>					
	10% appreciation							
Headcount	52.41	75.53	0.16	0.06	0.22	2.50	0.60	3.13
Pov. Gap	20.66	36.92	0.16	0.06	0.23	2.15	0.71	2.90
Sq. pov. Gap	10.61	21.88	0.14	0.05	0.19	1.76	0.64	2.44
Extreme Poverty								
Headcount	18.86	39.64	0.23	0.09	0.33	2.61	0.93	3.56
Pov. Gap	4.98	13.53	0.13	0.05	0.18	1.61	0.64	2.30
Sq. pov. Gap	1.77	6.07	0.07	0.03	0.10	1.08	0.44	1.57
	40% appreciation							
Headcount	52.41	75.53	0.64	0.22	0.86	12.04	2.43	15.77
Pov. Gap	20.66	36.92	0.66	0.26	0.92	9.88	2.89	13.79
Sq. pov. Gap	10.61	21.88	0.55	0.22	0.77	8.05	2.64	11.67
Extreme Poverty								
Headcount	18.86	39.64	0.93	0.37	1.30	11.24	3.71	15.79
Pov. Gap	4.98	13.53	0.53	0.21	0.75	7.23	2.68	10.70
Sq. pov. Gap	1.77	6.07	0.29	0.11	0.42	5.33	1.88	8.31

Source: Aldaz-Carroll, Angel-Urdinola and Wodon (2005) “Terms of Trade, Oil Surges, and Poverty: Simulations for Sao Tome and Principe Using the 1-2-3 model and SimSIP”, mimeo.

5.25 One last interesting result about the price shock simulations is illustrated in Table 5.6. Decomposing the overall poverty effects presented in Table 5.5 into a wage effect – which captures the wage drops agricultural workers face under export price drops – and an earning effect – which captures the direct drop in earnings exporters face under

unfavorable terms of trade – it can be seen that the wage effect is the one primarily driving the results. For instance, as Table 5.6 illustrates, a change in poverty for the overall (affected) population of 0.22 (3.13) percentage points (which reflects our results in the case of a 10 percent fall in agricultural prices; see Table 5.5) is equal to the sum of 0.16 (2.50) percentage points change due to the wage effect plus the 0.06 (0.60) percentage points due to the earnings effect. The decomposition suggests that about 73 (80) percent of the change in overall poverty can be attributed to the wage effect. The same result holds for simulations involving higher price falls as presented in Table 5.6. The larger impact of the wage effect is not surprising since, as mentioned earlier (see Tables 5.1 and 5.2), agricultural wages represent a larger share of overall income than agricultural-export earnings, and the share of households benefiting from agricultural wages (13%) is larger than that benefiting from agricultural exports (9%).

5.26 The deterioration of the terms of trade would increase poverty. It would also exacerbate income differentials since it would hurt the poor more than the non-poor population¹³¹ increasing therefore inequality. Both the wage effect and the export earnings have a non-redistributive effect.¹³²

Impact of the construction of a deep-water port

5.27 The construction of an efficient deep-water port would significantly decrease the transport cost of imports and exports, which would likely be transmitted into a lower import price paid by consumers and higher revenues for export producers. How much of the reduction in import and export costs is translated into lower final prices of imports and higher revenues for export producers depends on the degree of competition between transport suppliers in STP. Since there are only a few transport suppliers in STP, it is likely they would capture part of this reduction in transport costs and would not transmit it fully to import consumers and export producers into lower import prices and lower freight charges for exports.

5.28 Lower freight charges for exports would translate into greater export earnings for export producers. The impact of such a reduction would have a pro-poor effect, as it would reduce poverty by 0.03, 0.06 and 0.08 percentage points in the case of a 5, 10, and 15 percent fall in the transport cost of exports, respectively (see Table 5.7). It would also decrease income differentials since it would benefit the poor more than the non-poor population decreasing therefore inequality.¹³³

5.29 The direct effect of a fall in import prices would be that consumers would spend less on the same quantity of goods, which would contribute to decreased poverty. Consumers would then adjust their spending and this would *indirectly* affect poverty by a magnitude which is more complex to estimate. There would be two effects. The first is the substitution effect: the fall in the import price would make consumers buy more imports and less domestic goods. This would cause the price of domestic goods to fall as well as their production. The second effect is the income effect: people would employ

¹³¹ The gini elasticity is -0.5.

¹³² Gini elasticity=-0.3 and -0.4, respectively.

¹³³ Gini elasticity=-0.47.

their savings in consumption to consume more imports and more domestic goods. This would push up the price of domestic goods and their production, i.e. the opposite effect of the substitution effect. Which of these two effects dominates depends on the elasticity of substitution between domestic goods and imports. If the elasticity of substitution is very low – as tends to be the case in LDCs since domestic goods tend to be imperfect substitutes for imports – the substitution effect would be small and the income effect would dominate, leading to an increase in domestic prices which would benefit domestic good producers but would hurt everybody else, contributing to increased poverty. Thus, it is likely that the final impact on poverty of the fall in the import price would be lower than the above-mentioned *direct* effect. The indirect effect will be ignored in the simulation exercise since the value of the elasticity of substitution is unknown and the effect on poverty would be very sensitive to the elasticity value assumed. The estimated impact of the direct effect on poverty presented below should therefore be seen as the upper value of the impact of a fall in the import price on poverty.

5.30 The direct effect of the decrease in import prices is pro-poor, as it would reduce poverty by 1.03, 2.03 and 3 percentage points in the case of a 5, 10, and 15 percent fall in import prices, respectively (see Table 5.7). However, its effect would not be redistributive,¹³⁴ as it benefits the non-poor population, which has a higher propensity to import than the poor. While the reduction in import prices affects all the population, the poor (who constitute 52% of the population) only receive 2.8% of the benefits (i.e. of the import savings).

5.31 Thus the effect of the fall in the transport cost of exports and the direct effect of the fall in the import price would add up to a fall in poverty of 1.06, 2.08, and 3.08 percentage points for a given fall of 5, 10 and 15 percent, respectively.

Table 5. 7: Effect of a fall in import prices and an increase in export earnings of 5, 10 and 15 %

	Baseline	Change in foreign prices of								
	All sample	5%			10%			15%		
		Imports	Exports	Total effect	Imports	Exports	Total effect	Imports	Exports	Total effect
	%	(percentage points)								
Moderate Poverty										
Headcount	52.41	-1.03	-0.11	-1.14	-2.03	-0.22	-2.25	-3.00	-0.33	-3.33
Pov. gap	20.66	-0.53	-0.11	-0.64	-1.04	-0.23	-1.27	-1.53	-0.34	-1.87
Sq. pov. gap	10.61	-0.32	-0.09	-0.42	-0.64	-0.19	-0.82	-0.94	-0.28	-1.22
Extreme Poverty				0.00			0.00			0.00
Headcount	18.86	-0.57	-0.16	-0.73	-1.11	-0.33	-1.44	-1.64	-0.49	-2.13
Pov. gap	4.98	-0.22	-0.09	-0.31	-0.43	-0.18	-0.61	-0.63	-0.27	-0.89
Sq. pov. gap	1.77	-0.10	-0.05	-0.15	-0.20	-0.10	-0.29	-0.29	-0.14	-0.43

Source: Authors' estimates.

¹³⁴ Gini elasticity =1.1

Impact of oil money inflows

5.32 The exploitation of STP's oil reserves, which is likely to start around 2012, would cause a surge in revenues. This would increase the demand for imports and domestic goods drawing resources from the non-oil export sector and leading to a decrease in non-oil exports and to increases in prices and wages in the domestic sector causing a real appreciation of the exchange rate – standard features of what is known as the “Dutch disease”.¹³⁵

5.33 To determine the impact that such changes will have on poverty, the following steps are followed. For simulation purposes, the poverty level in 2012 is assumed to be the same as that of the latest 2001 National Household Survey. An alternative would have been to assume that the poverty level in 2012 would be around 30 percentage points lower in time for the PRSP objective of reducing poverty by two-thirds by 2015 to be met. Given that the oil inflows are not likely to take place before 2012 and that during that time terms of trade will continue to decline, if the PRSP objective is to be met it will more likely be the result of dramatic drops in poverty after rather than before 2012.

5.34 The appreciation of the real exchange rate is assumed to take place shortly after 2012, rather than gradually, so that the effect on poverty of changes in the terms of trade between the oil extraction and the appreciation can be ignored in this simulation. Finally, the impact of the oil money inflows is decomposed into the impact of price changes on poverty (which is labeled the *price effect* – impact of price changes holding quantities constant) and the impact of the *income effect* on poverty (impact of the income effect under the set of final prices).

5.35 The *price effect* consists of an increase in the domestic price relative to the import price – reflected in a real appreciation of the exchange rate – and an increase in wages in the domestic sector (which is measured with non-agricultural wages) since they will adjust to the higher inflation. These price changes would benefit net producers of domestic goods and would leave domestic-wage earners indifferent, but they will hurt producers and wage earners in the export sector, since the latter will see the cost of consumption increase but their earnings will remain unchanged.

5.36 It is not possible to estimate at this stage by how much the real exchange rate would appreciate – i.e. by how much would domestic prices change relative to import prices. Three alternative scenarios are, therefore, presented, where the appreciation of the real exchange rate is 10, 20 and 40 percent, respectively; these are likely to be conservative values. As can be seen in Table 5.8, the real exchange rate has been subject to large fluctuations in the past. It is thus possible that the exchange rate could appreciate

¹³⁵ The exploitation of the oil reserves might also generate employment in terms of jobs on the offshore platforms and in the sourcing of these platforms. This impact is very difficult to estimate at present and is not considered in the simulations. It is not likely to be high since Nigerian workers, who are more familiar with the oil business will also be competing for these same jobs and services. Furthermore, the provision of services to the platforms requires the satisfaction of very high standards for which STP firms are not yet prepared for.

by a larger amount than those set in the simulations, in which case the impact on poverty would be larger.¹³⁶

Table 5. 8: Evolution of the exchange rate and consumer prices

	1995	1996	1997	1998	1999	2000	2001	2002	2003
(Annual percentage changes, unless otherwise specified)									
Consumer prices (percentage change; end of period)	75.4	36.9	51.7	81.1	20.8	12.6	9.4	8.9	10.2
Exchange rate (in dobras per U.S. dollar; end of period)	1,757	2,833	6,970	6,885	7,250	9,020	9,192	9,456	
Real effective exchange rate (depreciation -)	-42.0	-25.6	1.4	-25.0	13.1	12.8	-0.6	-5.2	-8.7

Source: Aldaz-Carroll, Angel-Urdinola and Wodon (2005) "Terms of Trade, Oil Surges, and Poverty: Simulations for Sao Tome and Principe Using the 1-2-3 model and SimSIP", mimeo.

5.37 The simulation shows that a ten percent appreciation of the real exchange rate would cause an increase in the country's headcount poverty index of 0.28 percentage points, which is explained by the 1.77 percentage point increase in poverty resulting from the increase in domestic prices and by the 1.48 percentage point fall in poverty resulting from the increase in non-agricultural wage earnings (see Table 5.9).

Table 5. 9: Price effect of appreciation on poverty decomposed into wage effect and goods price effect

	Baseline	10% real appreciation			20% real appreciation			40% real appreciation		
	All sample	wage effect	goods price effect	total price effect	wage effect	goods price effect	total price effect	Wage effect	goods price effect	total price effect
	%	Change in Percentage Points								
Moderate Poverty										
Headcount	0.52	-1.48	1.77	0.28	-3.00	3.59	0.59	-6.13	7.38	1.25
Pov. Gap	0.21	-0.73	1.28	0.55	-1.41	2.50	1.09	-2.61	4.78	2.16
Extreme Poverty										
Headcount	0.19	-0.78	1.69	0.91	-1.43	3.25	1.82	-2.34	6.00	3.65
Pov. Gap	0.05	-0.22	0.62	0.40	-0.37	1.16	0.79	-0.52	2.02	1.50

Source: Aldaz-Carroll, Angel-Urdinola and Wodon (2005) "Terms of Trade, Oil Surges, and Poverty: Simulations for Sao Tome and Principe Using the 1-2-3 model and SimSIP", mimeo.

5.38 The country's headcount poverty would experience a greater increase in the case of a 20 percent or a 40 percent appreciation: 0.59 and 1.25 percentage points, respectively. The weights of the impacts of the increase in domestic prices and of non-agricultural wages on the total impact are similar to those in the ten percent case.

5.39 The impact of the price effect would not have a pro-poor impact as it increases poverty, and it would increase inequality as it benefits the non-poor population more than the poor.¹³⁷ The estimate of the impact of the price effect does not capture the impact that the price effect will have on services like tourism – tourism accounts for about half

¹³⁶ Note that while the real exchange rate depreciated in the last years, the oil money inflows expected around 2012 will exert an appreciatory pressure.

¹³⁷ Gini elasticity = -0.87.

of the country's export revenue. The increase in domestic goods prices and non-agricultural wages could make STP less attractive to tourists, and this would reduce households' revenues from tourism and increase unemployment.

5.40 The *income effect* depends on an array of factors difficult to determine at present. Its impact on poverty depends on the volume of money inflows, which depends on the yet unknown value of oil reserves and the fall in foreign aid likely to follow. It also depends on how the government spends the money in terms of public employment, wages and transfers. There is a group that benefits under all scenarios. This group is made up of net domestic producers, since they benefit indirectly from the increase in domestic sales that will result from higher government spending. The increase in domestic producers' income is not likely to be translated into a large fall in poverty or a decrease in inequality, since income from domestic production (trading and animal husbandry) represents a much larger share of income in the higher deciles than in the lower deciles (see Table 5.1). A group that will benefit if the government raises public wages is non-agricultural wage earners, since urban wages in the private sector will tend to follow public wages. However, people involved in the export sector (export producers and wage earners) are not likely to see their income increase unless they benefit from the increase in public spending (in the form of cheaper and/or improved public services or larger transfers).

5.41 By how much poverty falls would depend, to a considerable extent, on how pro-poor the increased government spending is. Increases in public wages are hardly pro-poor since they make a very limited contribution to reduced poverty.¹³⁸

¹³⁸ Only about 20 percent of the poor obtain wages from the public sector, and only 20 percent of the overall wage bill goes to the poor (although the poor represent more than half of the population). One exception is public wages for agricultural workers that tend to benefit the poor more, but these wages represent only a small fraction of the overall wage bill and still cover only a minority of the poor. According to simulations, increasing public wages by 15, 20, and 30 percent respectively would reduce the share of the population in poverty by only 1.0, 1.32, and 2.0 percentage points (World Bank 2005) "Sao Tome and Principe - Poverty Diagnostic," Washington DC.

Appendix 1: Actual and Predicted Evolution of Export Prices

	Year	Current U.S. Dollars				Manufacture Unit Value 1990=100
		COCOA (cents/kg)	COFFEE ARABICA (cents/kg)	PALM OIL (\$/mt)	COPRA (\$/mt)	
Actual prices	2000	90.58	191.97	310.25	304.75	97.18
	2001	106.87	137.31	285.67	202.08	94.32
	2002	177.79	135.66	390.25	266.25	93.14
	2003	175.09	141.54	443.25	299.94	100.04
Forecasts (as of Sept. 15, 2004)	2004	164.00	165.00	480.00	440.00	106.08
	2005	162.00	158.73	450.00	420.00	104.35
	2006	162.00	164.09	444.00	425.84	104.35
	2007	161.60	169.63	438.00	431.75	105.19
	2008	161.20	175.36	432.00	437.75	106.03
	2009	160.80	181.27	426.00	443.83	106.66
	2010	160.00	187.39	420.00	450.00	107.30
	2011	158.00	191.61	425.00	455.00	107.95
	2012	156.00	195.92	430.00	460.00	108.59

Source: Aldaz-Carroll, Angel-Urdinola and Wodon (2005).

Year	Cocoa exports (tonnes)	Annual average cocoa price (cents/kg)
1991	4759	117
1992	4363	104
1993	3725	105
1994	3160	126
1995	4577	122
1996	4415	131
1997	2935	156
1998	3928	168
1999	2126	114
2000	3549	93

Source: We are grateful to Nelson de Assunção for supplying production data. Cocoa prices are taken from DEC PG, World Bank.