15th November 2013

**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$15 million from the International Development Association (IDA) to support our program of structural reforms included in our recent Third Growth and Poverty Reduction Strategy Paper (GPRSP III) covering the period 2012-16. The aforementioned development policy credit is the first operation of a series of 3 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 the global slowdown that has been reflected in our country in declining 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 Cape 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

On 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 four 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), which reveals a more pronounced impact from the economic crisis on national output than had been previously estimated, 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.

Furthermore, 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. The National Accounts published by the INE regarding the period from 2009 to 2011 demonstrate that these anti-cyclical measures were duly and timely implemented and prevented the national economy from diving into a recessive wave.

Meanwhile, the global and domestic slowdown in economic activity led to a strong revenue fall that combined with our investment program resulted in high fiscal deficits and increasing indebtedness. To reverse this situation, since the beginning of 2013 year, 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 2014 budget and the mid-term programming (2014-2017), 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. The programming of revenues and expenditures has been discussed with the World Bank in a mission in August. The Bank team considered that estimates are realistic and that the phasing out of the public investment program should occur gradually in order to still mitigate potential negative effects on economic growth. The fiscal revenue is expected to reach 18.4% of GDP in 2014, a 0.6% percentage-points increase compared to the current year. In the midterm, it is expected that revenues might
reach 19.2% of GDP by 2017 due to the impact of the tax administration reforms, the new tax sources, and the dynamic of the economy itself.

On the real economy front, some signals of recovery have been observed since the second quarter of 2013. Positive results were noted in important economic sectors in 2012 reflecting the impact of a slight recovery in the economies of our main international partners and the completion of some of our investment projects and structural reforms. We highlight the excellent performance of the tourism sector. Infrastructure improvements, repositioning of the country as an attractive destination, the promotion of new markets and the political stability had contributed to the growth of tourism. In 2012 the number of tourists reached 533,877, an increase of 12.3 percent, overnights increased 17.9 percent. This positive evolution of the sector represented a rise in the tourism revenues of 21 percent and a 4 percent in the jobs creation. Data up to September indicates that these trends have been maintained and we expect to close the year with an increase of at least 10 percent in the number of tourist and revenues of more than 15 percent.

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 trough 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. For example, the storage capacity in dikes retention/funding and reservoirs have increased noticeably by 99.8 percent in 2012 compared to 2010, irrigated areas with drip irrigation system 91.5 percent and total area of hydroponic production units 400 percent.

The fisheries sector is performing well. It represents more than 80% of good exports, the capture capacity is estimated between [36,000-44,000] ton/year and the exports over 1,000 container per year. In 2012 the incorporation of national fisheries products in the industry of transformation activity increased 115 percent.

In the transport sector, we register a recovery in passengers and containers flows in caboverdean ports. The national airports are receiving more international flights, with a 12 percent growth in 2012 and the number of passengers increased by 3.7 percent, reflecting the investment capacity improvement in the transport sector.

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 increased from 89 MW to 156MW in 2012 and an increase in the coverage increased from 85 percent to 96 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 major 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. In the near future we will put in place a national investment system that 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.

In the 2014 budget, the Government will continue to favor the maintenance of macroeconomic stability through a cautious fiscal and budget policy. The overall deficit is projected at 7.4% according to the latest Medium Term Fiscal Framework, total revenues are projected to rise at a realistic 2.7% in 2014 taking into account in a conservative fashion both the new sources of revenue and the tax administration reforms now taking place. On the expenditure side, the effort to consolidate the public investment program will continue and capital expenses will reach an expected 7.5% of GDP in 2014 down from the 8.2% of the 2013 reprogramed budget. Due to the nature of the project cycles, now in a conclusion stage, and in accordance with debt sustainability parameters, the public investment program will reduce in volume during the next fiscal years. The Medium term Expenditure Framework also envisages a prudent framework put in place. The 2013 budget execution reprogramming already provides examples of important measures of precautionary cuts specifically in: goods and services purchase (30%); fuel expenses (30%); travel and subsistence (40%); variable remuneration (10%); investments by public autonomous funds and services (between 30 and 50 depending on the entity) and freezing acquisitions of non-financial assets.

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.

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. The Government will continue adopting the necessary measures for fiscal alignment, taking into account recommendations made by partners, and which will include the improvement of the efficiency of tax collection (with advances already seen in the ongoing restructuring of the tax administration and its directorate general) and through the careful oversight of the public investment program. Other important advances on the fiscal legislative front that are expected to increase revenue and achieve a better fiscal balance are the harmonization of the VAT in critical sectors such as tourism as well as the 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 – and is now in a final review 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. The consolidation of this process will be reflected in the submission of a new budget organic law 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 noted 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 four 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. Secondly, 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 third pillar, 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. Last but not least, 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 furthers 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 plan to replicate it to other SOEs. 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 will receive heightened attention in these reform processes aiming to improve the associated
efficiency and service delivery level. Specifically on transport, a series of measures recently 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 will also prioritize the restructuring of the national airline TACV. The reorganization of the business units notably through the spin-off of the handling services is already underway and scheduled to be completed by June 2014. The energy sector will also see significant changes, specifically in the ability of the utility ELECTRA to collect and cut losses and increase the overall efficiency of energy and water production and distribution.

Additional critical areas of reform of noted importance are those related with the labor market. A series of recent 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 draft of a revision of the labor code was already been endorsed by the Council of Ministries and is in its public consultation period before its submission to the Parliament in early 2014.

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 GPRSP III.

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.