



**MILLENNIUM
CHALLENGE
CORPORATION**
REDUCING POVERTY THROUGH GROWTH

FRANCES C. MCNAUGHT
VICE PRESIDENT, CONGRESSIONAL AND PUBLIC AFFAIRS

CONGRESSIONAL NOTIFICATION

PROGRAM: Millennium Challenge Account "Threshold Program"
APPROPRIATIONS CATEGORY: Millennium Challenge Account
INTENDED FY 2008 OBLIGATION: \$8,661,894 (FY 2006 Program Funds)

In accordance with section 515 of the Foreign Operations, Export Financing, and Related Programs Appropriations Act, 2006 this is to advise that MCC will obligate up to \$8,661,894 in FY 2006 Millennium Challenge Account (MCA) program funds in an agreement with the United States Department of the Treasury, Office of Technical Assistance (OTA) under section 632(b) of the Foreign Assistance Act of 1961, as amended. These funds will finance assistance to the Government of São Tomé and Príncipe under the program authorized under Section 616 of the Millennium Challenge Act of 2003 (the "Threshold Program"). Of the amount made available to OTA, up to \$7,362,426 will fund Threshold Program assistance for São Tomé and Príncipe, and up to \$1,299,468 will fund OTA's program management costs related to implementing the program on behalf of MCC.

MCC's Threshold Program is designed to assist countries that are committed to undertaking the reforms necessary to improve their policy performance and potentially qualify for Millennium Challenge Account Compact assistance.

The attached Threshold Program Summary outlines the São Tomé and Príncipe's threshold program. Members of MCC's staff are available to meet with you to discuss the planned program. If you or your staff would like to arrange a meeting, please contact Ellona Fritschie or Rick Stilgenbauer at (202) 521-3850. This Congressional Notification is being sent to the Congress on September 12, 2007.

Sincerely,

Frances C. McNaught
Vice President
Congressional and Public Affairs

Enclosure:
As stated

Threshold Program Summary

<u>Country:</u>	São Tomé and Príncipe
<u>Budget:</u>	\$8,661,894 (includes \$1,299,468 for program management costs)
<u>Fiscal Year Funding:</u>	2006
<u>Estimated Program Duration:</u>	2 years
<u>Indicator Focus:</u>	<u>Economic Freedom</u> : <i>Fiscal Policy, Days to Start a Business, Cost of Starting a Business</i>

Principal Objectives:

The main objective of the São Tomé and Príncipe Threshold Program is to improve performance on the *Fiscal Policy* indicator by increasing revenue as a result of improved tax and customs administration and enforcement. The São Tomé and Príncipe Threshold Program will also seek to improve performance on the *Days to Start a Business* and *Cost of Starting a Business* indicators by streamlining business registration procedures.

Background:

São Tomé and Príncipe, a small island nation with a population of about 200,000, has struggled economically since transitioning to a “mixed economy” of privately and publicly managed companies and cooperatives in the 1980s and 1990s. The Government of São Tomé and Príncipe responded to this economic stagnation by embarking on a series of reforms directed at building the private sector. Nevertheless, the Government of São Tomé and Príncipe has remained dependent on donor support, and is classified by the International Monetary Fund (IMF) as a highly indebted poor country.

Over the past several years, São Tomé and Príncipe has been the subject of intense interest as a potential source of significant quantities of offshore petroleum. Though no major petroleum finds have occurred to date, the Government of São Tomé and Príncipe has benefited substantially from “signature bonuses” received in exchange for offshore drilling rights. Whether São Tomé and Príncipe will achieve sustainable, long-term economic returns from the extraction of offshore petroleum remains uncertain.

Limited administrative capacity and a narrow economic base have significantly constrained the ability of the Government of São Tomé and Príncipe to maintain fiscal stability without support from external donors and one-time petroleum signature bonuses. With MCC assistance, São Tomé and Príncipe will implement a four component program to improve performance on three indicators in the *Economic Freedom* category: *Fiscal Policy, Days to Start a Business* and *Cost of Starting a Business*. The São Tomé and Príncipe Threshold Program will likely also positively impact the *Trade Policy* indicator.

The primary objective of the São Tomé and Príncipe Threshold Program is to increase revenues through improved tax and customs administration and enforcement. The Government of São Tomé and Príncipe estimates that if its program is fully implemented, tax revenues will increase by 15 percent due to increases in taxpayer registration, returns filed and arrears collection. The Government of São Tomé and Príncipe has also

estimated a 20 percent increase in customs revenue, which would result from reductions in clearance times, improved inspection capacity and staff professionalization measures.

Finally, the São Tomé and Príncipe Threshold Program will fund technical assistance from the International Finance Corporation (IFC), a division of the World Bank, to help São Tomé and Príncipe to improve performance on the *Days to Start a Business* and *Cost of Starting a Business* indicators.

Program Components – Objectives and Proposed Activities:

Component 1: Increase Tax Revenue Through Higher Voluntary Compliance with Tax Laws

Low levels of tax compliance in São Tomé and Príncipe have resulted in inadequate overall tax revenues. It is estimated that of about 4,500 registered businesses, only 1,140 file tax declarations, and a large percentage of returns show no tax due. Further, of 3,700 individual registrants, fewer than 900 file returns. Among the reasons for the failure of self-assessed taxation in São Tomé and Príncipe are exceedingly high rates of corporate and personal income taxation, as well as perceived cost and time involved in business registration.

The system of taxpayer registration is also not functioning well. Taxpayers are required to obtain taxpayer identification numbers, but many potential taxpayers are not registered and many have multiple or false tax identities.

Legislation to improve the environment for self-assessed taxation has been proposed in São Tomé and Príncipe, which includes a reduction in the corporate income tax rate to 25 percent from the current rate of 40 percent. A draft “Tax Procedure Code” has also been proposed to clarify administrative processes and ensure that tax requirements are met.

Objective: Achieve increased levels of tax revenue through increased taxpayer registration and compliance.

Proposed Activities:

1. Provide technical assistance and analysis of new tax legislation and regulations, to include the General Tax Code, the Procedural Code and Urban Property Tax Registration, followed by the dissemination of formal implementation procedures to staff and the public and all necessary related training.
2. Improve the integrity of the taxpayer registration system through analysis of the current system and its shortcomings, and the development and implementation of recommendations, to include the potential acquisition of database hardware and software.
3. Conduct analysis of the taxpayer accounting system, and develop and implement recommendations for its improvement, to ensure the ability to determine taxpayer compliance history.

Component 2: Increase Tax Revenue Through Strengthened Tax Enforcement

The capacity of the Government of São Tomé and Príncipe to conduct tax enforcement activities is extremely limited due to deficiencies in staff training, information resources, and the means of transportation needed to conduct on-site audits or collection activity. Consequently, the government is unable to perform an adequate number of tax audits and experiences difficulty in collecting arrears. Those audits that are conducted are done so in an *ad hoc* and inefficient manner.

Objective: Achieve increased levels of tax revenue through the completion of a larger number of audits, to be conducted in a systematic and efficient manner, and improved identification of non-filers.

Proposed Activities:

1. Strengthen informational infrastructure to facilitate interagency cooperation and information sharing in order to identify unregistered taxpayers and non-filers.
2. Conduct analysis of tax collections process to develop and implement recommendations in order to maximize its effectiveness.
3. Provide technical assistance to develop a strategy to identify non-filers and prioritize enforcement actions.
4. Provide technical assistance to improve auditing procedures, to include the creation of standardized procedure manuals and related training.
5. Improve the ability of tax officials to conduct on-site canvasses, audits and collections activities through the acquisition of vehicles (to be procured and overseen by U.S. Government implementing officials).

Component 3: Increase Customs Revenue

The Customs Service of São Tomé and Príncipe is limited by a lack of basic inspection equipment and transport, and difficulties in communication. The accessibility of the coast of São Tomé and Príncipe to small boats has, in the absence of consistent enforcement, allowed smuggled textiles and low-value consumer goods to enter the marketplace. Further, a lack of communications and inspection capacity has reduced the effectiveness of the Customs Service in São Tomé and Príncipe.

Objective: Achieve increased levels of customs revenue by modernizing and streamlining customs procedures, to include improving professionalism in the customs service in order to improve business confidence and reduce illegal practices.

Proposed Activities:

1. Modernize the Customs Service by conducting an assessment of all facilities, upgrading customs software to ASYCUDAWorld in collaboration with the United Nations Conference on Trade and Development, analyzing and supporting implementation of new legislation and regulations, conducting training activities, establishing a Customs Cooperation Council along with the local trade

- community to encourage compliance, providing support for entry into the World Customs Organization (WCO) and providing basic inspection, communications and transport equipment.
2. Enhance customs operations and procedures to improve auditing and enforcement and interdiction efforts.
 3. Enhance professionalism in the customs service by implementing procedures to limit discretionary actions, developing and implementing a Customs Code of Ethics and Conduct, establishing an Ethics Council in the Ministry of Planning and Finance and providing related trainings.

Component 4: Improve the Business Environment

In 2006, the International Finance Corporation determined that registering a business in São Tomé and Príncipe required an average of 144 days and cost an average of 147.2 percent of per capita income. Redundant administrative procedures and high costs in this area have the effect of discouraging private sector investment and depressing tax revenues.

Objective: Reduce the average number of days and costs associated with registering a business.

Proposed Activities:

1. Draft legislation and identify administrative procedures necessary to streamline business registration, to include the establishment of a “one stop shop” for business registration and other regulatory reforms.
2. Develop recommendations for implementation of new business registration procedures.
3. Draft work procedures and recommendations for organizational restructuring required to implement new business registration legislation.
4. Conduct training concerning revised procedures and legislation.

Highlights of Expected Results of the São Tomé and Príncipe Threshold Program:

1. Increase tax revenue by 15 percent.
2. Increase customs revenue by 20 percent (not including revenues derived from import of petroleum products).
3. Reduce the time to start a business to 32 days or less.
4. Reduce the cost of starting a business to 18 percent of income per capita.

Implementing Partners:

The Office of Technical Assistance of the U.S. Department of Treasury will oversee implementation of the São Tomé and Príncipe Threshold Program.