Fiscal Policy: the Ultimate Verdict in Evaluating Poverty & Inequality Reduction Policies

A Case Study of Cape Verde from 2001 to 2016

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The adoption of a holistic approach

- **Fiscal policy**—the range of the government’s taxing and spending decisions— has a relevant **impact** on all aspects of **sustainable development**:
  - Economic, social, and environmental. Fiscal policy affects sustainable development through its impact on growth, the environment, and human resource development.
  - This impact operates at both a macroeconomic level, and
  - … through the myriad ways in which governments’ tax and spending decisions affect incentives to work, spend, save, and invest.
- The **strengthening and reorientation of tax and spending structures** often has a central role
- This is the challenge …. doing nothing usually translates in a pro-rich bias economic growth, to avoid such bias income-earning potential should ensure that vulnerable people also share in the fruits
- Or in other words …. **It is not possible to deliver sustainable development if we are not able to associate economic growth with income distribution** …. And this requires people-centered policies.

Cape Verde :
From Poverty to a MIC … Four decades of change

Cape Verde, after its independence in 1975

- No Nation, no State, & no Human Capital
- Memories of frequent famines (1947, 30% of the pop. died);
- Only 10% of the land is suitable for agriculture ..out of 4.033 km2
- No resources, even water ….. due to low rainfall
- Limited internal market
- Zero Infrastructure
- Educational opportunities were scarce → only 2 high schools
- Per capital income was about US$190
- National treasury was zero → Had to appeal to Portugal for US$300,000
- Many (including Cabo Verdeans) did not foresee a future

In 2008 …. Cabo Verde graduates to MIC

- Per capita income increased from US$190 (1975) to US$ 3,800 (2012);
- Poverty reduced from 49% to 24%;
- Literacy among youth – 95%;
- Infrastructure development - 5th in Africa
- Cape Verde was considered among the "Top 10" FDI destinations in the world;
- Cape Verde was considered among the "Top 10" country reformers in the world;
- ICT Development index – 4th in Africa
- E-governance index – 6th in Africa

- **HOWEVER …Cape Verde STILL FACES A HIGH LEVEL OF VULNERABILITY**!

The Adoption of a PFM's Holistic Path: Treasury -> Budget Expenditures -> Budget Revenues -> Debt Management -> Deficit Financing

- The PFM reforms were delivered through four major axes:
- 1) Get control of treasury management;
- 2) Qualification of expenditures;
- 3) Consolidation of revenues,
- 4) Endogenous debt restructuring; and
- 5) Efficient deficit financing.

- But more important … policy makers need to be pragmatic and realist – avoid populist measures and have strong political will.

1st Axe: Get Control of State Treasury

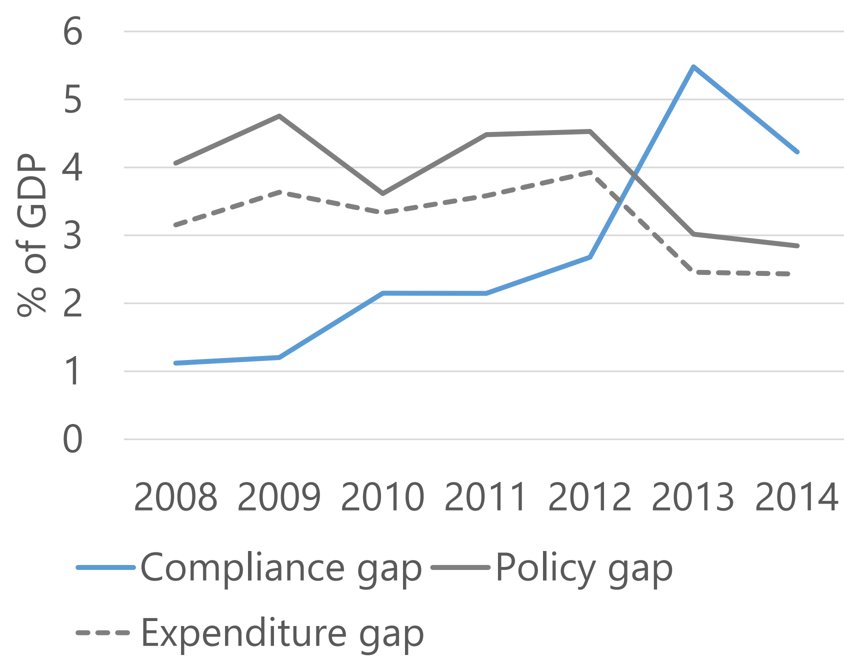
- "**Bankarization"** of State Treasury - integrated and dematerialized system of procedures for revenue collection and spending for enforcement throughout the central administration.
- Short term liquidity increase and, consequently, liquidity risk decreased significantly impacting positively on short term financing costs, quickly creating fiscal space.
- Previously, short term treasury bonds financed with treasury liquidity placed in the banking system.
- Main Goal: stop paying interest rates on "our own money".
- Low hanging fruit to compensate for the decrease in budget revenues.
- <u>Digitization played a crucial role</u>!

2nd Axe: Tackle first the expenditures side of the budget – due to higher elasticity

The Challenge: Expenditures efficiency

- Cut budget oil subsidies → align oil domestic prices with international ones - generate budget savings → fiscal space
- Rationalization of the tax incentive system (intentionally mentioned in the expenditure side). The tax incentives were completely proliferated after a more than a decade of managing them on a ad hoc and vested interest base, undermining the tax base and creating distortions in the functioning of the market.
  - Changed the logic underlying their attribution, moving from the sectoral approach to a result based management approach. Everyone, regardless of the sector, activity, can access tax benefits as long as the investment contributes to macro economic objectives: investment, job creation, production diversification, internationalization, savings, etc and consequently democratizing the access by cancelling the previous vested-interest approach.
  - Cut current expenditures (fat!) to create additional room for capital expenditures.
- Restructure of the VAT: excess credits vs refunds and the need to pay attention to tax compliance gap and tax policy gap.
  - Decrease in the policy gap was due to the policy change abolishing reduced rates, which is in line with good practices of efficient VAT legislation.
  - There are significant 'trade-offs' between policy gap and compliance gap.

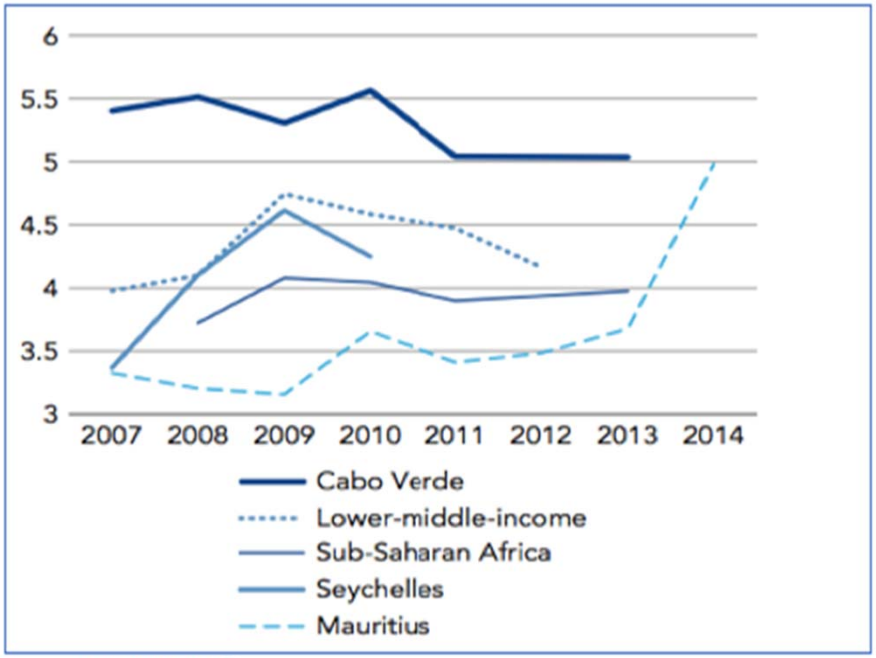
VAT Policy gap decreased to 2.8 percent of GDP in 2014



… By doing so, fiscal space was created which was used to fight monetary poverty …

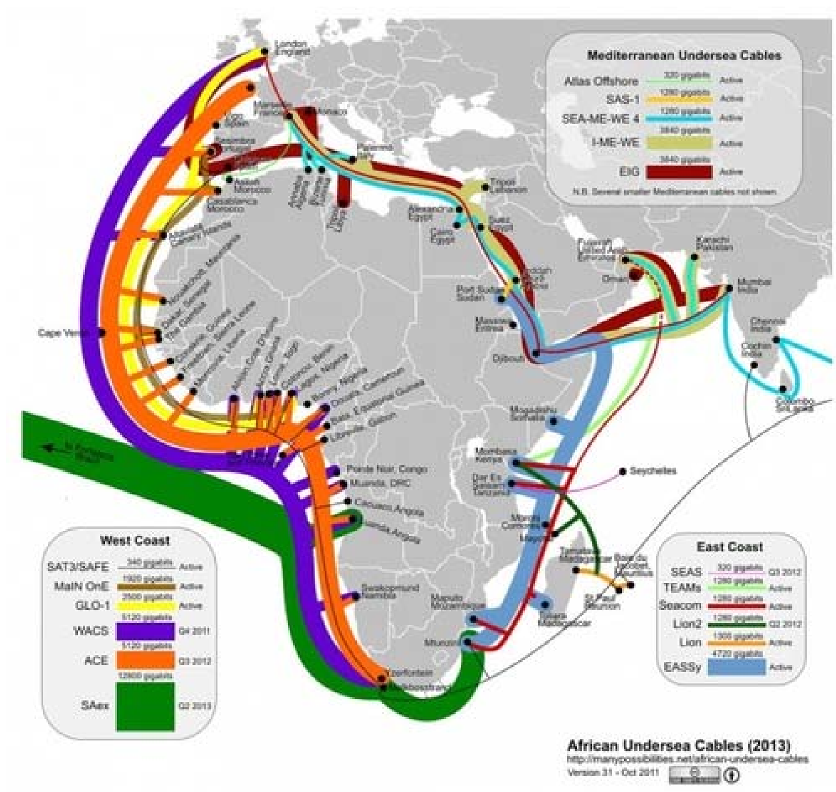
- This additional fiscal space was channeled to fight monetary and non-monetary poverty.
- Monetary poverty:
  - Increase of the social pension: 285%;
  - Enlargement and consolidation of the social protection system:
    - Non-contributive beneficiaries increased by 100%.
    - Contributive, universalization of the social protection system: a) to all public administration (central and local); b) to all family members; c) householders, small holder farmers, SMEs, etc…
- Education: scholarships; school transportation; school feeding; school kits;
- In the middle of the crisis WFP withdraws from School Feeding program: thanks to fiscal space previously created we were able to switch to 100% financed with domestic resources.

Government Expenditure on Education (% of GDP)



Source: SCD, WB, 2018[29]

… and also non-monetary poverty through a strong infrastructure program …



4 international airports

9 ports, 2 deep water (Santiago e São Vicente)

2 atlantic cables & all islands connected

Energy: 95% coverage rate

E-government : integration of the back offices

3rd Axe: Revenue Side of The Budget – lower elasticity

- **<u>Decrease corporate taxes from 35% to 25% :</u>**
  - Strengthen enterprises' fiscal competitiveness;
  - To support the private sector to cope with international crisis
  - Helped enterprises to better manage their working capital
  - For small and micro enterprises decrease from 20% to 15%

- **Decrease of income taxes from 45% to 35% (highest bracket) and from 15% to 11% (lowest bracket):**
  - To help families cope with international crises protecting their purchasing power

- **The Special Regime for Micro and Small Enterprises:**
  - Covers around 83% companies, at a single rate of 4% on turnover (replacing 5% VAT, 15% IUR, 15% INPS concerning the employer's charge) - clearly constituted a great boost to the economic dynamics in this business segment.
  - In addition, a reduction of 20 to 30% of the single special tax in the first two years for micro and small companies – an attempt to reduce the informal sector.

- **Digitization of the National Revenue Authority**

4th Axe: Endogenous debt restructuring

1st: Replace bad debt for good debt:

↓ public debt/PIB: 2005: 75,5%; 2006:70,3%; 2007:62,5%; 2008: 57.2% → mainly current expenditures

↑public debt: 2009:62,8%; 2010: 72,1%; 2011:78,5%; 2012: 85,9%; 2013: 99,2% → mainly capital expenditures (infrastructure)

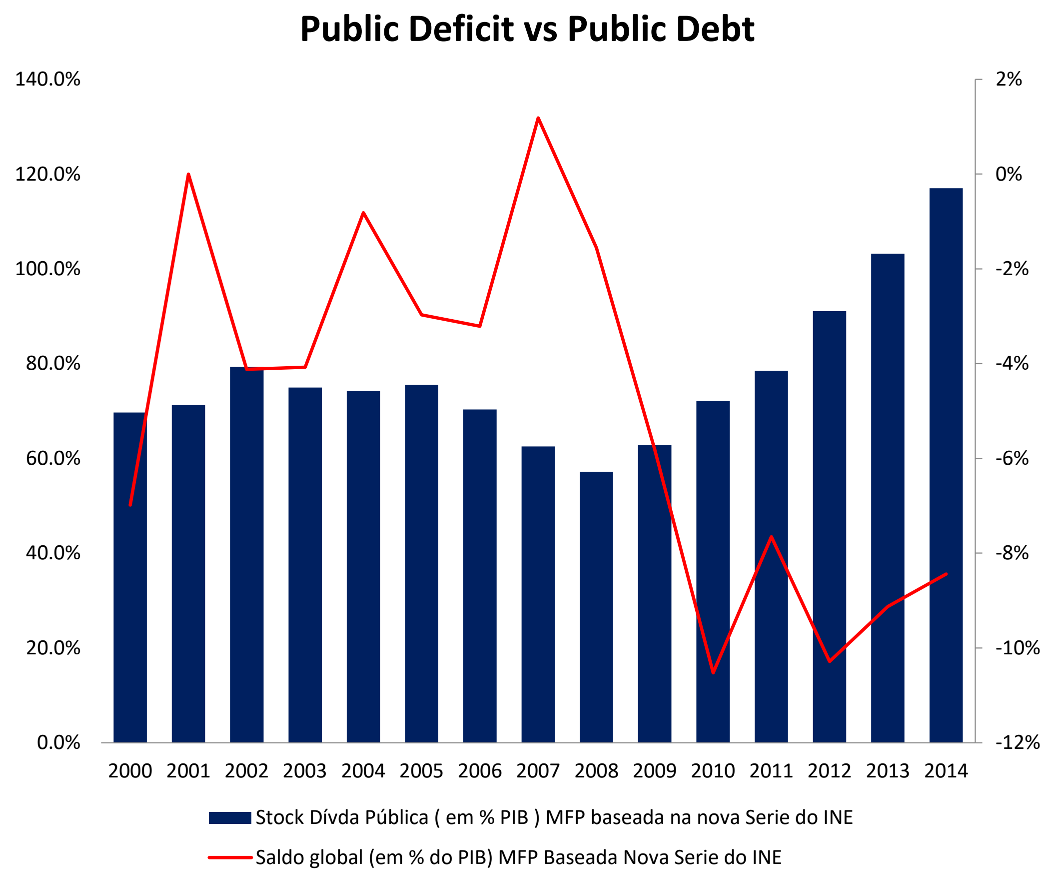
2nd: Replace domestic debt for external debt → peg with the Euro. Domestic debt decrease from 33% to 19%.

3rd: Release budget resources for investment → Revenues – Current Expenditures → current primary balance positive → release resources for pubic investment → crucial for the mobilization of external financing

Investment → Public **Deficit**: 2005: -3,0%; 2006:-3,2%; 2007:1,2%; **2008: -1,6%; 2009:-5,8%; 2010:-10,5%; 2011:-7,7%; 2012: - 9,8%; 2013:7,3%**

"Between 2005 and 2009 → very large capital inflows entered Cabo Verde causing domestic credit boom, strong asset appreciation (touristic real state) and currency appreciation ..., increase in imports of goods ..."

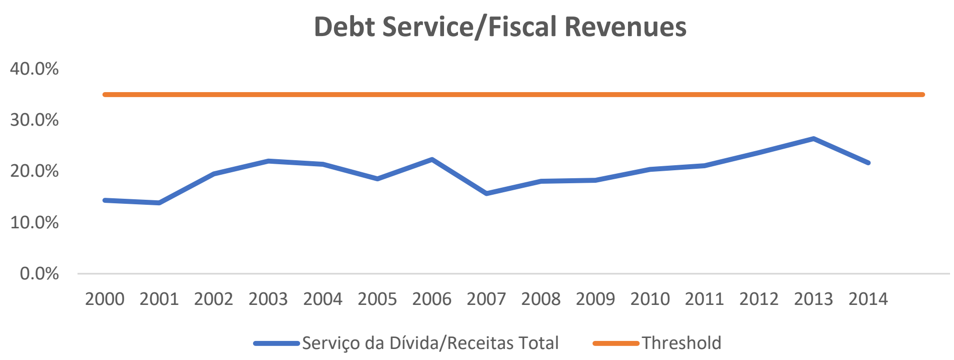
- **Window of opportunity → MIC transition period!**



5th Axe: Efficient Deficit Financing

- We strengthened infrastructures in the country, both “physical” and “institutional” … trough strong mobilization of concessional financing …
  - Average maturity was over 25 years, grace period 7 years ...
  - Average interest rate was 1.41%
  - About 95.6% of the debt is on fixed interest rate, 3.9% floating interest rate and 0.5% no interest
  - 53% of our debt was in the Euro Zone, while 17% is in SDR
  - 52% of the debt was with Multilateral partners, 23% with Bilateral partners and 24% with Commercial entities
- The structure of external debt is important: 98% to official creditors … and due to the peg with the Euro, it is mainly denominated in Euros…
- **“The sustainability of an external debt depends on the relationship between the growth of domestic income + exports earnings AND the average interest rate + maturity profile of the debt stock → foreign capital inflows should be used to expand production capacities”**

A Debt Strategy ....
High Stock (Debt/GDP) but reasonble Flows (Debt/Revenues)

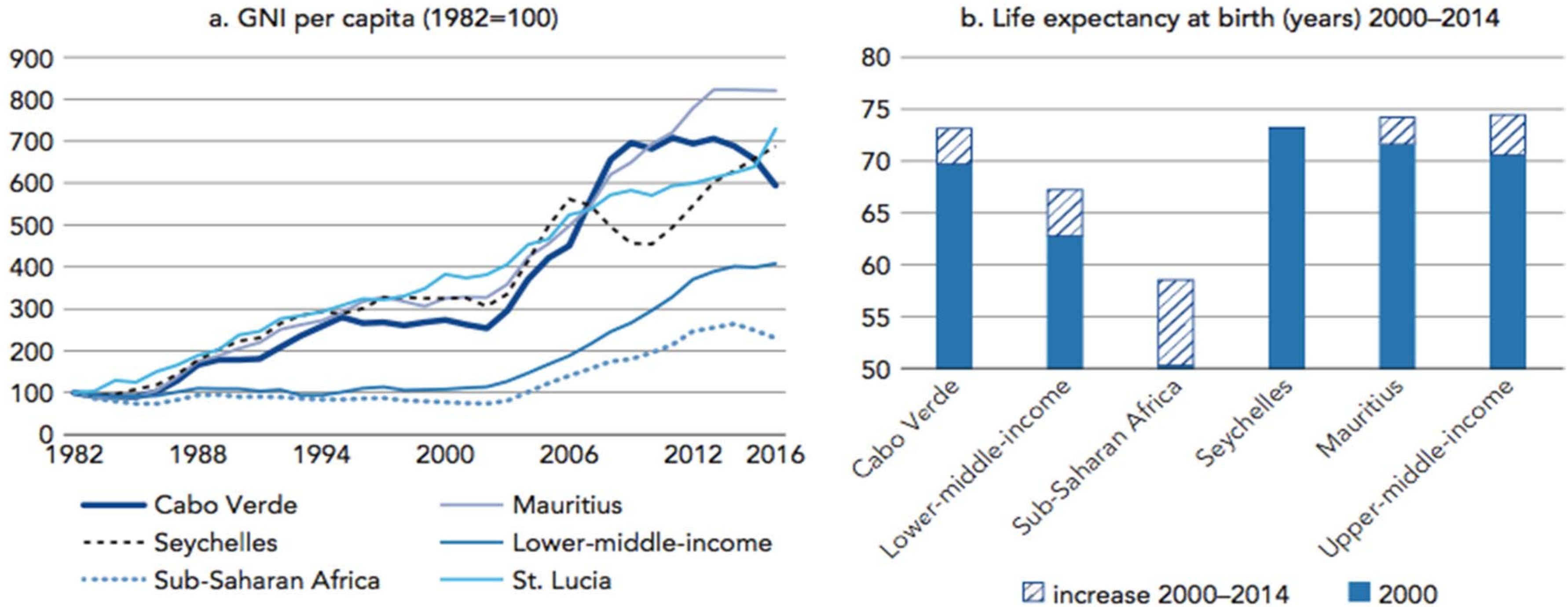


The impact on poverty reduction and inequality

- **Social achievements have been equally impressive.** The *extreme* poverty rate—based on the national food poverty line—reduced from 30 percent in 2001 to 10 percent in 2015;
- Inequality fell as the Gini index dropped from 53 in 2001 to 42 in 2015.
- Improvements along non-monetary poverty indicators were even more important, including life expectancy (see figure 1b), maternal mortality, net primary school enrollment, and access to improved water sources.
- **Social Space:** long term investment in education, health → society could accumulate social space to cope with the international crisis → poverty rate decrease from 37% in 2000 to 24% in 2007

The impact on poverty reduction and inequality

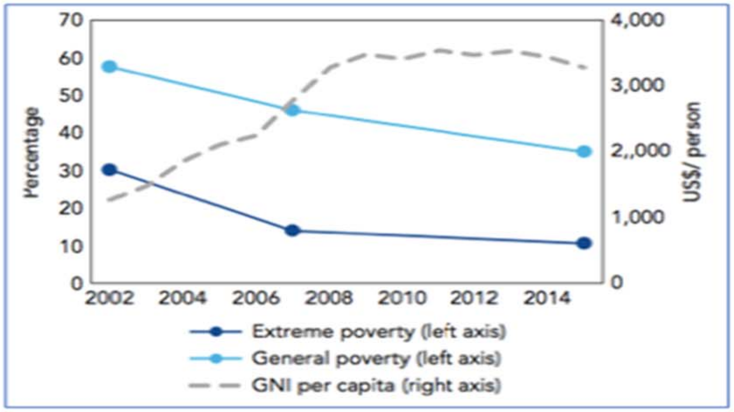
FIGURE 1. Cabo Verde has Made Remarkable Progress in Economic Growth and Human Capital Achievements



Source: World Development Indicators.
Note: 1982 is the first year for which GNI data for Cabo Verde is available.

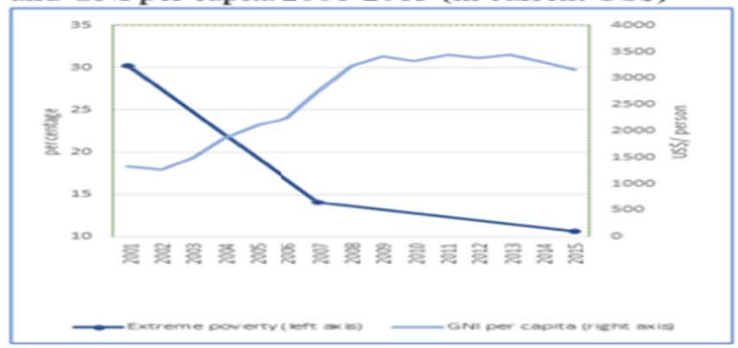
The impact on poverty reduction and inequality

Chart 2a: Poverty incidence and GNI/capita 2001–2015



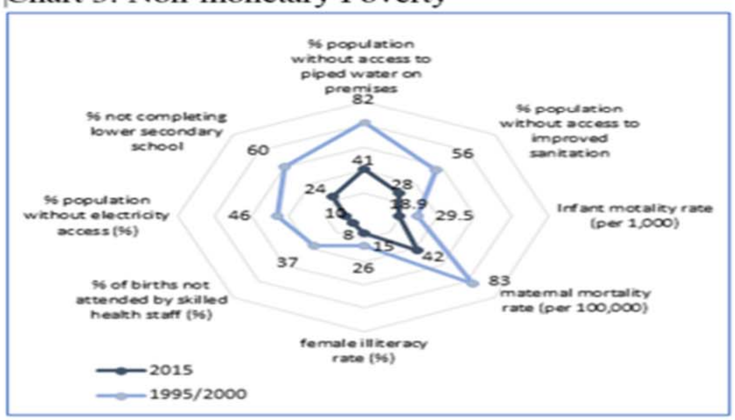
Sources: Based on IDRF 2001, QUIBB 2007, and IDRF 2015 surveys

Chart 2b: Extreme Poverty rate (at US$ 2.9 PPP) and GNI per capita 2001-2015 (in current US$)



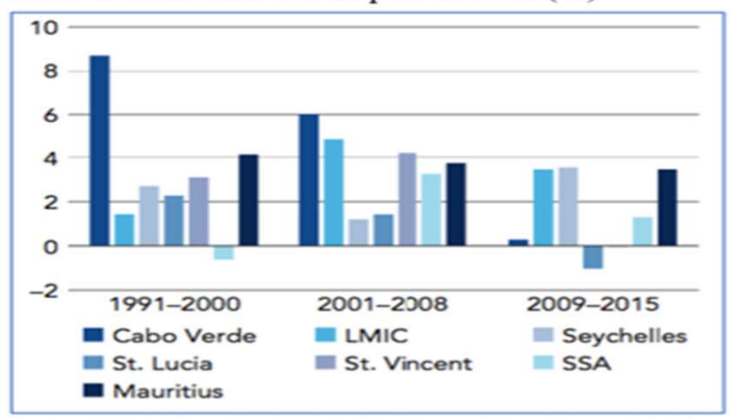
Source: National Statistics Institute (INE). Right chart - WDI

Chart 3: Non-monetary Poverty



Source: World Development Indicators

Chart 4: Real GDP Per Capita Growth (%)



Source: World Development Indicators and country authorities

Thank You