



A MINISTRA



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Topic: Letter of Development Policy

Mr. Jim Yong Kim
President of the World Bank
1818 H Street, NW
Washington, DC 20433
US.

Dear Mr. Kim,

On behalf of the Government of Cabo Verde (GOCV), I am requesting a development policy credit in the amount of US\$10 million from the International Development Association (IDA) to support our program of structural reforms included in our Third Growth and Poverty Reduction Strategy Paper (GPRSP III) covering the period 2012-16. The aforementioned development policy credit is the second operation of a series of programmatic development policy operations and will help us to meet financing needs the GOCV faces for the implementation of our GPRSP III in a context of an adverse global performance that has been reflected in our country in less robust GDP growth and impacting adversely government revenues.

This letter briefly describes the main objectives of the GPRSP III, ongoing macroeconomic adjustment efforts and the structural reform agenda that we are implementing.

The GPRSP III

Based on the assessment of Cabo Verde's comparative advantages and recognizing the difficult external environment facing Cabo Verde and the transition to middle-income country (MIC) status, the GPRSP-III aims at operationalizing through structural reforms and programs the government's objective of "building a dynamic, competitive and inclusive economy".

The GPRSP III is an instrument that implements the Agenda for Economic Transformation by structuring, in the multiannual framework, measures and actions for meeting the objectives laid down in the Government Program of the 8th Legislature for 2011-16. The main goal of the Agenda and the Program is to promote shared and a

more robust economic growth with opportunities for all as the driver of poverty and inequality reduction. In this framework, macroeconomic stability and good governance, job creation, improvements in human capital development and an enhancement role of the private sector, which is expected to become the economy's main engine, are key pillars of the GPRSP.

Macroeconomic situation and government policies

Regarding the macroeconomic front, the context of the uncertain international economic environment has taken a toll on the caboverdean economy and the budget policy that has been followed in the last years has sought to compensate the impacts of the global economic and financial crisis. The recent historical GDP data disclosed by the National Institute of Statistics (INE), covering the period until 2013 which reveals somehow the impact from the economic crisis on national output, has further added to the case for the use of counter cyclical stimulus to the economy. The Government's support to the economy through the investment program attempted to mitigate the negative impacts of the crisis on national demand and investment. Furthermore, the investment program is a necessary condition to increase competitiveness by alleviating chronic infrastructure bottlenecks and reducing the cost of factors in the medium-long term.

Additionally, the Public Investment Program (PIP) is heavily connected with Cabo Verde's graduation from the United Nations (UN) Least Developed Countries' list in 2008. By occasion of the transition to a Middle Income Country Status, development partners agreed in the establishment of a transition window that enabled the country to continue access concessional resources to fund infrastructure projects that would alleviate chronic bottlenecks to the development of Cabo Verde. This window also provided a fundamental and sustainable source of funding to adopt anti-cyclical measures to counter the effects of the international crisis on the caboverdean economy.

Recent GDP data released by INE reflects an initial trend of a gradual recovery of caboverdean economy (real GDP is preliminary estimated on 2.7% for 2014) even under stressed conditions from external environment. Revenues, after a period of shortfall, started to positively responding to the reforms, presenting good performance in the first quarter of 2015. It's important to mention that, since the beginning of 2014, the GOCV has been adopting revenue enhancement measures including a broad tax reform on our Value Added Tax (VAT), establishment of a touristic fee, improvements on tax administration (technically supported by the IMF) and the increase of cost recovery measures for the services provided from our main State Owned Enterprises (SOEs). On the expenditures, tight controls on recurrent spending and the cancellation of some of our investment projects are expected to reduce total spending, resulting in the reduction of our overall deficit.

The 2015 budget and the mid-term programming (2015-2018), taking into account recent developments, reflect conservative estimates on revenue performance and a containment effort on the expenditure side in order to safeguard the principles of public



debt sustainability and the alignment of the economic activity with the potential growth of the economy.

Fiscal Consolidation

One of the main goals of the Government and that is reinforced on the 2015 State Budget is the gradual program of fiscal consolidation, based on four major axes:

- Gradual phasing out of the Public Investments Program;
- Containment and optimization of public spending, (the focus of the reforms implemented during the period 2006 to 2011 and continued until now);
- Recentralization/Refocusing of the revenue centers, highlighting the consolidation of the *bancarização* and the tax administration process on the period covering 2011 to 2016;
- A strong program of institutional reforms.

As a result of the clear assumption of the fiscal consolidation program by the Government, the management of public finances in Cape Verde reached, in the last decade, from high government standards levels. It is now important to consolidate the gains at all levels of the reform to undertake a new stage.

Cape Verde faces new challenges in an environment marked by great adversity, greater budgetary stringency and rigor. Therefore, it is crucial to adopt measures that promote the efficiency and effectiveness of revenue and public spending, ensuring thus a sustained fiscal consolidation in the medium term.

The focus on fiscal consolidation effort reinforces the implementation and the deepening of the structural reforms and the reconciliation of these two aspects are the guideline of economic policy of the Government. In fact, the IMF recently evaluated the consolidation strategy presented by the Government and it confirmed its alignment with the recommendations made for the necessary medium-term fiscal consolidation.

The economic reforms aim the improving of the competitiveness of the economy and in this way boosts endogenous capacity to generate revenue with enterprises more competitive and laboring in an enabling environment of investment and growth. On the other hand, tax reform, which is also based on tax evasion and fraud combating, must underpin the enlargement of the tax base, allowing the Government to increase revenue collection, helping to reduce the budget deficit. However, important challenges remain. In other words, the successful implementation of the tax reform is a key factor of the fiscal consolidation program. Improving tax administration efficiency in the collection and payment of taxes surveillance enforces this same administration to adopt stringent measures to collect the necessary resources in order to finance the development process of Cabo Verde and also generate flows to remunerate and repay credits already hired. To this end, it is expected a gradual improvement in the quality of leadership of the Tax Administration as well as the technical teams (a National Directorate was been created in order to better administrate this process).

In 2015 year, it is expected that tax revenues register a positive performance over the previous year, particularly due to the behavior expected of VAT, results of measures



taken both in terms of fiscal policy (alignment of the effects) or on Tax Administration (dematerialisation and later Electronic Declaration) as well as the projected recovery in economic activity. The preliminary data of the first quarter of 2015 shows a first sign of recovery on the revenue side with an increase around 10% comparing with same period of 2014.

In addition to the reforms that will ensure that the State improve their capacity to collect revenues, another front which should allow the deficit reduction will be the containment/optimization of public spending. On this front, the Government, given the structure of expenditure, will continue to invest in the implementation of programs with the greatest impact on growth and poverty reduction. To that end, according to the current Medium Term Fiscal Framework, efforts of fiscal consolidation will be continued, which has been marked by a high level of commitment on the expenditure side, for example by incorporating measures in the area of human resources, social benefits, transfers and investment. In addition, measures are envisaged aimed at the efficient functioning of the public administration towards its reorganization and centralization of resources. Regarding the investments, it is important to highlight the gradual phasing-out of the public investment program undertaken by the government, without neglecting economic growth, while the public debt sustainability is guaranteed. The public investment program should continue aimed at the promotion and diversification of the economic base of the country, but creating space for engaging the private sector in boosting the country's economy and strengthening its growth potential.

On the real economy front, some signals of recovery have been observed. Positive results were noted in important economic sectors in 2014. We highlight the excellent performance of export sector, mainly the fisheries sector and a recovery on the FDI. Tourism has been affected indirectly by the Ebola nevertheless Cabo was free of this disease, but with the reforms planned for this sector (the WB is working with the Government on a project that will enhance the competitiveness of the tourism sector) we expect better performance during this year.

In the agriculture sector investments focus on the increasing collect, storage and distribution of spring-fed and rain-fed water resources, enabling farmers to irrigate their fields through new efficient technologies which are contributing to improve agricultural productivity and promoting agri-business. Extension of irrigated land and increasing water supply reliability are facilitating a shift from low-value, rain-fed subsistence agriculture (such as corn and beans) to high-value horticultural and fruit crops.

In the transport sector, we register a recovery in passengers and containers flows in caboverdean ports. The national airports are receiving more international flights. Concerning the energy sector, Cabo Verde is striving to overcome one of its major development challenges – reduce dependence on fossil fuel for energy generation, nevertheless the country has already attained its goal of 25% energy generation from renewable resources. Large investments in the sector resulted in an increase from 89 MW to 156MW in 2012 and an increase in the coverage increased from 85 percent to 95 percent. Moreover, renewable energies represent 25 percent of our installed electricity capacity. Last but not the least, institutional, regulatory and managerial reforms supported by the World Bank in recent years are beginning to generate positive results reflected in the improvement of the financial situation of our Electricity and Water utility ELECTRA which will enable to sustain the improvements described here.



Concerning the investment program specifically, it should be noted that some of new projects will not be pursued in the near future considering the priorities of debt consolidation and sustainability. The current focus now is the conclusion of ongoing investments. Certain recently commissioned projects such as the Praia international airport expansion or the technology park remain on the pipeline in the context of the development strategy and were considered in the debt sustainability analysis prepared by my team with the support of the World Bank. The National Investment System is being put in place during 2015 with the World Bank financial support and it will enable to improve the quality of future investments opportunities. With the support of donors, the government is undertaking studies to determine the potential of new dams and will only move forward with new projects in this area once the strategy for the development of associated rural areas and agribusiness clusters is properly conceived and safeguarded.

Structural reform agenda

The Third Growth and Poverty Reduction Strategy Paper (GPRSP III) aims at accomplishing the goal of creating a dynamic, competitive and sustainable economy in order to enable an environment for inclusive growth that will reduce poverty. Considering its cross-sector nature, the GPRSP III imposes several simultaneous structural reforms that will aim to empower the development of the private sector around the anchor sectors of competitiveness – agribusiness, tourism and the sea cluster. The agribusiness sector for example will open up opportunities to rural populations by interlinking the production capacity with tourism demand for products and services, hence enabling the reduction of unemployment and poverty in areas traditionally hardest hit by lack of economic opportunities. A PPP Unit has been recently created with the propose to prepare the necessary conditions for the PPP and privatization process of some services (concessional port and airport services, especially) and national companies.

On the sea cluster, an important set of reforms is taking place on the fisheries sector seeking to leverage the good export results in recent years. The strategy will seek to promote a national value chain for competitive endemic species. Specific measures will include enhanced quality control and product certification; investments in modern freezer facilities (a competitive advantage in the sub-region); consolidation of the ongoing investments in modern ports facilities; attracting foreign and domestic companies, amongst others. The tourism sector, a defining anchor of the country's service economy as it is, will comprehend a broad set of measures seeking to diversify the tourism product into new high potential niches (rural, adventure, sports) and improving authorities' capacity to conduct proper monitoring and evaluation of existing projects with a strong focus on safeguarding environmental sustainability.

In effect, the nature and substance of the public investment program effort converges with the vision for competitiveness of the national economy. Furthermore, the investments will continue supporting key projects in enhancing the quality of education



and health services and sponsoring cross sector reforms in the area of good governance (e-governance, state reform, and judicial system).

In simultaneous with competitiveness clusters specific reforms, the overall reform agenda will look to tackle and advance cross sector issues. The first great pillar of the agenda is the maintenance and enhancement of good macroeconomic governance. In order to face the new challenges brought on by a more volatile international environment, it is important that several key reforms ongoing in the area of public finance management be continued and complemented in order to increase the country's macro-fiscal resilience. Other important advances are related to the fiscal legislative front that are expected to increase revenue and achieve a better fiscal balance anchored in the approved revision of the investment code and associated tax benefits diploma. The implementation of additional revenues sources such as the tourism surcharge and the statistical tax are expected to diversify the base of revenue. Still on the legislative dimension, the overhaul of major fiscal diplomas continues – e.g. *Código Geral Tributário*; *Código de Execuções Tributárias*; *Código de Processo Tributário* – approved as well by the Parliament.

Other key reforms in the public finance management area continue to advance and will aim to increase the efficiency of resource planning at the central administration level according to the newly updated PEMFAR based reform action plan. The operation of the single treasury account has already made significant advances in improving the Government's cash flow management and predictability. In 2013, we introduced program-budgeting which represent a strong improvement in our public finance management and for the first time we presented the State Budget on a programmatic base.

The consolidation of this process is reflected in the approval of the new planning law in later September 2014 and the submission of a new budget organic law expected by the end of this semester and that will make legal the changes in budget management that are already in place. The overall debt management reform will seek to increase and broaden the marketability of government debt securities to domestic and international savers and hence reduce the costs of indebtedness. The aspect of strengthening the in-house assessment and management of debt risks is also a priority (particularly those related to state owned enterprises). The area of public procurement has seen notable advance in the regulatory and legislative front and is now advancing toward e-procurement solutions that can further increase transparency, reduce the costs of transactions and broaden the scope of potential suppliers to the Government.

The establishment of a new National Planning System (SNP) provides a more ample framework to understand the full scope of public finance management reforms. The creation of a solid mechanism for policy creation, analysis and implementation remains a challenge that will “make or break” a successful implementation of the GPRSP III and the achievement of its vision. The SNP is made up for a group of integrated subsystems. The first is monitoring and evaluation seeking to link the resource allocation to measures of physical execution and outcomes. The programmatic reform of the State



Budget to include all GPRSP III programs, each with a logical framework for indicators and outcomes, is a significant step in that direction. Significant challenges remain considering the complexity of this reform, the associated in-house development of the necessary information technology platform, and the learning curve involved with all sectors. The national investment system will seek to promote a comprehensive framework for *ex ante* cost benefit analysis and *ex post* impact assessment of capital expenditure. This will be essential in order to look for those projects which will yield the highest return on investment and ensure that scarcer public investment resources are used to the highest possible utility to the population and economic agents. The system will also deal with the careful analysis of recurrent costs associated with some of the major infrastructure projects and will examine new cost sharing mechanisms such as public private partnerships. The national statistics system will aim to enhance the timeliness and quality of output data across a range of socioeconomic domains. This is absolutely critical to ensure that policy makers and other economic agents, including donors and creditors, have access to the right information for decision making purposes – with a special focus on the essential monitoring and evaluation of the GPRSP III. Concrete actions are already being taken which include the institutional strengthening of INE and the timely provision of the required national accounts data outputs. The geographic information system will seek to leverage information technologies to resolve the issue of territorial planning by creating an information platform easily accessible to public, private and civil society stakeholders for issues of land use, regulations and custody amongst others.

The reforms above mentioned in the area of overall macroeconomic and PFM will continue to require close support from our development partners, especially those in the Budget Support Group which is currently led by the World Bank. The GPRSP III further highlights as a part of its reform agenda a critical area for improvement – ownership and control of state owned enterprises (SoEs) – that constitutes a multidimensional challenge spanning not only the management of the contingent fiscal risk but also the service level of these companies as key enablers of the competitiveness of the country. The signature of performance management contracts with key public utilities – Electra has been a key and successful step and we replicated it to other biggest SOEs (TACV, ASA, EMPROFAC and IFH). The overall broad reform of the SoEs and strengthening of the Government's ownership and control capacity remains however a dense challenge and further measures are required. These companies must be able to utilize and achieve returns on many of the public infrastructure projects recently concluded. Only then will a private sector driven economy around the above mentioned clusters be possible.

In this sense, the transport and energy SoE infrastructure companies are receiving heightened attention in these reform processes aiming to improve the associated efficiency and service delivery level. Specifically on transport, a series of measures were published in a sector policy letter and the amendment of the law on ports, which will enable concessions (including the restructuring of port operator ENAPOR), the review of the port authority, a tariff revision already executed by the port operator, to foster the participation of the private sector. The focus on transports is also prioritizing the restructuring of the national airline TACV. The spin-off of handling activity is an important accomplishment. The energy sector is already seeing significant changes,



specifically in the ability of the utility ELECTRA to collect and we aim to enhance the capacity to cut losses and increase the overall efficiency of energy and water production and distribution.

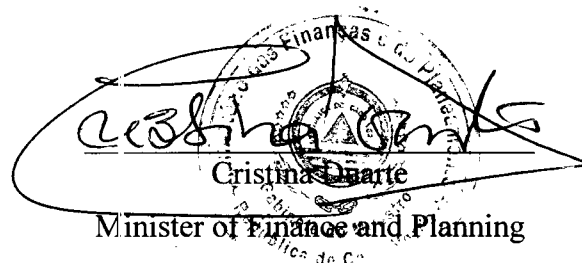
Additional critical areas of reform of noted importance were those related with the labor market. A series of diagnosis documents have shown that the rigidity of the labor laws favors informality and reduces the competitiveness of the critical labor production factor. An appropriate balance must be sought between the protection of the workers and the ability of firms to easily contract and manage their workforce according to principles of good performance and meritocracy. In this regard, the revision of the labor code was already been approved by the Government after some discussions with the union and the private sector representation. in early 2015.

Still in the scope of human capital, education is to remain an area of maximum priority. Over the past decade, Cabo Verde has made noted progress in expanding the coverage of its conventional education system nationwide under a banner of low cost universal access to all. The effort was also noted in the university higher education system. However, the paradigm is shifting towards the reinforcement of quality and the proper enabling of a technical and vocational education and training system that can provide skilled employees to service private sector operators especially in the areas of competitiveness of the GPRS III, although the progress made in this front.

Conclusion

To conclude, it is in this scenario of important challenges that the Government of Cabo Verde reaffirms once again its commitment with fiscal sustainability and a broad-band structural reform agenda. In this sense we hope to continue receiving the important support of the World Bank through this development policy credit and the technical assistance which is critical for the implementation of our reform agenda. The World Bank's support over the past years has been instrumental and remains a necessary condition to ensure a continuing transformation of Cape Verde during this difficult international environment.

Reiterating once again our desire on maintain an excellent collaboration between the World Bank and Government of Cabo Verde, please accept my best regards.



Cristina Duarte
Minister of Finance and Planning