

## **BENIN: COUNTRY FINANCING PARAMETERS**

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### **Summary**

1. This note provides the supporting analysis and background for the country financing parameters under the new policy framework for expenditures eligibility. The new policy framework, approved by the Bank in April 2004, makes development objectives the primary determinant of Bank financing, while making sure that risks, such as those to fiscal sustainability and the use of Bank funds, are appropriately addressed. In doing so, it reduces the disconnect between the types of expenditures that borrowers need to incur to implement their development programs and those that the Bank may finance. Also, within broad country-specific financing parameters, it offers more flexibility and lower transactions costs in setting cost sharing arrangements. Benin should make full use of the greater flexibility of this framework that should simplify and modernize investment lending.

2. Based on discussions within the country team and with Government officials, it is proposed that Bank financing for individual projects may be up to 100 percent of project total cost and no country-limit level on recurrent cost financing be set. It's also recommended that the Bank may finance local expenditures in any proportions as needed for individual projects. The current tax and duties system is considered to be reasonable, therefore the Bank may finance taxes and duties in project costs.

### **Bank's Country Assistance Strategy (CAS)**

3. The Country Assistance Strategy (CAS), approved by the Board in July 2003, is consistent with Benin's PRSP adopted by the Government in December 2002 and endorsed by the Bank and Fund Boards in March 2003. The strategic objective of the CAS is to support the implementation of the PRSP over the period 2003-2005. The PRSP outlines and prioritizes the Government's poverty reduction strategy in four areas: (i) strengthening the macroeconomic framework over the medium term; (ii) strengthening human development and environmental management, including improving access by the poor to quality basic services (basic education, primary health care, water and sanitation, food security and nutrition, adequate habitat, and rural roads); (iii) improving governance and completing institutional reforms in the areas of decentralization, public administration, and the legal and judicial systems; and (iv) improving employment and income-generating opportunities for the poor, and strengthening their capacity to participate in decision-making and production.

4. The CAS has a determined lending volume for the period FY04 - FY06 amounting to US\$200 million, of which a large part of IDA financing (US\$85 million) will be channeled through PRSCs. Indeed, as outlined in the Country Assistance Strategy (CAS), annual single-tranche PRSCs are envisaged to become a key vehicle for Bank support for the country as the transition toward consolidated programmatic lending become effective. A first PRSC was approved by the Board in March 2004 and fully disbursed in August 2004. The preparation of the second and third PRSC is underway.

5. The current portfolio comprises six projects, with a net commitment of US\$171.4 million and an undisbursed balance of US\$128.9 million. These operations support health (HIV/AIDS), education, the cotton sector reform, the private sector development, community driven development and energy services. The sectoral composition of the portfolio is: 17.7 percent for private sector; 10.5 percent for agriculture, 16.3 percent for education/health; 29.2 percent for social protection sector and 26.3 percent for energy sector. The overall performance of the portfolio has been satisfactory with currently only one problem project. The Benin country portfolio continues to be characterized by a good disbursement ratio. Between FY00–FY04 it was on average 27.4 percent compared to the Africa regional average of 21.9 percent and a Bank-wide average of 20.5 percent. Disbursement could furthermore be improved if the government would strengthen its procurement capacities and its knowledge of Bank procedures. For the remainder of the CAS period a Second Decentralized City Management project and a regional Malaria program, where Benin is considered to be one of the pilot countries, are currently under preparation.

### **Macroeconomic and fiscal performance**

6. Benin's macroeconomic performance has been broadly on track over the past three years although economic activity has been adversely affected by major shocks in 2004. Real GDP growth averaged 5.0 percent over 2001-03 but declined to 2.7 percent in 2004. Despite the increases in the international prices of oil, inflation was kept at 1.5 percent in 2003 and is expected to remain under the 3.0 percent ceiling of WAEMU convergence criterion this year. The current account deficit, including current official transfers but excluding project grants, is estimated to have slightly narrowed from 9.0 percent of GDP in 2002 to 8.5 percent of GDP in 2003, because of the recovery in the price of cotton on the international markets. The volatility of international cotton prices and lower cotton exports put stress on the external balance in 2004.

7. Fiscal consolidation has been a major achievement over the last decade. But, fiscal position has been deteriorating since the beginning of 2004 reflecting the deterioration of economic activity and the decline in re-exports to Nigeria but also the lack of control over fiscal exemptions and weak performance of customs and the fiscal administration. Accordingly, the overall deficit excluding grants widened from 3.5 percent in 2000 to 5.5 percent in 2004. Redressing the fiscal situation will require strong measures to boost revenue collection with key emphasis on combating tax evasion, fraud and corruption, broadening the tax base and controlling exemptions, and increase the level and quality of poverty-reducing spending, while curbing nonpriority expenditure. Overall fiscal deficit, excluding grants is projected to be about 5.5% of GDP in 2005-2007.

8. Benin reached its HIPC completion point in March 2003. HIPC assistance amounted to US\$265 million. At the completion point, the net present value of the debt-to-exports ratio was projected at 161 percent in 2003 and decreased to 154 percent in 2004 while the debt-to-GDP ratio averaged around 33.4 percent in 2004. Over the 2005-2007 period, Benin's external debt would remain on a sustainable path but the debt sustainability could be adversely affected by external shocks or domestic policy slippages and need to be closely monitored. The debt-to-exports ratio is projected to be around 137 percent while the debt-to-GDP ratio would average at 31 percent.

## **Public Financial Management**

9. Since the Government launched the public expenditure management reform in 2001, considerable progress has been made in the area of budget formulation, execution and reporting as a result of key institutional reforms and an intense capacity building effort. This progress is reflected in Benin's HIPC expenditure tracking Assessment and Action Plan. Indeed, in the assessment undertaken for the March 2002 HIPC expenditure tracking Board paper, Benin met 8 of 15 benchmarks, one of the higher scores.

10. The budget is fairly comprehensive and integrates current and investment expenditures and is gradually integrating donor financing. Budget preparation has been strengthened through the introduction of the Medium Term Expenditure Framework (MTEF) which accompanies the PRSP. The MTEF is broadly in line with the strategic priorities for poverty reduction and builds on detailed program budgets for priority sectors that link quantitative result targets, policies and actions, and expenditure. This triennial budgetary framework is updated each year in the context of budget formulation and takes into account recurrent cost implications of new spending. Although the use of MTEF and program-budgets is helping line ministries to improve budget formulation, there is scope for strengthening the planning of budget-programs and sectoral and intra-sectoral arbitrage.

11. Spending procedures have been streamlined and computerized (an integrated computerized expenditure management system, SIGFIP is in effect since January 2001). This has considerably reduced budget execution delays. Nevertheless the Public Expenditure Management system continues to suffer from weaknesses in reporting, such as the production of functionally based in-year budget reports, the closure of annual accounts, and the timeliness of presentations of audited accounts to the legislature.

12. Following the recommendations of the Country Procurement Assessment Report (CPAR) prepared by the Bank in 1999, a detailed three-year action plan for procurement reform was prepared and a new law has been adopted by the National Assembly to amend the institutional framework of the procurement code creating and defining the attributions of the: (i) national regulatory agency for procurement; (ii) national executing agency for public procurement and (iii) procurement units in all Ministries. In addition, the legal texts to accompany the law amending the institutional framework of the public procurement code were adopted by the Council of Ministers.

13. A CFAA update is being carried out in close collaboration with the Government and relevant development partners and stakeholders to ensure that the outcome feeds directly into the reform process and in any future program design. Its diagnosis would help to improve Government Financial Management system by providing a comprehensive and integrated assessment of Benin's key fiduciary risk, as reflected in public financial management at both central and local government level but also by providing both donors and Government with an updated review of public sector challenges and an integrated action plan of short and medium term actions for which donors can provide assistance.

14. A Public Expenditure Review has recently been finalized in the health, education and rural water sectors. It shows that fiscal performance has been generally satisfactory and the budget is being framed and executed broadly in line with the priorities outlined in the PRSP but it recognizes that more effective prioritization in expenditure policy will be required to face emerging fiscal pressures and to help line ministries to sharpen the sectoral content of their budget-programs. The current development of a programmatic approach should facilitate prioritizing among sectors and programs, provided that further progress is made in strengthening the expenditure monitoring system.

15. Although the PER recognizes that important progress has been made in strengthening the public expenditure management system, it highlights some weaknesses that would need to be addressed. The priority actions identified are: (i) the improvement of the presentation, coverage and consistency of the budget documents and program-budgets; (ii) an effective move towards program-budgeting; and (iii) improvement in rationalizing commitment accounting at the budget execution stage, allowing multi-year commitment appropriations and reducing the use of special payment procedures.

### **Cost Sharing**

16. Under the current arrangements, the cost-sharing limit for Benin is 90 percent for investment projects<sup>1</sup>, applied on a rolling three-year basis. For individual projects 10 percent minimum borrower contribution to project cost (net of taxes and duties) is expected. The actual level of Bank financing has been about 83% of project costs for projects approved from FY01-04 (all in FY02) and 59% for projects approved in FY05 to date.

17. Government's commitment to sustaining reforms and deepening its policies and programs in areas critical for growth and poverty reduction is strong. Also, progress in achieving the PRSP objectives has been relatively satisfactory during the first year of its implementation although efforts need to be strengthened in the areas of privatization, governance and monitoring and evaluation.

18. Reflecting PRSP priorities, the Government is continuing to increase budget allocations for priority sectors. But, given the low level of domestic resources, Benin financial commitment and ownership to its development program is weak. The contribution of Benin's development partners financing to the overall budget and investment spending are 22 percent and 55 percent respectively. Bank-financed projects are well aligned with Benin's PRSP and Bank financing is integrated into the national budget. The overall performance of the portfolio has been satisfactory though capacity weaknesses and cumbersome procurement procedures have been major impediments to project implementation.

19. Although the authorities demonstrated their willingness to participate in projects financing, mobilizing Government's counterpart funds has been one of the major impediments to project implementation according to the latest CPPR.

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<sup>1</sup> Excluding financial intermediary, supplemental, emergency recovery, development policy and technical assistance loans.

20. Government ownership is key and will continue to be emphasized. The Bank's financing share in individual projects would be determined in a manner which supports government ownership of projects, and on that basis counterpart funding by Government will generally be expected in all projects. Cost sharing arrangements and Bank financing proportion in individual projects would be determined by the availability of IDA allocations and by the prioritization outlined in the PRSP and the CAS. The Bank will continue to promote harmonization of its program with other donors' assistance including through seeking cofinancing. Enhanced flexibility is expected to be particularly appropriate in the case of social sectors and decentralized or CDD operations, although typically contributions from Government and community contributions to local development programs will be sought. Nonetheless, there may be projects where Bank financing of up to 100% would be required, for example in operations supporting regional HIV/AIDS or Malaria programs and reform efforts.

### **Recurrent Cost Financing**

21. Like in many African countries, the Bank has been financing a part of recurrent project costs in Benin on a case by case basis. Recurrent costs comprised mainly project operating costs. Average Bank financing for recurrent costs of projects approved in Benin during FY01-04 was 12.5 percent of total Bank financing.

22. As already said, fiscal position has been deteriorating since the beginning of 2004 reflecting the deterioration of economic activity and the decline in re-exports to Nigeria. But, the authorities are taking strong measures to redress the fiscal situation. These include broadening the tax base, controlling exemptions and combating fraud and corruption. However, given the stress put on both internal and external balances by recent external shocks, fiscal and debt sustainability should be closely monitored as well as the implications for recurrent cost financing.

23. As indicated by project implementation completion reports (ICRs) and OED project assessments over the past five years Benin's track record on the implementation of the IDA portfolio has been overall satisfactory with respect to its development objectives, institutional development impact and ensuring sustainability.

24. No country-limit level is set on recurrent cost financing. The Bank would continue to monitor the overall fiscal and debt position/performance and its implications for recurrent cost financing. The appropriateness and the level of recurrent cost financing in each individual project would be decided on a case-by-case basis, based on the assessment of sustainability at the project and sector levels. It is not expected that recurrent cost financing will exceed the average of previous years.

### **Local Cost Financing**

25. The total financing requirement for Benin's development program is US\$3.1 billion (21.3 percent of GDP) over the period 2005-2007. Due to lower revenue mobilization (16.3 percent of GDP) and unanticipated significant increase in tax collection and limited access to domestic borrowing, the share of the country's own financing of its development program would be low. Indeed, domestic borrowing, taxes, HIPC debt relief and other revenues provide only for 74 percent of the total requirements

while 26 percent would need to be financed by additional external borrowing and/or external grants. Therefore, financing requirements for Benin's development program will exceed the domestic resources generated through taxation and other revenues and expected domestic borrowing.

26. Projects in the current portfolio or in the pipeline require substantial contracting of local goods and services and thus the financing of foreign expenditures alone would not be sufficient to help these projects meet their development objectives. Local costs have accounted for a substantial proportion of IDA investment lending disbursements: these were 83%, 73% and 97% of investment lending disbursements in FY02-04 respectively. For example, the HIV/AIDS project and the Community Driven Development (CDD) project have a high share of local costs, in particular at the community level.

27. Benin meets the requirements for Bank financing of local expenditures. Therefore, the Bank may finance local costs in any proportions as needed for individual projects.

### **Taxes and Duties**

28. The major taxes and duties are customs duties, Value Added Tax, corporate income tax, and single progressive tax on wages and salaries, discussed below. As a WAEMU's member, Benin's trade policy is largely determined by its membership in the regional monetary union. The country has maintained a liberal trade and payments system and introduced the WAEMU common external tariff (CET), composed of four rates (0, 5, 10 and 20 percent) in 2000. The average tariff rate is 14.6 percent, lower than the average for SSA countries (17.6 percent). Benin's trade restrictiveness has been rated 2 out of 10 (1 being the least restrictive). A Value Added Tax at a single rate of 18 percent was introduced in 1991. Income tax of resident individuals is withheld at the source of income according to a progressive schedule and takes into account the size of the family. The rates for the single progressive income tax on wages and salaries range from 0 to 40 percent. The average income tax rate for an experienced person with an average family size would be around 19 percent. The corporate income tax is 38 percent. The averaged income tax for local consultancy firms and individuals are respectively 7.6 percent and 5 percent. For foreign firms and individuals, a 10 percent income tax is withheld at source.

29. In the view of the above, Benin's current tax and duties system is considered to be reasonable. Thus, there are no taxes or duties associated with project expenditures that the Bank would not be able to finance. At the project-level, the Bank would consider whether taxes and duties constitute an excessively high share of project cost.