

**PROGRAM INFORMATION DOCUMENT (PID)  
APPRAISAL STAGE**

April 27, 2015

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<b>Operation Name</b>	Cape Verde Ninth Poverty Reduction Support Credit
<b>Region</b>	AFRICA
<b>Country</b>	Cabo Verde
<b>Sector</b>	Central government administration (60%);Private Sector Development (10%); General energy sector (10%); General transportation sector (10%); General finance sector (10%)
<b>Operation ID</b>	P147015
<b>Lending Instrument</b>	Development Policy Lending
<b>Borrower(s)</b>	IDA
<b>Implementing Agency</b>	
<b>Date PID Prepared</b>	April 27, 2015
<b>Estimated Date of Appraisal</b>	May 6, 2015
<b>Estimated Date of Board Approval</b>	June 16, 2015
<b>Corporate Review Decision</b>	Following the corporate review, the decision was taken to proceed with the preparation of the operation.
<b>Other Decision</b>	None.

## I. Country and Sector Background

Cabo Verde is an archipelago with a population of about 500,000, fragmented across nine inhabited islands. The country faces considerable development challenges, including a small and fragmented domestic market, remoteness from international markets, no significant natural resources, and an arid climate with limited supply of fresh water. Yet Cabo Verde has made considerable gains, experiencing growth in excess of 6 to 7 percent on average before the eruption of the global financial crisis. In return, poverty fell considerably: between 2002 and 2008, the poverty rate (at US\$1.25/day) dropped by 7.3 percentage points (p.p.) to 13.7 percent. Cabo Verde is also one of the few countries on track to achieve all Millennium Development Goals. Strong economic performance, translating into progress on social indicators, was largely a consequence of considerable FDI in the tourism sector, but also effective government policy, strong institutions, and a credible peg with the euro which kept inflation low. In December 2007 Cabo Verde became one of only four countries to graduate from the UN list of Least Developed Countries (LDCs).

However, development challenges remain considerable. With the graduation from the list of LDCs, concessional financing is phasing out and Cabo Verde currently does not have access to international market. A key challenge will be to strengthen the domestic revenue basis, hold expenditures in check, and maximize the returns from a considerable government effort to

provide key infrastructure to the country. The ambitious Public Investment Program, drawing on remaining concessional resources, has resulted in a public debt stock exceeding 100 percent of GDP in 2013, expected to peak at 125.9 percent in 2016/2017. Strengthening the fiscal position will be crucial for the country's ability to service its debt and continue to provide public goods to Cabo Verdeans. It is also crucial to provide room for a fiscal policy buffer in response to shocks, both economic shocks—such as the recent global financial crisis—and natural shocks—such as an eruption of the volcano on the island of Fogo in November 2014. The PRSC IX supports the government in strengthening fiscal resilience. In addition, the PRSC IX supports the government in improving the conditions for private-sector led growth, as a precondition for more and better jobs and higher wages, which are crucial to reduce poverty and boost shared prosperity. The most vulnerable, including women, stand to gain both from a solid fiscal position, ensuring the reliable provision of public services, and an improving labor market as a consequence of economic growth.

## **II. Operation Objectives**

The proposed operation is the second in a series of three one-year operations designed to support the implementation of the Government of Cabo Verde's GPRSP-III. The main development objectives of this new PRSC series are: (i) enhancing macro-fiscal stability; and (ii) increasing Cabo Verde's competitiveness.

The PRSC IX continues the focus on the main policy areas under PRSC VIII, which became effective in June 2014. The budget-support operation will address both short- and long-term priorities by supporting the difficult but necessary process of macroeconomic adjustment and by accelerating progress on the structural reform agenda, the success of which is crucial to Cabo Verde consolidating past achievements and creating the conditions for further prosperity gains.

The proposed PRSC series will support the government's efforts to: (i) consolidate progress achieved during the previous series and pursue critical follow-up actions; and (ii) support new initiatives under the GPRSP-III's structural reform agenda aimed at adapting the country's economic growth model to meet the demands of its evolving circumstances. Building on previous reforms, areas for consolidation include Public Financial Management, trade facilitation and financial-sector development. In addition, the proposed PRSC series will support programmatic areas including reforms to improve the oversight of state-owned enterprises and enhance their service delivery, as well as the establishment a public-investment management system to ensure the allocative and technical efficiency of public investments and taxation reforms designed to reduce distortions and foster job creation. The area of environmental protection will be continued to support policies aimed at preserving the natural beauty of the country, which is crucial to sustain the development of the tourism sector.

## **III. Rationale for Bank Involvement**

The government of Cabo Verde has taken bold steps to strengthen fiscal sustainability and macroeconomic resilience. To counter falling tax revenues, the government has been undertaking decisive reforms both with regards to tax policy and tax administration, supported by this PRSC

series. These measures are beginning to yield results, strengthening the fiscal accounts. Moreover, the ambitious Public Investment Program, the key driver behind the rising public debt burden, has started a trajectory of consolidation in 2013, decelerating public debt dynamics. World Bank Technical Assistance and this PRSC series support the government in setting up a National Investment System (NIS) that will help ensure that public investments have their desired economic returns.

Given limited fiscal space and a pegged exchange rate, structural reforms are a particularly important policy tool for the government to create the conditions for poverty reduction and shared prosperity. With regards to structural reforms under the GPRSP-III, the government has been making considerable progress, amongst others in the areas of aviation, electricity, financial sector development, trade facilitation, and environmental protection. These areas have been supported by this PRSC series. The World Bank has been following progress on these reforms closely, through a coordinated donor group, the Budget Support Group (BSG), comprising all donors providing budget support to the country. BSG review missions are held twice a year.

#### **IV. Tentative financing**

Source:	(\$m.)
BORROWER/RECIPIENT	0
International Development Association (IDA)	10
Borrower/Recipient	
IBRD	
Others	
	Total

#### **V. Tranches** *(not applicable)*

	(\$m.)
First Tranche	
Second Tranche	
Etc.	
Total	

#### **VI. Institutional and Implementation Arrangements**

The Department of National Planning (DNP) at the Ministry of Finance and Planning will be responsible for the overall implementation of the proposed operation and for reporting on its progress. The Bank will vet the prior conditions for effectiveness and disbursement. It will be the responsibility of the DNP to present this information in a timely manner and in a format satisfactory to the Bank.

The Monitoring and Evaluation (M&E) system that supports the implementation of the GPRSP-III will be instrumental to assessing progress on the reforms included in the proposed PRSC series. Since the previous PRSC series, the World Bank team has worked in close collaboration

with the government and its budget support partners to ensure adequate monitoring and evaluation. There are still shortfalls in the country's M&E system and the BSG has established a working group to resolve these issues jointly. The World Bank is supporting the improvement of the M&E system through a Trust Fund for Statistical Capacity Building.

## **VII. Risks and Risk Mitigation**

The overall risk rating for the RRSC IX is 'moderate', with four sources of risks associated with a moderate or higher risk rating.

### *Political and governance risks*

Political risks are considered to be substantial in light of the 2016 elections. Governance is strong in Cabo Verde, but political risks in relation with the upcoming legislative, municipal and presidential elections, jointly to be conducted in 2016, cannot be discounted. A large number of academic studies demonstrates that fiscal policy tends to be expansionary when elections loom.<sup>1</sup> This could undermine the fiscal consolidation effort supported by this PRSC series, and especially pillar I on macro-fiscal stability. Evidence of pre-electoral fiscal expansions in Cabo Verde is weak, however. For example, in 2011, during the last round of elections, the fiscal deficit was lower than in 2010 and 2012. The Bank, in close coordination with the IMF and also members of the BSG, will support mitigation of these risks through active policy dialogue with the government.

### *Macroeconomic risk*

An IMF program is currently not in place but the IMF conducts two missions per year to Cabo Verde in the context of their Article IV mandate. The World Bank and the IMF teams coordinate closely on the macro-fiscal policy dialogue.

The fragile economic recovery poses a high risk to the operation. Compared to the high growth figures of the time before the global financial crisis, the expected average growth of about 4 percent in the medium term is conservative. However, economic realities have changed as the country switches to a new development model driven by competitiveness. The success of this new model partly hinges on the public investments of the past eventually yielding the expected growth dividends. This will also be important to ensure that SOEs are able to service their debt obligations resulting in considerable contingent liabilities to the government. Moreover, the private sector has to be able to respond to the associated new economic opportunities, which is difficult in an environment where the financial sector focuses on repairing its balance sheets. Finally, the global economy, including European economies, remains fragile and Cabo Verde's fiscal space to absorb further shocks has been exhausted. Deflation in Europe threatens the economic health of Cabo Verde both through the channel of external competitiveness and a low GDP deflator which results in lower than expected ratios of fiscal variables (including public debt) to GDP. Although the threat of deflation in the Eurozone appears to have been averted by the European Central Bank's quantitative easing program, it is important to remain vigilant.

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<sup>1</sup> See, e.g. M. Hanusch and P. Keefer (2014) 'Younger parties, bigger spenders? Party age and political budget cycles', *European Economic Review*, 72:1-18.

Unexpected economic headwinds have the potential to imperil the development objective of enhancing macro-fiscal stability and fostering private sector-led growth.

With respect to realizing the expected returns of the infrastructure agenda, the government is making a considerable effort to strengthen its oversight of SOEs and to further engage the private sector in infrastructure management through PPPs, efforts that are supported by the PRSC series and WBG TA. This TA will also help contain the large contingent liabilities in SOEs which can result in shocks to the trajectory of public debt-to-GDP. With respect to enabling the private sector, the government is—with accompanying WBG TA—supporting activities such as establishing a tourism board, an SME finance project, a Financial Sector Development Strategy, and the passing of the insolvency law.

#### *Institutional capacity for implementation and sustainability*

Capacity of the civil service is relatively high Cabo Verde. However capacity gaps exist, justifying a ‘moderate’ risk rating on institutional capacity for implementation and sustainability. Cabo Verde’s 2013 CPIA score on the cluster ‘public sector management and institutions’ is 4.1 which is high for IDA countries. However, it is important to bear in mind that Cabo Verde continues to be a lower middle income country, and it experiences capacity shortfalls in some areas as do its peers in that income category. Weak capacity in some areas constitutes a moderate risk for this operation in many ways. It can undermine the goal of fiscal sustainability if capacity building TA in the tax office does not yield the expected results; it can limit the effectiveness of the government’s oversight capacity of SOEs if capacity building in the SPE falls short of expectations. Strengthening the government’s capacity to monitor policy outcomes through a functional M&E system will be crucial to eventually implement program-based budgeting. Whilst all these areas constitute risks, mitigation efforts are in place for all of them, building capacity through World Bank TA and/or policy dialogue, in close coordination with a large number of other development partners.

#### *Environmental and social risks*

Cabo Verde is highly vulnerable to natural disasters, which can pose a moderate risk to the PRSC series. The most recent eruption of the volcano in Fogo island has demonstrated the country’s vulnerability to natural hazards. Information provided by the UN (based on information from PreventionWeb) suggests that natural hazards that have affected Cabo Verdeans the most between 1980 and 2010 are: (i) drought (46.2 percent of the population affected), (ii) epidemics (37.6 percent), (iii) storms (8.9 percent), and (iv) volcanic eruptions (7.3 percent). Indeed, in 2014, Cabo Verde experienced another drought, adversely affecting the incomes of farmers and especially the poor. Natural disasters, such as the recent eruption of the Fogo volcano, can also undermine the conditions for private sector activity—when destroying vital infrastructure—and put pressure on the national budget in view of emergency recovery and reconstruction needs. Cabo Verde has disaster risk management plans in place and when natural disasters materialize the government receives strong support from humanitarian agencies. The WBG has systems in place to support recovery assessments and longer-term recovery efforts (currently ongoing for the case of Fogo), thus moderating the impact of natural disasters.

## **VIII. Poverty and Social Impacts and Environment Aspects**

## Poverty and Social Impacts

The evidence base on poverty and poverty dynamics in Cabo Verde is needs to be strengthened. The World Bank is increasing its efforts in this area. The latest poverty data are based on a representative household survey from 2008. A poverty map was prepared in 2012, combining data from the 2008 expenditure survey and the 2010 census. Capacity and financing constraints in the national statistics office (INE) have resulted in a lack of expenditure surveys since, which means that there is little information on poverty in Cabo Verde. While it is likely that poverty has increased in response to the economic downturn after the global financial crisis, there is no evidence base to evaluate the extent. The World Bank is providing an NLTA that works with INE both to improve access to poverty data and an effort will be made to impute poverty dynamics from annual multi-objective surveys through survey-to-survey imputations. These surveys have been carried out since 2011.

In spite of the absence of recent poverty data, the reform program supported by this operation is expected to have positive long-term impacts on poverty and social conditions in Cabo Verde. Considerable poverty reduction between 2002 and 2008 coincided with a period of high economic growth, fuelled by large inflows of FDI. This supports the notion that growth has a considerable pass-through for poverty reduction, and it is corroborated by the poverty map which demonstrates that the touristic islands, i.e. the main beneficiaries of FDI, have the lowest poverty rates. The PRSC series supports the government in returning to the growth rates that have facilitated the progress on human development outcomes, including poverty and shared prosperity, in the past. Growth will also support the livelihoods of the more vulnerable members of society, including women. Although the unemployment rate for women is lower than for men (15.2 percent compared to 16.3 percent for men), female labor force participation is 14 percentage points below male participation and women are jobless for a significantly longer time than men, according to 2014 data from INE. Women thus have particularly much to gain from economic growth and job creation.

Better public service delivery, supported by this PRSC series, is crucial for alleviating poverty. This PRSC series has a strong emphasis on the delivery of services. Improving the efficiency of infrastructure and expanding social-service delivery is expected to benefit the poor through increased access to essential services, reduced transportation costs, lower import costs, and the economic integration of less-developed islands through improved inter-island transport services. Better public services, as well as support to public goods, such as environmental preservation, are also good for sustainable growth, and in turn, poverty reduction.

## Environmental Aspects

The specific actions supported under the proposed PRSC IX are likely to have positive effects on the country's environment, including the integrity of its agricultural land, forests, fisheries and other natural resources. Protecting the country's natural assets is vital to maintain the national wealth and also to continue attracting tourists to the archipelago. The PRSC IX focuses on the operationalization of the Environmental Fund which is currently being replenished with resources from the Environmental Tax (supported by PRSC VIII). The Environmental Fund supports investments by the central government as well as municipalities in environmentally important projects and also makes resources available for environmental education.

Improving evaluation mechanisms for public investment projects is expected to further enhance the preservation of natural assets. The NIS will include environmental impact assessments as an important criterion for public investment decisions. The BSG is also concerting its efforts to improve the M&E framework for environmental aspects.

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